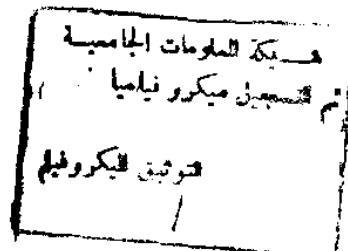


CAIRO UNIVERSITY
FACULTY OF ECONOMICS & POLITICAL SCIENCE
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**SHARE VALUATION TECHNIQUES IN EMERGING
STOCK MARKETS**

**M.A DISSERTATION SUBMITTED TO THE FACULTY OF
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INTRODUCTION

The recent massive interest in investing in emerging markets has been primarily caused, by the high returns generated in these markets and their low correlation with the developed markets.

In the mid eighties, there were 31 emerging stock markets in operation, mostly concentrated in South Asia and Latin America, with total market capitalization of \$171,263 million. The number of listed domestic companies reached a total of 8,916 companies in all emerging markets at the time. By the end of 1995, total operating emerging stock markets reached 59, with total market capitalization of \$1,895,709 million, and 19,397 listed domestic companies.¹

The capital inflows to emerging stock markets are considered an important source of external finance for developing countries. These inflows have taken several forms: direct equity purchases by investors in stock markets, issues of rights on equities in the form of depository receipts held by foreign depository institutions in the form of global depository receipts (GDR) or American depository receipts (ADR).

The World Bank's assessment of the financial sector performance of developing countries relies heavily on its evaluation of the stock market development of that country. Structural adjustment loans offered to aspiring developing countries often contain conditions related to the stock market development. The rationale behind such policy is that stock markets have a significant role in mobilizing and allocating domestic savings. Moreover, because of the continuous valuation of share prices and the possibility of takeovers, stock markets can impose discipline on companies and lead to a more efficient allocation of capital.

The availability of a reliable share valuation technique in an emerging stock market will be a major factor in determining the rate of capital inflows to that market. Despite the fact that the share valuation models applied in emerging and developed stock markets are the same, the immature nature of emerging markets, resulting in a very poor database system, insider trading and the lack of transparency and surveillance systems, makes the valuation process less accurate in emerging markets.

The aim of this study

The aim of this research is to explore the share valuation techniques in emerging markets, and demonstrates the application of the most appropriate of these techniques. A major consideration throughout the study is that the valuation models applied in emerging markets are the same as in developed markets. However, the main difference lies in applying these models. This difference is related to the nature of the market being emerging or mature, and the prevailing policies, regulations and procedures.

¹ Emerging Stock Markets Fact book, 1996- International Finance Corporation.

Contents of the study

The research is descriptive and analytical. The first chapter, which deals with stock markets, and their relationship to their economies, with especial emphasis on emerging stock markets, relies on surveying some of the relevant literature on the subject, together with some concluding remarks.

Chapter two explores three of the acknowledged techniques of share valuation in any stock market, and explains how the application of these techniques may differ in emerging stock markets.

Chapter three demonstrates the application of the most appropriate technique of share valuation for the company selected in the Egyptian stock market.

CHAPTER ONE: STOCK EXCHANGE MARKETS

Introduction

Different studies have emphasized the relationship between the effectiveness of an economy's financial markets and its level of real development. This is primarily because financial markets provide liquidity, promote the acquisition and dissemination of information, and permit agents to increase specialization. A further explanation behind this relationship is that the most productive capital investments will often require that large amounts of funds be committed for long periods, with investors facing relatively long time to payoff. However, investors are unlikely to commit funds to such investments in the absence of well functioning financial markets that can provide them with liquidity.

World financial markets in recent years have been characterized by trends towards increased integration and liberalization. Financial markets nowadays show a much higher degree of integration, with large amounts of capital flowing across borders to take advantage of the perceived higher return or diversification benefit. Gross capital outflows from the main industrial countries reached about \$850 billion in 1993, compared with an average of about \$500 billion during 1985-90¹. Much of this outflow has been in the form of easily tradable securities (bonds, equities, and other negotiable instruments).

