

VENTURE CAPITAL: A NEW APPROACH TO FINANCING SMALL AND MEDIUM ENTERPRISES IN DEVELOPING COUNTRIES *

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1. Introduction

The objective of this paper is to examine the need for venture capital in developing countries, and to assess the conditions required for its successful introduction¹. The paper will consider the financing of SME's, the role and limitations of capital markets and existing methods of SSE financing, and the role which venture capital might play. We will then discuss venture capital in industrialised countries, the embryo venture capital sector in the developing countries, and conclude by assessing conditions needed for venture capital to succeed in developing countries.

2. Capital Markets and SMEs

Why does the financing of SMEs deserve special treatment relative to other businesses? In financial terms, the characteristic of SMEs is that they are relatively high risk. Compared to larger businesses smaller businesses possess shallow management, often with little experience and training; they are usually undiversified, one product firms; they are sometimes new businesses, with little track record, and poor financial recording; they may have a new, unproven product, or a product new to its country; they have little to offer by way of security to a lender; they may be reluctant to raise outside equity

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1 Writers have expressed conflicting views on the suitability of venture capital in developing countries. Harper (1984, pp.60-61) wrote:

"Specialised venture capital or equity financing schemes such as have been successful in the United States, are unlikely to be appropriate for the financial needs of small scale enterprises in developing countries. It is difficult enough for an unsophisticated entrepreneur to appreciate the differences between his own investment and any loan he may have received. The distinction between short and long term financing adds a further complication. The addition of outside equity and the associated need for incorporation, shared responsibility and dividends as opposed to drawings is unlikely to be manageable".

Two years later, I made an equally broad generalisation, but with a rather more positive view of the possibilities of venture capital.

"For many developing countries we see considerable potential in the venture capital approach to SME (Small and Medium Enterprises) financing. The provision of equity, rather than loan, capital conforms to the principle that the higher the risk, the lower the debt to equity ratio should be. More important, it also enables suppliers of funds to share in the growth of successful companies which will offset the losses subsequent on financing the companies which fail" (Kitchen, 1986, p. 293).

capital for reasons of expense, loss of control and increased disclosure requirements. These risks have been fully described by, for example, Anderson (1982) and also Levitsky (1983), quoted in Little (1987).

The degree of risk, as measured by the default rate of lending programmes to small businesses in developing countries, varies considerably. Anderson (1982), for example, speaks of default rates varying from 10% to 60% or more. Little (1987) quoting Levitsky (1983) and Rangarajan (1980) concludes «when loans have been made to very small and new enterprises by development banks, the default rate has been high-often catastrophically high».

Although the subject of this paper embraces both small and medium enterprises, the problems of financing them are rather different. Medium enterprises will usually have a reasonable track record, significant fixed assets and management with some experience. Few enterprises (unless subsidiaries of larger enterprises) start off at «medium» size; most have got there by growing from small enterprises. Medium enterprises, therefore, are likely to be able to attract financing from conventional sources more readily than small enterprises. The main difference is likely to be that medium enterprises generally require new finance in larger amounts than do small enterprises. The problem of the scale of financing may be a problem, particularly with equity financing, unless access to outside equity, for example through a stock market listing, is available. As the problems of small scale enterprises are likely to be more acute, this paper is written particularly with them in mind. We will continue to speak of «SMEs» at times, but the reader should be aware that this is often a piece of convenient shorthand.

Capital markets provide debt and equity finance from external sources (as opposed to internal finance, from the sponsors or from retained earnings). Capital markets may be divided into the formal (stock markets, bank and non-bank financial institutions) and the informal (friends, relatives, money lenders, kurb markets). The latter may be of more relevance to small businesses in developing countries, especially at the start-up stage.

For purposes of exposition, I will distinguish between the perfect capital market, «natural» imperfections and government induced imperfections². The perfect capital market is competitive, possesses a wide range of instruments offering many different combina-

2 I do not use the term imperfection (or its alternative, distortion) in a perjorative sense. Indeed, many governments induced imperfections which are intended to ensure the stability and honesty of financial markets and institutions are to be welcomed.

tions of risk and expected return, has perfect knowledge and foresight and no transactions costs. Natural imperfections include monopoly or cartel elements, imperfect knowledge and foresight, significant transactions costs and significant gaps in the range of financial instruments and institutions in the market. Government induced imperfections include controls on interest rates, controls on the direction of lending (for example to specific sectors such as agriculture or SME's), taxes and reserve requirements which drive a wedge between borrowing and lending rates, taxes on dividends, subsidies to various classes of borrowers and lenders, and direct controls or regulations which limit institutional activities and developments.

Even with a perfect capital market the availability of credit for small businesses is far from assured. First, the level of the risk perceived by the putative lender may be so high that the compensating return may be too high for the project to bear comfortably, which would increase the risk of failure still further. In formal terms, an increase in the interest rate will increase the expected net present value of the loan up to an optimum point; beyond that point the expected NPV would fall. If the expected NPV at the optimum point is too low, the bank will not lend.

The capital market is imperfect and fragmented, to varying degrees, in all countries. Market imperfections may work in two ways: they may either favour small business borrowers, or discriminate against them. The general presumption is that the latter applies. However comparisons tend to be made between the ways financial institutions actually treat small businesses and larger businesses, not between the actual treatment afforded to small businesses and the treatment they would receive under perfect capital markets. *A priori*, it is not possible to judge whether natural imperfections (or distortions) tend to favour or disfavour small businesses. It is quite possible that financial institutions make loans to small businesses which they would not do if their behaviour accorded with the perfect capital market model.

A natural imperfection which does impinge significantly on SME's, though, is that of transaction cost. The costs of loan investigation and administration are not proportional to the size of the loan, and weigh more heavily on smaller loans than on larger loans. The consequence is that, in formal terms, the cost of the loan increases making the expected NPV at the optimum rate of interest too low. The cost of loan investigation can be largely eliminated if the lender requests collateral instead of examining the use of the loan. However, many smaller business, and their owners, may be unable or unwilling to provide adequate collateral.

Government-induced imperfections may encourage or discourage SME financing. Finan-

cial repression through controlled interest rates, and high bank deposit requirements with the central bank will generally lead to credit rationing and the favouring of large, well established borrowers with a good track record and valuable collateral, and therefore discriminate against smaller, younger, more innovative and, essentially, riskier businesses³. On the other hand, the direction of lending to SMEs, the creation of special (and usually subsidised) arrangements for SME financing, and the provision of subsidised loans, subsidised loan guarantee schemes and subsidised industrial estates tend to favour SMEs.

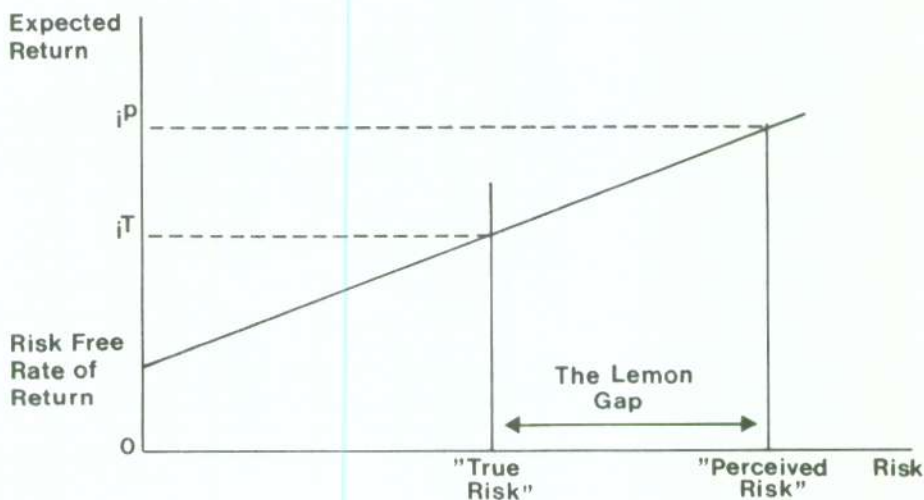


Figure 1. True Risk and Perceived Risk

3 A non-economic obstacle to SME lending lies in the risk-averse attitudes of loan officers. In generally conservative financial institutions, a loan officer is likely to perceive that his career prospects are unlikely to be enhanced by taking on a number of high risk loans. A further non-economic obstacle to SME financing is that unprofessional lending practices, such as collusion and corruption are encouraged by financial repression and credit rationing. Many authors, including Anderson and Khambata (1985), Lipton (1976), Howell (1980) and von Pischke, Adams and Donald (1983), have found that unprofessional practices lead to higher default rates, thereby increasing risk.

A systematic bias, though, may arise in SME financing because of the theory of the market for «Lemons» (Akerlof 1970)⁴. Because small businesses, especially in developing countries, are regarded as «high risk», the level of risk associated with the riskiest small business tends to be applied to all small businesses. As a consequence, bad businesses tend to drive the good out of the financial markets, as the latter have to raise equity or debt on terms which exaggerate their risk. The gap between the true risk and the perceived risk of the financial markets may be termed the «Lemon Gap». Only in cases where financiers are in a position to assess carefully the true risk of a small business can the cost of capital match the true risk; this may be the case with local money-lenders, but is seldom the case with financial institutions.

The case for subsidising conventional small business financing (whether credit schemes or venture capital) rests on the social desirability of eliminating the Lemon Gap. Subsidy would compensate for failure of the market to identify the true risk of individual investments.

The specialised venture capital fund (VCF) should itself go a considerable way towards eliminating the Lemon Gap, as VCFs depend for their success on careful assessment of risk. They therefore tend to compensate for the failure of conventional financial institutions. VCFs thereby fulfil a social function, but with high transaction costs (only 1 proposal out of 40 may be accepted, for example). Again, a case for subsidy may rest on compensation for these high costs.

Anderson and Khambata (1985) argue that in the case of debt markets, an efficient supply of finance for small industry requires the simultaneous liberalisation of the level and structure of interest rates, and the development of schemes for sharing the risks and administrative costs between the public and private sectors. They make the point that attention to one (interest rate) without the other (risk sharing in particular) is unlikely to be successful from either a financial or economic point of view. This implies that SME lending schemes should be subsidised, but Anderson and Khambata argue that this would be justified, as lending institutions would learn from experience to discriminate between potentially efficient and potentially inefficient investments: this externality, they argue, justifies the subsidy, which can eventually be phased out. The externality only accrues in the long run, though, and seems as speculative as much of the high risk lending it is intended to improve. Nonetheless, we accept their argument that the sub-

4 Akerlof (1970) is a foundation work on the market for higher risk assets. It is also worth recalling the comment of Rothschild and Stiglitz (1976): «high-risk individuals cause an externality: the low-risk individuals are worse off than they would be in the absence of high risk individuals».

sidy should not be provided through concessional interest rates, even though we would prefer to justify it on the grounds that in some sense SMEs may be more efficient and dynamic than larger enterprises.

3. Capital Structures

The key to SME (or any other business) financing is the debt/equity ratio, or more accurately, the debt/shareholders' funds ratio, as retained earnings belong to shareholders, and are a very common form of financing expansion investments. Under certain highly restrictive assumptions, Modigliani and Miller have shown that there is no optimum debt/equity ratio.⁵ However in practice, high capital gearing⁶, through the effect of fixed interest charges on fluctuating earnings, increases the risk of failure. There is, therefore, a limit to the extent to which lenders are prepared to see a debt/equity ratio rise. Given the rule of thumb that the assets in a «gone» concern will fetch only 50% of their book value, the cautious lender restricts the debt/equity ratio to 1:1. In many countries such a limit would be seen as being unduly conservative, and norms of 2:1 apply, for example in India and Indonesia, and 3:1 in the Philippines (a few years ago it was 5:1). Practice varies from country to country, depending on financing traditions, the availability of debt and equity, the perceived risk of the venture, and the ability of the entrepreneur to persuade people to put up equity or debt.

That being said, there is a ground rule we can now lay down: the higher the risk of an enterprise, the higher the proportion of equity to debt should be. If we take volatility of trading profit as a measure of risk⁷, then a company with high gearing would increase its risk of failure because of the impact of the high and regular interest payments on its cash flow. If the risk of outright failure is perceived as being considerable, then lenders will not want to provide much debt. Rather, they may be more interested in sharing in the potentially high returns (which presumably are expected in view of the high failure risk), and will prefer to participate in the form of straight equity, convertible loan stock, or debt plus an equity option on terms defined at the outset⁸. In effect, if a financial

5 The assumptions include a perfect capital market, no risk of failure and no taxation. See Archer and D'Ambrosio, eds, (1983) for the main Modigliani-Miller articles.