Driven by improved domestic policies and increased economic growth, developing countries have shared in these trends. Total equity flows to developing countries were \$13.2 billion in 1993, quadruple that of three years earlier.²

In this chapter we present an overview of stock markets, and their relevance to economic development. Section (1.1) examines the term "stock market", explaining its functions in the economy. Section (1.2) presents the different forms of stock markets. Chapter (1.3) discusses the relationship between stock markets' existence and economic development, highlighting their advantages and disadvantages to economic growth. Section (1.4) of this chapter addresses emerging stock markets, their characteristics, attractions and risks.

1.1. Functions of stock exchange markets

The financial market, in its broadest sense, includes any form of commitment into which savings may flow. It includes not only stocks and bonds issued by private companies, governments and public authorities, but also demand deposits in banks, money, and government bonds³. As such, it is responsible for the temporary surplus funds of various types of economic units seeking employment for short periods, and the satisfaction of short term needs for funds. It includes all short-term loans made by banks, finance companies, suppliers' facilities and other types of lenders. The sources supplying funds in these markets include individual savers, commercial and other banks, finance companies, insurance companies and local governments. Demand for short-term funds come from the government, security brokers, households, business concerns and banks.

On the other hand, financial markets serve as the medium through which funds are channeled for investment in stocks, bonds, mortgage loans and other types of long term securities. Among the suppliers actively seeking finance in these markets are governments, corporate

¹ The World Debts, The World Bank, 1996, p.4

² Ibid, 1996, p. 10.

³ Adams, (1989), p.111

businesses, and governmental units. On the demand side, entities seeking return on their investments are individuals, life insurance companies, mutual funds companies, commercial and merchant banks.

The term 'Stock markets' (or 'securities markets') is used to denote the markets for those financial instruments/claims/obligations that are commonly and readily transferable by sale, namely, shares, bonds, etc., issued by companies as well as bonds, bills, and stocks issued by governments and public authorities. 'Securities' is used as the generic term for the various forms of financial instruments in the stock market. The stock market is, therefore, a narrower concept than capital market, which embraces all forms of borrowing and lending, (including mortgages for example).¹

Stock markets play a vital role in the financial development of countries. The basic functions of stock markets can be summarized in the following:²

1. Raising capital for public sector economic units as well as private sector units. In an economy where there is a private ownership of companies (manufacturers, traders or services), and where governmental units borrow funds for public improvements, a need exists for a service specializing in marketing new security issues to willing lenders. Stock markets have always been a mean by which investors seeking finance can approach lenders (fund holders) to finance their projects, whether for start up projects or expansions. At the same time stock markets can provide the same service to the public sector, upon wishing to raise funds from residents for new investments or privatizing the already existing economic units.
2. Trading of securities through buying and selling. Stock markets have always been the first resort for market participants seeking liquidation of their securities. The ease with which a small investor can sell a security is an important factor when investment decision is made. Unless a security can be resold readily, the investor will be reluctant to effect the purchase in the first place.
3. Regulations. The stock markets have always acted as the benchmark for dealing and transacting in the market through certain guidelines. The involvement of a higher authority in regulating the performance of the stock markets projects a sense of security to all types of dealers in the market. Regulations include ceilings for charges and commissions, as well as rules for implementing transactions.
4. Another important function of stock markets is financial product innovation. Security exchanges and investment bankers are continually developing new products to meet the objectives of investors. Prior to 1973 the principal securities were common and preferred stocks and various types of coupon-bearing government, corporate and municipal bonds. Today investors can choose from a large variety of instruments: stocks, bonds, financial futures, option and warrant (Sears and Trennepohl, 1993).

In general, the major function of stock exchange markets is to efficiently allocate financial resources from ultimate savers to ultimate borrowers. In this function, it has to gain the trust of the market participants that not only will the primary, but also the secondary markets operate efficiently. This can be achieved through stock markets reflecting the fair price of the listed shares using all information available on the company. Accordingly, any attempt by speculators to deviate the share price from its intrinsic value will be immediately corrected by the stock market forces.