6 Capital gearing (U.S. leverage) is the effect that the debt to equity ratio has on a company. The higher the gearing (i.e. a high debt to equity ratio), the higher the interest payments which a company has to make.

7 The volatility of earnings over time is usually measured by the standard deviation or variance in financial theory.

8 This statement presupposes a willingness on the part of the lender to take relatively high risks. A lender who is by inclination very risk-averse will not be interested in financing small businesses anyway.

institution is faced with an equity risk, it should prefer to provide equity capital. To the extent that equity is scarce, (which it is in many developing countries), the suitable financing of small businesses is relatively more difficult than raising expansion capital for medium or large scale businesses.

4. Established Methods of SME Financing

In most countries the access of small businesses to external financing (external to the business, that is) is usually difficult. Bhatt (1978) and Nanjundan (1987) describe the general practice of financing small businesses in developing countries. Start-up capital is provided almost entirely from personal savings, with some help from friends and relatives. As firms grow and become profitable, institutional credit, mainly from commercial banks, may provide working capital finance, but trade credits are equally important. The expansion of firms (except in Africa) tends to be financed by money lenders, other informal credit markets and retained earnings. Finally, the role of institutional finance and of special credit institutions, as well as of credit guarantee schemes, becomes important in the upper ranges of small enterprises, that is, in medium sized enterprises. «The bias of financial institutions towards units of larger size reflects a natural tendency to want to lend where costs are lower and risks less» (Nanjundan 1987).

SMEs in many countries are dependent on Informal Financial Markets (IFMs) as a source of finance. Much has been written on IFMs in rural areas, where they provide predominantly small farm finance (Bottomley 1975; Wai 1957 and 1977; Miracle, Miracle and Cohen 1980; Adams 1980, Schaefer-Kehnert and Von Pischke 1986). However comparatively little has been written on urban IFMs, which are more relevant to the financial needs of SMEs. One study of India (Timberg and Aiyar 1984) brings out a major difference between operators in IFMs and formal markets: those in IFMs are much closer to their clients and potential clients, and through gossip and daily contact are much more aware of their activities than a formal banker would ever be. The important thing about these close relationships is that the IFM lenders know the risks they are exposed to. This enables them to discriminate between borrowers, and reduce the risks which they face. This in turn permits a financial market to operate by removing the imperfections of lack of knowledge which pervade formal financial markets. In many ways, informal markets conform rather more closely to the perfect market ideal than do formal markets. Although interest rates charged may appear high in informal markets, these probably only reflect the risk, and are well below the rates which would be charged

relatively small amounts of very high risk capital. The second stage is the start up, when the idea has been developed to a point when it is ready for commercial production and marketing. As the product is now known (but not its commercial potential) there is less risk involved. The third stage is expansion; by now the product has had some commercial success, and the management some experience of running the business; the risk is much reduced.

The provision of seed capital is a specialised business, and while specialists do exist, they usually need to be complemented by other activities as the volume of business (say £ 250,000 divided between 10 firms) is generally small. Seed corn funds are sometimes financed by larger, conventional venture capital funds (VCFS), who are subsequently given first refusal to take over the more promising investments when further funds are needed. The provision of seed-corn capital is highly management intensive, and the failure rate is high. On the other hand, by investing at an earlier stage than anyone else, the seed corn fund can come in cheaper and obtain higher returns if the venture succeeds.

The provision of larger amounts of capital may be undertaken by a single firm, but the syndication of the investment is increasingly common. This involves spreading the investment, and the risk, between several venture capital funds. On occasion, a fund may provide all the capital, and place some of the equity among other investors subsequently. This is known as the «bought deal».

Venture capitalists, then, look for small or start-up businesses with potential to grow beyond merely providing a lifetime income for its owners. The venture capitalist is prepared to risk his equity, but in return wants a full share of the future growth of the business, which sometimes can be spectacular. Therefore a company unwilling to admit outside shareholders would not be of interest to a venture capitalist. VCFs reckon on perhaps three investments in ten being successful (spectacularly so, they hope), three failures and four which remain steady («sleepers»). Their profits come from the successes. They will invest a second and third time to help to finance expansion of promising companies, but will tend not to invest a second time until companies have produced good growth. Essentially VCFs are expected to revolve. However, a VCF will usually be willing to provide additional injections of capital to a promising firm, as it grows and requires new funds for expansion.

Most small businesses are not suitable for venture capital financing. Wall (1986) reported that in the U.S.A., it is common practice for a VCF to screen one to two hundred proposals for each investment made.

Divestment possibilities are vital to venture capital funds. The best known way is for the target company to obtain a stock market quotation, thus giving the fund an opportunity to sell its stake. We discuss the importance of equity markets below. However, divestment by this route may be slow, both because of the time required to obtain a listing, but also because the fund can usually sell its shareholding only gradually, otherwise it risks depressing the market. An alternative, which seems to be finding increasing favour, is to arrange a management buy-out, a merger, a take-over or a placing of the fund's equity. In this way the fund can sell its share stake much more quickly. However, the divestments of venture capital funds require stock markets which offer the potential for flotation of the client company, an active over-the-counter (OTC) market, or an active acquisitions climate.

6. Venture Capital in Industrialised Countries

Space does not permit a detailed analysis of the growth of the venture capital industry in industrialised countries. However, it is possible to come to a number of conclusions which are relevant to the establishment of venture capital in developing countries.

Annex 1 shows the high variation in the importance of venture capital in industrialised countries. Only Ireland, the UK, the USA and the Netherlands have substantial amounts of venture capital available. By contrast, the ratio of venture capital/GNP in Japan and Germany is low relative to other countries.

Annex 2 shows that with the notable exception of the USA, venture capital has benefited from incentives (effectively subsidies) in most countries where it has developed significantly. In Japan and Germany, no incentives are provided. This suggests that the risk - expected return relationship in venture capital is not attractive to investors, and that incentives may generally be headed to reduce risk or increase returns.

Annex 2 shows that in many industrialised countries efforts have been made to increase share trading in smaller and younger companies, thus facilitating divestment by venture capitalists.

OECD (1986a), more specifically, gives three major reasons for the venture capital boom in the USA.

- a very favourable attitude by the public at large towards entrepreneurship, success as well as failures;
 - a very dynamic financial market illustrated by the existence of an efficient stock ex-
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change, a tradition of company shares held by the public and a competitive banking system,

- government intervention limited essentially to acting on the major framework conditions including the individual taxation system.

A recent assessment of the rapid growth of the *UK* venture capital industry (Mason 1987) gives the following explanation.

- The demonstration effect of the profitability of venture capital in the United States (e.g. the flotation of Apple Computer).
- The establishment of the Unlisted Securities Market and the Business Expansion Scheme.
- The growth in the number of management buy-outs, which has created a demand for equity finance.
- The increased involvement of merchant banks, providing venture capital to small, growing companies with a view to obtaining future fee earning work from them.
- The «bandwagon» mentality.

Analyses of venture capital in other industrialised countries may be found in OECD (1986a), Wall (1986) and the Financial Times (4/12/1987).

7. Venture Capital in Developing Countries¹¹

Only in a handful of developing countries has any progress been made in establishing venture capital companies. The easy way to establish a venture capital company is for development banks to set up independently managed specialised funds or subsidiaries, as the functions of development banks are generally very similar in principle to those of venture capital companies. However, some may prefer to take smaller, higher risk, equity investments through a specialised subsidiary rather than through the mainstream development bank activities. This route has been taken, for example, by the state-owned National Development Bank in Brazil, which has established a venture capital subsidiary, BNDESPAR.

11 Wall (1986) provides substantial descriptive material on risk capital (defined more broadly than venture capital) in Argentina, Brazil, Colombia, Greece, India, Indonesia, Kenya, Korea, Malaysia, Mexico, Philippines, Portugal, Singapore, Spain and Turkey. Not all these countries have venture capital funds yet. Several industrialised countries are also included in the survey.

Specialised, independent venture capital companies are few in developing countries, and several of those which do exist have been developed as joint ventures with the IFC since 1978, notably Sofinnova (Spain), VIBES (Philippines), Brasilpar (Brazil), IPS (Kenya), KDIC (Korea), and SEAVI (South East Asia). Although the IFC has helped with the development of these enterprises, its financial contribution has been limited, varying from 2% of the total initial capitalisation in the case of VIBES to 8% in the case of Brasilpar. OECD (1986) has details of the structure of these enterprises, but it is too early to make a full assessment of their performances. The main characteristic of these enterprises, though, is their diversity.

It should not be thought, though, that participation of the IFC is a necessary condition for the successful establishment of venture capital companies. Brazil has a number of other companies apart from those mentioned. Taiwan too has had venture capital companies for some years, the Development Bank of Malaysia has a venture capital scheme¹², and Malaysia Ventures Bhd. is a private sector VCF, set up in 1984. Korea is particularly noteworthy, with a number of companies having had their origins in the Korea Technology Advancement Corporation (KTAC) venture capital group set up to invest in high-tech fields in 1974. KTAC was set up to commercialise R and D results from the Korea Advanced Institutes for Science and Technology, (UNIDO 1987). The Korean Technology Development Corporation, the private sector Korea Development Investment Corporation and the Korea Technology Finance Corporation also provide venture capital. The Asian Development Bank has made direct equity investments in the latter two (ADFIAP 1987), and the Deutsche Entwicklungs Gesellschaft in KDIC. Venture capital is developing in India, also. All the countries mentioned, significantly, have active stock markets.

Taiwan has attracted a number of foreign venture capital firms as well as local ones since the initiation in 1983 of policies to encourage venture capital growth. The government sees venture capital investment as a means of encouraging the growth of a high-tech industry, thereby upgrading its industrial structure from reliance on traditional and labour intensive manufacturing. It has invested in venture capital funds through the development banks. However, progress to date has been slow, with a reluctance among

¹² The Development Bank of Malaysia (Bank Pembangunan Malaysia) set up a Venture Capital Loan Scheme in 1981 which provides «financial assistance in the form of soft loan, equity loan and equity participation to a project with the objective to get the project on, which in terms of quantum and evaluation criteria transcend normal banking risk». (Salim bin Dato Osman, n.d.)

Taiwan's entrepreneurs to take on board outside, and expensive equity. Moreover, the requirement that they should invest only in high-tech firms has made venture capitalists cautious. One interesting aspect has been the export of venture capital to small U.S. businesses, with a view to attracting them to invest in Taiwan when they want to expand. In this way, the funds hope to bring new technology to Taiwan¹³.

A significant aspect of venture financing in developing countries is the paucity of funds set up by development banks. These institutions do on occasion make equity investments, but they can hardly be considered to be entrepreneurial, venturesome, institutions. India is a notable exception, as numerous state-owned DFI's provide venture capital, even seed capital. But Wall (1986) noted that some schemes have performed disappointing, partly because of poor investment appraisal and lack of entrepreneurial spirit among technicians and managers. Islamic development banks, too, with their preference for providing equity rather than debt, also provide exceptions, as does the Development Bank of Malaysia, which is something of a special case. The Industrial Finance Corporation of Thailand (IFCT), acts as a venture capital organisation, with investments in some 40 manufacturing enterprises. IFCT is now considering whether to set up a special unit within the organisation to deal with venture capital, or whether to set up an entirely separate entity. Either way, it envisages stepping up its appraisal capacity to 300 projects per year. However, these cases seem to be among the few development banks with serious involvement in venture capital.

Commercial Banks have been active in setting up VCFs. In Argentina, the S.A. Inversiones de Capital de Riesgo was set up in late 1986 by a leading bank, insurance company and two large diversified industrial holding companies. In 1986, Philippines had 16 VCF's all «closely affiliated to commercial banks» (Wall 1986). In India, Grindlays Bank has a VCF, and in Spain the Bank of Bilbao is a partner alongside IFC in SEFINNOVA.

While a venture capital sector may be desirable, it may be difficult to stimulate it. We take the view that governments and government owned institutions are generally not a suitable base for venture capital funds although there may be exceptions. Civil servants and government employees are unlikely to possess the entrepreneurship, flexibility and managerial skills needed in a venture capital firm. This view is shared by Miller and Cote (1985) who state that government sponsored venture capital funds «have a dismal record in first round financing».

13 See Far Eastern Economic Review, 5 November 1987, for further details.

But while direct public sector involvement may not be desirable, governments have a crucial role to play in creating the right commercial, financial and social environment for venture capital to be successful. Here we return to the discussion of capital markets in the first part of the paper. In terms of finance, perhaps the most important thing government can do is reduce financial market imperfections, both government-induced and «natural» imperfections. Ideally, venture capital firms should be able to survive in financial markets on «level playing fields». Should a government feel that special encouragement should be given for the financing of SMEs, (in our analogy that venture capital firms should be allowed to play downhill), then it may provide incentives.