In other words, with the notion that the price of a common stock is a function of the level of a company's earnings, dividends declared, business risks, the cost of funds, and the future growth rate, stock markets act as the indicator of the company's value.

¹ Badger, Torgerson, & Guthmann, (1964), p.16

² Rose, 1978, pp.400-403

Finally, investors will be reluctant to trade in securities in the stock markets unless they are confident that the market accurately prices the traded shares.

In operating to achieve their functions, stock markets have always required some elements to facilitate its existence. These are the motives for individual savings, opportunities for investment, and the existence of social institutions favorable to investments.¹

In an environment that encourages capital markets, motives for individual savings should be available all the times. These motives will help individuals to accept the presence of capital markets as an absorbent of their savings, and at the same time a medium for liquidating their investment when required. Among the reasons people feel a desire to save are:

- Provisions for emergencies, where people like to save for the "rainy day" when these funds are mostly needed.
- Desire for ownership of a business, which basically reflects individual desire of independence and financial opportunities associated with owning a business. This will lead individuals to save not just for the initial start up investment cost, but for potential expansion of the business in the future.
- Savings for meeting substantial life expenditures, such as vacations, children education, or purchase of large items.
- Provision for retirement. This has been a major factor affecting the supply of savings, which actually reflects people's desire for future security guaranteed through the stream of income provided after retirement.
- Desire for the security of investment income, which is likely to be stronger as the individual's income passes the point where it obtains for him what he regards as necessities of life.

In addition to the motives for savings and the ability to save, there must be a demand for formal savings before investment markets can arise and social institutions can be created to encourage individuals to save. The investment opportunities should be profitable, or at least promising, otherwise savings will take specific channels than others, meaning that investors might prefer keeping their savings in cash forms maintained at their end.

While the institutions of investment could exist on a limited scale without capitalism, as in the government loans of the pre-capitalistic era, these institutions owe their present magnitude and importance to the technological development of a capitalistic society that uses a great variety of durable goods in production. For example, discoveries of new products through large expenditure for research by industry and the increasing use of equipment in every phase of business foster the demand from business firms for investment funds.²

The final condition essential to the creation of capital markets is the existence of favoring political and economic institutions. Some of these are:

- Stable government and legal safeguards, for before investors are willing to invest their funds, they need assurance that a stable government will protect their contractual and property rights so that they may enjoy the fruits of their investment. An unstable government, with the severe uncertainty associated with its policies, will definitely discourage accumulation of savings and their use.
- A reasonably stable currency. Some investments take the form of debts payable in currency of the country. Domestic inflation can destroy much of the real value, or purchasing power, of these debt claims. Moreover, deflation can be equally disastrous by shrinking the nominal value of inventories, plants, and real estate.

¹ Reilly, 1982, pp.192-207

² Badger, Torgerson, & Guthmann, (1961), pp.22-27

- Financial institutions to aid saving. As investment becomes more widespread, financial institutions that are designed to gather savings and direct them to productive employment, grow in importance. The largest of these institutions are the commercial banks, the insurance companies, the mutual funds companies, and the investment banks. Most of these institutions serve as intermediaries in bringing lenders and borrowers together.

1.2. The different forms of stock exchange markets

In studying the world stock markets, historical and cultural differences explain most of the significant differences in stock trading practices around the world. Apart from legal structure, numerous other differences are found in the operations of different types of stock markets. Understanding the specific operations and mechanics of the stock market requires an understanding of the overall organization of the market. This understanding will provide insight into the purpose of the different segments of the stock market and their interrelationships. The principal distinction between markets is based on the following:¹

1. Based on the type of issue; whether the issued shares are a new issue of a company or the government, or already outstanding and traded in the market: markets are classified to *Primary markets*, and *Secondary markets*.
2. Based on the regulations applied on the market: markets are classified to *organized markets* (the *Listed security market*), and *unorganized markets* (the *Over The counter Market*, *The Third Market* and *The Fourth Market*).