More specifically, OECD (1986) identifies three areas where government action may be required. There are, in ascending order of difficulty, tax policy, divestment avenues and attitudes towards risk. «In a general sense, governments and societies should not discourage an investor's ability to profit and accumulate wealth». (p. 32) We believe that care and skill is needed in developing tax incentives. What works in one country may not work in another. In particular, tax incentives may not be effective if the marginal tax rates are low. The question of avenues of divestment is important, and we take it up in our discussion of securities markets, below.

Few developing countries provide specific incentives to VCFs. This is in marked contrast to industrialised countries where incentives are frequently encountered. Moreover, several developing countries discriminate against VCFs, as their tax laws favour debt rather than equity. This applies, for example, where there is double taxation of dividends, or where there is no indexation of capital gains for tax purposes. Both these factors have been identified by Wall (1986) as acting as disincentives in Colombia, which has no VCFs. Brazil, on the other hand, provides tax concessions on both dividends and capital gains for venture capital investment, and Korea gives exemption from capital gains tax. In India, a third country where venture capital is well developed, the legislative and tax framework for VCFs is apparently unclear.

By far the most difficult environment to create is one of risk taking. Risk averse individuals will not be attracted to high risk/high expected return investments, whether physical or portfolio in nature. High risk taking investors are generally ambitious, or hungry, or gamblers, with perhaps a touch of all three. The attitudes are societal, and not ones which governments can develop by decree. Exhortation, and tax policies which give incentives may help, but do not guarantee the right attitudes.

8. Equity Markets

Equity markets provide important vehicles for divestment by VCFs, and their development is therefore important for the development of venture capital. We should note, through, that the share price falls of 1988 exposed the vulnerability of equity based methods of financing to stock market movements. Alternative methods of divestment, such as mergers, acquisitions, private placements and management buy-outs may become increasingly popular.

In recent years equity markets have assisted the financing of SMEs in a number of ways. First, the development of second and third tier markets have allowed SMEs, including even some start-ups, direct access to funds. The expansion of over-the-counter (OTC) markets, notably the NASDAQ (National Association of Security Dealers' Automated Quotations) market in the United States has performed the same function. Secondly, venture capital funds hope to realise their capital gains by floating their client companies on stock markets (and, in some cases, by direct sale to other companies). Third, venture capital companies sometimes issue their own shares on stock markets, and use this route as a means to raise capital for investment. In the U.K. and France a number of venture capital firms have gone public, in some cases at an early stage in their life. Fourth, novel methods of attracting direct investment by individuals in SMEs, such as the UK's Business Expansion Scheme, are underpinned by equity markets, especially second and third tier markets, because investors have a strong interest in being able to realise their investments after 5 years. A market quotation affords an important method of realisation for individual investors.

Second and third markets. In many countries the main stock markets have entry requirements of size of share issue and length and consistency of track record (such as 5 years profitability) which cut out flotation by many SMEs. Therefore to enable such firms to raise equity capital, the U.K., Japan, Netherlands, France and Denmark have introduced second tier markets, in which the entry requirements are much less demanding, and less costly. On the USM and the Second Marche only 10% of the share capital of a company need be sold, as against 25% on the main market. In Holland issues on the second market must be for a minimum of DFI 250,000, one tenth of the requirement of the main market. The first of these markets, the U.K.'s Unlisted Securities Market (USM), established in 1980, can now be judged to be a substantial success. The rules are sufficiently flexible to admit even start-ups, and well over 500 companies have obtained USM listings, with some 75 moving up to a full listing. The Second Marche, which

started in 1983, had attracted some 230 listings by the end of 1987.

UK experience was that most businesses which obtained a USM listing were at the larger end of the SME scale, most having a market capitalisation in excess of £1 million. This led the stock exchange to introduce a Third Market, starting in January 1987, for smaller companies, and with even easier listing requirements than required by the USM¹⁴. Third Market companies can, under certain circumstances, qualify for BES relief, whereas USM companies cannot. It is as yet too early to judge the effectiveness of the Third Market, but it has certainly not been a failure, even though it may not have fulfilled the more optimistic forecasts of the number of listings. About 30 companies were listed in 1987. It is of interest to note that the stock exchange established the Third Market as a direct competitor to the OTC market, which has not been a success in the U.K. We will turn to the OTC markets below.

Over The Counter (OTC) Markets. By far the largest OTC market in the world is the NASDAQ market in the U.S.A. The number of companies traded is greater than on the New York Stock Exchange. Undoubtedly the availability of NASDAQ has been an important facility for venture capital companies.

Elsewhere, OTC markets have not always been so successful. In the UK, it is small (about 230 companies traded), and operated by a number of licensed dealers in securities. Its reputation has been tarnished by the dubious promotions and activities of some of the market makers, and the Stock Exchange is endeavouring to replace it with the Third Market, so far with limited success. The Swedish OTC market, introduced in 1982, appears much more successful. Since then, 70 SMEs have been listed on the OTC market, and many others have applied; the capital raised by SMEs is about SKr 900 million (OECD 1986a).

Singapore established a new OTC second tier market in January 1987, known as the Stock Exchange of Singapore Dealing and Automated Quotation System (SESDAQ). It provides a market for young, growing companies to raise equity capital when they do not meet the minimum qualifications for a main Stock Exchange of Singapore listing. SESDAQ has based its listing requirements broadly on the UK's USM, and its trading arrangements on the USA's NASDAQ, with trading by telephone on the basis of prices

14 For third market listings, there is no minimum proportion of equity which has to be in public hands; companies need only a one year track record, as opposed to (normally) three years on the USM; there is no specific obligation to publish half-year figures; and listing requirements are less onerous and therefore less expensive, than on the USM. (Market for Gamblers, Investors Chronicle 23 January 1987).

displayed on computer screens by competing market makers, similar also to London's Stock Exchange Automatic Quotations, SEAQ. To obtain a listing on SESDAQ, companies must have a paid up capital of S \$3 million (US\$ 1.5 million), and must offer at least 15% of the issued share capital to the public. Although it is an OTC market in terms of trading practice, it is strictly regulated by the Stock Exchange of Singapore. (Dinyar bin Framjee, 1987).

The unfortunate events in the Kuwait OTC market in 1982 should serve as a salutary reminder that trading on unregulated markets can get out of hand. So far, it seems, this sort of excess has been avoided in Saudi Arabia's OTC market, but *prima facie* the case for bringing share trading into a more formal regulatory framework seems strong.

Securities Markets in Developing Countries. Should developing countries governments encourage securities trading? In an earlier work (Kitchen 1986) I have analysed the advantages and disadvantages¹⁵, and much of the available evidence. Without going over the same ground again, my conclusion is still the same, that I am substantially in favour of encouraging stock markets in developing countries, within a sound regulatory framework. Considerable detail of the operations of securities markets in several developing countries is given in van Agtmael (1984).

Of more importance to this study is the use of securities markets for SME financing. It is natural that organised stock exchanges should attract listings from the larger enterprises; indeed it is doubtful if stock exchanges *should* encourages SME listings until the regulators and investors have acquired several years experience of trading in the stocks of major companies. It would be unwise of the authorities to rush into the establish-

15 Briefly, the advantages of stock markets are:

- they provide firms a means of raising finance, both through primary issues and subsequent secondary issues (e.g. rights);
- they provide governments with an alternative way of issuing bonds and raising capital;
- they provide savers and investors an alternative market for their funds;
- they provide a spectrum of risks and returns;
- they provide a vehicle for indigenisation and privatisation of firms;
- they provide a means of attracting foreign portfolio investment.

The disadvantages are:

- they may increase the unequal distribution of wealth to an undesirable extent;
- they may encourage speculation which can be destabilising;
- they may provide a vehicle for dishonest activity such as market rigging;
- because of the distorted nature of some developing economies, efficient financial markets can lead to a misallocation of resources;
- inefficiency in the markets can nullify many of the advantages.

ment of second or third tier markets which are designed for smaller, riskier businesses. If things did not go well, such stocks could easily give a stock market a bad name before the market became well established. Nonetheless, the provision of organised markets for smaller companies should be seen as a long term aim of a stock exchange. To date, Nigeria is the only developing country with a second tier market, although the idea has also been discussed in India.

In the meantime, this leaves an OTC market as the only possibility in many countries. As we have seen already, OTC markets, taking a global view, have a mixed record. The objective, then, must be to try to capture the good points while excluding the bad. It seems that this can best be achieved by government approval and regulation of the market makers, and setting minimum qualifications for companies whose stocks are to be traded. Rules on disclosure of information and reporting should also be established. The Singapore SESDAQ may be worth examining in some detail, although it is very computer-intensive.

In many developing countries, development banks are the best placed organisations to operate an OTC market. Indeed they are often seen as the main alternative to an organised stock exchange. However, conflict of interest can arise when the development banks take shareholdings in client (or other) companies. Therefore what appears to be the current practice in Saudi Arabia, that commercial banks (as well as brokers) are permitted to sell stocks, providing an informal OTC market, but are forbidden to buy and sell stocks for their own portfolios¹⁶ has much to recommend it. In spite of practice in most of the major stock markets of combining the functions of jobber and broker into market makers, we prefer in principle to keep the functions separate to avoid conflict of interest. This is particularly important in countries where regulators may be inexperienced or weak. In small markets, or in stocks in which trading is thin, this may restrict the level of activity, and may lead to trading on a «matched bargain» basis, but this is preferable to the risk of ruining the reputation of a market through undesirable practices, which will lead to distrust, and avoidance of share buying by all but the cowboys and the gullible.

The encouragement of unit trusts and investment trusts (we prefer the latter)¹⁷, with

16. The Middle East, May 1985.

17. Investment trusts are generally more transparent than unit trusts. Managers of the latter have all sorts of opportunities of abuse open to them, which act to the detriment of the unit holders. On the other hand, quoted investment trusts need a set of regulations to limit gearing and «pyramiding», which gave them such a bad reputation in the Wall Street crash of 1929. Venture capital companies, incidentally, are really a form of investment trust, but play an active part in the direction of their client companies. They are not usually subject to investment trust regulations.

approval to investment a proportion of their portfolios in the shares of unquoted companies, can also help SME financing. Shares in investment trusts or units in unit trusts may be particularly convenient instruments for islamic banks to offer in return for deposits.

The existence of a well run securities market may encourage international flows of venture capital. Because of the need of venture capitalists to be in close contact with their client companies, the most likely vehicle for international spread is for a venture capital company in, say, the USA or the UK to set up a subsidiary (wholly owned or joint venture) in a dealer's country¹⁸. The existence of a securities market would offer prospects for offering shares in client companies for sale, and even for a sale of shares in the local venture capital firm.

The trend in recent years towards large-scale international share trading has squeezed out small, regional stock exchanges within countries. In the U.K., all the regional stock exchanges had historically provided opportunities for medium sized, local businesses to obtain a stock market listing without the trouble and expense of a London Stock Exchange listing. However in 1972 all the U.K. stock exchanges were merged into The Stock Exchange, and regionalism almost disappeared. The USA and Canada still have regional stock exchanges, as do some third world countries such as India and Nigeria, but improved communications tends to be a unifying force. Perhaps there is still room for regional stock markets, just as there is an evident need for second and third tier markets.

9. Conclusions

It is important to recognise two types of measures to improve small business financing: those which tend to reduce capital market imperfections and those which tend to discriminate positively towards SME's. While improving the efficiency, competitiveness and foresight of capital markets is in itself a worthwhile aim, measures which discriminate positively towards SME's need to be justified on the grounds that SMEs deserve special encouragement. It is beyond the scope of this paper to go into this question, but a full

18 International diversification by VCF's has to date been limited, as managers appear to prefer to stay in the market they know. However, some U.S. companies have set up subsidiaries in the U.K. and Europe, and two firms with U.K. stock market listings (Biotechnology Investment Trust and Newmarket) have shifted their registered offices to the Bahamas, as they have considerable investments in the USA (and elsewhere).

list of the reasons for favouring small industry is given in Nanjundan (1987). Little (1987) concludes more precisely:

«To summarise, the prima facie case for policy interventions in favour of SSEs as a means of raising overall welfare in developing economies must rest on evidence that small units on average use factor inputs more productively than their larger counterparts, so that a shift of resources in favour of smaller units would yield a net increase in output as well as an increase in the demand for unskilled labour.»

The first lesson — from theoretical discussions — is that SMEs require a sound equity base to provide financial stability. This may be provided by the owners, or acquired gradually through retained earnings. However, outside equity is often needed, as owner's resources may be small, opening the door for VCFs. On the other hand, outside equity financing requires that owners of SMEs should be willing to accept it.