1.A Primary Market

The primary security market is the market in which new issues of shares or bonds are sold by various economic units to acquire capital. These economic units include private corporate entities, the government, and public sector corporates. On the demand side parties willing to purchase these securities are individuals, mutual funds, investment banks, and corporate businesses. The important factor in this definition is that the proceeds of the issued securities go to the issuing economic unit as new capital.

Because these economic units, seeking new capital, are not in the business of trading or issuing securities on regular basis, they usually employ another party to handle the registration, sale and distribution of securities in the primary market.

This party is the investment bank. The latter gives advice to the issuing unit on the general characteristics of the issue, its pricing, and the timing of the offer, and in some cases the investment bank acts as an underwriter, thus transferring the risk of the sale from the issuer to the investment bank.

In emerging markets, with a large number of privatization issues and the presence of large numbers of economic units joining the stock market for the first time, the primary market takes an especially important role in these markets.

1.B Secondary Market

Once securities have been publicly sold for the first time, they are traded in the secondary market. In this case, the proceeds from the sale in the secondary market do not go to the issuer but to the current owner of the security.

The importance of the secondary market is realized in the fact that the ability to convert a security into cash is heavily dependent upon the secondary market. The primary market would be seriously hampered in its function of helping the economic units to acquire new capital without the liquidity provided by the secondary market.²

¹ P. J. Drake, 1980, pp.59-60

² Brigham and Gapenski, 1985, p.12

markets and economic growth, it was explained that Bagehot (1873) and Hicks (1969) view the liquid financial markets as playing a critical role in the industrialization in England by facilitating the mobilization of capital on massive scale. Goldsmith (1969) argues that when a country grows faster than normal, the ratio of the financial system's assets to GDP also tends to experience above average growth. In contrast, Robert Lucas (1988) asserts that economists overstress the role of the financial factors in economic growth. Also, Nicolas Stern's (1989) review of development economics ignored the financial system in discussing the factors enhancing the economic development process.

The linkage between the functioning of the stock markets, as part of a well functioning financial system, and economic growth has been recently a critical issue in the economic literature. This aspect was very important for researchers and policy makers because it meant that in many countries stock market reform should be high on the reform agenda. However, the benefits of stock markets have to be balanced against certain costs incurred for developing the financial system in these countries.

The following section presents the different views introduced in some of the World Bank researcher papers about the importance of the mentioned relationship.

The studies favoring a positive relationship between the financial system and economic development has basically focused on the efficiency of the financial system as reflected in liquidity, capital allocation, and risk diversification. On the other hand, studies against the positive role of the financial system in the economic growth have inclined to focus on the impact of stock markets on savings patterns in the economy.

1.3.1 A positive relationship between stock markets and economic development

- Early observations by Gurley (1955), Shaw (1960) have looked in the relationship from the view of the changes that occur in the financial system as countries develop.

They concluded that as economies develop, self financed capital investment first gives way to bank debt finance and later to the emergence of equity markets as an additional instrument for raising external funds. They also indicated that moving from poorer to richer economies, commercial banks and nonbank financial institutions grow in importance, while the role of the central bank diminishes. Furthermore, the financial system allocates more credit to the private sector as a share of GDP in richer countries; and richer countries tend to have larger financial system and stock markets as percentages of GDP than poorer countries.¹ Figure 1 demonstrates how the financial structure of economies varies with their income.

The figure indicates that economic development is highly correlated with the development and efficient functioning of the financial system (including banks, private non banks, stock markets, insurance companies and pension funds). The correlation exists because as shown in the figure,

at low levels of development commercial banks are the dominant financial institutions. As economies develop and grow, saving and investment rates increase, thus, the need for specialization grows, allowing for efficient allocation of capital, risk diversification, and facilitating information flows. Accordingly, specialized financial intermediaries and stock markets develop and prosper.

- The link between liquidity and economic development has been a major concern in the studies of the finance-growth relationship. Many studies have emphasized that the positive relationship between the presence of stock markets and the higher economic growth rates relies heavily on the liquid nature of stock markets.