The provision of outside equity from the formal sector requires a set of financial institutions or mechanisms which is willing to provide equity. However, the provision of equity means taking rather more risk than does the provision of debt, and equity based financing requires individuals and institutions who are willing to take the higher risk for a higher expected (but not assured) return. The VCF is ideally suited to play this role.

The second lesson is that the providers of venture capital appear to need incentives (See Annex 2). As the OECD (1986a) remarked, «The Governments of almost all OECD countries supply some form of finance of financial assistance which would be used as a source of venture capital» (p.39). It is likely that the same applies to developing countries.¹⁹

Thirdly, it seems that an «enterprise culture» is needed to stimulate the supply of, and demand for, venture capital. The rapid growth in venture capital in the UK in the 1980s can be seen as being a response to the encouragement of enterprise, combined with generous tax incentives.

Fourth, avenues for divestment are important. This would appear to limit VCFs to the more advanced developing countries, with active equity markets. However, within these

¹⁹ It is arguable that the provision of equity, by taking risk, fulfils an important economic function which the provision of secured debt does not. Therefore the risk taking capitalist, despised in the traditional socialist lore, is performing a much more valuable function than the lending bank which obtains its reward for much less risk, in that it is a preferred, and usually secured, supplier of finance. This may justify the subsidy in the form of a tax concession.

countries, it seems that VCFs can play an important role in SME financing, and should be encouraged. VCFs should also find a niche in those islamic countries which prefer equity to debt financing.

Finally, Development Banks have good opportunities to develop venture capital, either within their present framework or by setting up specialised subsidies. They should be encouraged to provide more equity capital.

Annex 1

VENTURE CAPITAL POOLS

| Country | Number of Venture Capital Firms | Venture Capital Pool (ECU billion) ¹ | Venture Capital Pool/GNP ² (UK = 100) |
|--------------|---------------------------------------|--|--|
| USA | 530 | 21.2 | 49 |
| UK | 120 | 5.7 | 100 |
| Japan | 80 | 3.0 | 14 |
| France | 90 | 1.3 | 16 |
| Canada | 45 | 1.0 | 28 |
| Netherlands | 60 | 0.9 | 46 |
| West Germany | 30 | 0.6 | 9 |
| Ireland | 8 | 0.6 | 259 |
| Italy | 15 | 0.3 | 5 |
| Belgium | 10 | 0.2 | 16 |
| Spain | 27 | 0.2 | 10 |
| Sweden | 30 | 0.2 | 14 |
| Denmark | 19 | 0.2 | 3 |
| Switzerland | 15 | 0.1 | 6 |
| Austria | 3 | 0.02 | 0.1 |

1. The pool is the total sum raised by venture capital funds, accumulated over the years.

2. Based on end 1986 GNP and exchange rates.

Sources: (1) Venture Economics, quoted in the Financial Times supplement 'Venture Capital', 4 December 1987.

(2) Author's estimates.

Annex 2

INCENTIVES TO VCF's IN CERTAIN COUNTRIES

| Country | Incentives | Capital Market Attractions |
|--------------|---|-----------------------------------|
| USA | Financing through Government R & D expenditure | NASDAQ |
| UK | BES tax incentives to individuals | USM/Third Market |
| Japan | None | Second tier market; OTC market |
| France | Tax concessions to start-up companies and to investors in registered VCCs. | Second Marche |
| Canada | Guarantees to investors in risky enterprises | None |
| Netherlands | Tax concessions on dividends and capital gains | Parallel (second tier) market |
| | Government regional finance; guarantee scheme. Tax exemption on dividends from PPMs. | None |
| West Germany | None | USM (linked to UK) |
| Ireland | State financing. BES type scheme. | None |
| Italy | Tax concessions under consideration | None |
| Spain | Capital Gains Tax concessions | None |
| Denmark | None | SME division of stock market |
| Sweden | State financing | OTC market for SMEs |
| Switzerland | None | None |
| Austria | Similar to U.K. | None |
| Australia | 100% tax allowance on investments in licensed Management and In- vestment Companies (VCCs) | Second board markets |

The Governments of almost all OECD countries supply some form of finance or financial assistance which would be used as a source of venture capital (OECD, 1986a, p. 39).

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Abstract

To date, venture capital has been largely a financial mechanism of the western world, notably the U.S.A. and the U.K. This paper argues that it has considerable potential for financing small and medium enterprises (SMEs) in developing countries, where equity capital tends to be scarce, and where the (perceived) high risk of SMEs indicates that relatively low debt-equity ratios are required.

The paper reviews briefly the development of the venture capital industry in industrialised countries, and finds that, with the notable exception of the USA, venture capital has usually received some form of government incentive. In economic terms, this may be justified by the social desirability of closing the gap between the perceived risk and the true risk of SMEs.

A review of developing country experience suggests that venture capital is restricted to a handful of newly industrialising countries, all of which have active securities markets. Such exit routes are important. Other necessary conditions are likely to be the provision of incentives to venture capitalists, and the creation of an «enterprise culture» which encourages risk taking and profit making. Finally, venture capital is likely to be suitable for islamic cultures where debt financing is discouraged on religious grounds.

LE CAPITAL À RISQUE: UNE NOUVELLE APPROCHE POUR LE FINANCEMENT DES PETITES ET MOYENNES ENTREPRISES DANS LES PAYS EN VOIE DE DÉVELOPPEMENT

RÉSUMÉ

Jusqu'à présent, le capital à risque a été largement utilisé seulement dans le monde occidental et surtout aux Etats-Unis et au Royaume-Uni. Cet article suggère que cette forme de financement peut être très utile pour les petites et moyennes entreprises dans les pays en voie de développement où les fonds propres sont insuffisants et le degré élevé de risque des petites et moyennes entreprises montre la nécessité d'un faible rapport entre dette et capital social.

L'article analyse brièvement les développements du capital à risque dans les pays industrialisés en montrant que, si l'on exclue les Etats-Unis, le capital à risque a toujours reçu des subventions de la part des pouvoirs publics. Du point de vue social, cette politique peut être justifiée pour réduire ou annuler la différence entre le risque réel et le risque apparent des petites et moyennes entreprises.

L'analyse s'est ensuite adressée à l'expérience récente des pays en voie de développement. Seulement dans un petit nombre des pays de nouvelle industrialisation (P.N.I.) le capital à risque a pu se développer au même temps que des efficients marchés obligataires. Toutes les deux formes de financement sont importantes. Pour encourager le recours au capital à risque, il faut octroyer des subventions aux participants et créer une "culture d'entreprise" qui favorise le risque et la création des profits. Enfin, le capital à risque peut trouver un terrain favorable dans les pays islamiques qui, à cause des croyances religieuses, préfèrent ne pas recourir aux prêts à intérêt pour le financement des entreprises.

Book reviews

Revue bibliographique

Secchi Carlo, «L'Italia ed il commercio internazionale dei servizi», F. Angeli, Milano, 1988, pp. 286, Lit. 28.000.

Ces dernières années le secteur des services a été au centre de l'attention des économistes pour différentes raisons.

D'une part le poids de ce secteur a encore augmenté au niveau soit national (dans les pays industrialisés et du Tiers Monde). Pour cette raison dans le contexte des négociations tarifaires du G.A.T.T. (l'ainsi-dit Uruguay Round) le secteur des services a été classé et considéré à part. D'autre part, à cause de son importance croissante, l'attention de la littérature économique la plus récente a été concentrée sur la nature et la spécificité du secteur des services dans le contexte de la théorie du commerce international.

Aussi la C.E.E. a prêté une attention croissante aux problèmes liés à la croissance du secteur des services pour deux raisons: d'abord pour rendre homogène la position de la Communauté vis-à-vis des négociations G.A.T.T. et ensuite pour se rendre compte des effets de la création du marché unique européen à la fin 1992. En effet, à cette date on devrait aboutir à la libre circulation à l'intérieur de la C.E.E. des services, déjà souhaitée par les articles 56 et 62 du Traité de Rome, qui devrait avoir des effets prévisibles sur la situation actuelle.

Donc, on peut conclure que le secteur des services joue un rôle important dans le processus de développement économique. Toutefois nos connaissances sur le phénomène sont encore trop limitées qu'il s'agisse des données empiriques ou bien des recherches sur le plan théorique.

Ce livre analysé est le fruit des travaux d'un groupe de chercheurs travaillant avec C. Secchi et rassemble les recherches de trois années dans le contexte du projet C.N.R. (Conseil national des recherches): "Structure et évolution de l'économie italienne". Son but est de combler, au moins en partie, l'insuffisance des recherches dans le secteur des services: l'intérêt est centré plus particulièrement sur le phénomène de l'internationalisation des services avec un regard particulier sur la situation de l'Italie et sur les choix qu'elle doit envisager. Ces choix doivent tenir compte de l'évolution structurale du système productif comme des changements des politiques commerciales qui sont en train de se manifester au niveau international.

Les chapitres de la première partie du livre sont dédiés aux différentes définitions des services qui ont été proposées par la littérature économique, à la classification des obstacles au commerce international des services, à la justification de ces mesures restrictives et aux données statistiques concernant le flux international des services, leur composition et leur évolution dans le temps. Sous certains aspects la dernière partie du livre est la plus intéressante car elle concerne directement l'Italie: elle est dédiée totalement à l'analyse de la position de notre pays dans le commerce international des services utilisant aussi des techniques économétriques.

En conclusion on peut affirmer que l'ouvrage analysé présente un intérêt réel car il permet de clarifier des points importants concernant un phénomène pas suffisamment étudié surtout dans notre pays. Cette recherche ne doit pas être considérée seulement comme un point d'arrivée; elle peut constituer un point de départ d'efforts de recherche ultérieurs en ce qui concerne les faiblesses et les points forts des différents pays européens relativement à l'échéance de 1992. On pourra alors tirer des suggestions importantes quant à la distribution des futurs bénéfices dérivants de la réalisation de l'intégration européenne dans le secteur des services.

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Alessandro Pio (a cura di), «**Europa-America Latina: nuove forme di cooperazione**», Edizioni Unicopli, Milano, 1988, pp. 223, Lit. 22.000.

La faible importance des rapports économiques entre l'Europe et l'Amérique Latine peut être considérée comme une des occasions perdues pour favoriser une plus importante insertion de la Communauté dans le contexte international.

On peut surtout confier à l'Europe le rôle stratégique de médiation entre les conflits, parfois violents, entre les systèmes industriels et les pays en voie de développement. Il ne faut donc pas seulement considérer les rapports entre l'Europe et les pays industrialisés mais élargir le rôle du "vieux continent" au niveau mondial.

Si on veut dessiner les directions souhaitables de la coopération économique entre l'Europe et l'Amérique Latine, il ne faut pas s'arrêter seulement au financement public des programmes de développement. Il faut au contraire élargir l'analyse à toutes les formes de coopération économique telles que le commerce, les investissements directs, les transferts technologiques où l'importance du secteur privé est fondamentale et où les deux partenaires participent activement et avec des résultats positifs réciproques dans l'immédiat comme dans le futur.

De cet esprit s'inspire l'ouvrage analysé. Dans la première partie on examine les rapports économiques actuels entre l'Europe (et en particulier l'Italie) et l'Amérique Latine pour ensuite en dessiner les perspectives d'évolution à la suite de l'adhésion de l'Espagne et du Portugal à la C.E.E. Cet élargissement de la Communauté peut d'une part conduire à une plus forte intégration à cause des liens économiques et culturels entre les pays considérés et l'Amérique Latine mais peut d'autre part accroître la concurrence entre Espagne-Portugal et les pays latino-américains en ce qui concerne l'accès aux capitaux et aux marchés communautaires.

Dans la deuxième partie, trois formes de coopération économique (investissements directs, trading companies, engineering societies) sont examinées en détail. Ces trois formes de coopération ont enregistré ces dernières années une importance croissante. L'analyse de ces trois formes, dernière étape des politiques de coopération, a demandé un effort de synthèse entre la théorie économique et l'étude de cas au niveau des entreprises concernées (un intérêt particulier a été consacré aux entreprises italiennes agissant en Amérique Latine). De cette façon on a pu mettre en lumière en même temps les effets positifs et les difficultés pour développer les formes nouvelles de coopération.

Cet ouvrage représente un instrument utile pour la compréhension de quelques caractéristiques plus récentes de la coopération internationale. En même temps, il peut être considéré comme un point de départ intéressant pour développer des relations nouvelles entre la Communauté Economique Européenne et l'Amérique Latine.

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