John Hicks (1969) indicated that stock market improvements that mitigated liquidity risk were primary causes of the industrial revolution in England. According to Hicks, the products manufactured during the first decades of the industrial revolution had been invented much

¹ Sofinak , The World Bank, Nov.1993 p.103-105

earlier. Thus, technological innovation did not spark sustained growth. Many of these existing inventions, however, required large injections and long-run commitments of capital. The critical new ingredient that ignited growth in the 18th century in England was stock market liquidity. With liquid stock markets, savers can hold liquid assets, such as stocks and bonds that they can quickly and easily sell if they seek access to their savings. Simultaneously, stock markets transform these liquid financial instruments into long-term investments in illiquid production processes. Because the industrial revolution required large commitments of capital for long periods, the industrial revolution may not have occurred without this liquid transformation.¹

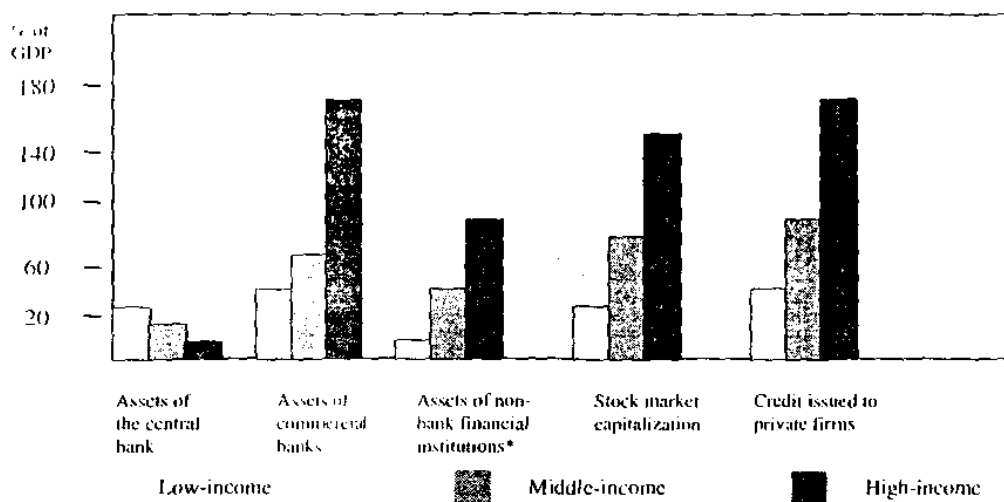


Figure 1 Financial structure in Low, Middle, High-Income Economies (1990)

Note: The data are for eleven low-income economies (Bangladesh, Egypt, Guyana, India, Indonesia, Kenya, Nigeria, Pakistan, Zaire, Zambia, and Zimbabwe), twenty two middle-income economies (Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, the Dominican Republic, El Salvador, Greece, Guatemala, Jamaica, the Republic of Korea, Malaysia, Mexico, Paraguay, the Philippines, Taiwan, Thailand, Tunisia, Turkey, Uruguay, and Venezuela) and fourteen high-income economies (Australia, Canada, Denmark, Finland, France, Germany, Italy, Japan, the Netherlands, Singapore, Spain, Sweden, the United Kingdom, and the United States).

In 1990, low-income economies had an average GDP per capita of \$490; middle-income economies \$2,740; and high-income economies \$20,457.

* Non-bank financial institutions include insurance companies, pension funds, mutual funds, brokerage houses, and investment banks.

Source: The World Bank Economic Report, November 1993

Levine (1991) emphasized the same argument by explaining that stock markets may affect economic activity through the creation of liquidity. The presence of liquid equity markets make investment less risky and more attractive because they allow savers to acquire equity with the ability to sell it quickly. Levine explained that a fraction of savers receive "shocks" after choosing between two investments: an illiquid, high return project and a liquid low return project. Those receiving shocks might want access to their savings before the illiquid project produces. This risk creates incentives in investing in the liquid low return projects.

In the presence of liquid stock markets, savers receiving "shocks" can sell their equity claims on the profits of the illiquid project to others. Market participants do not verify whether other agents received shocks or not, they simply trade in *impersonal* stock markets. Thus, with liquid stock markets, equity holders can readily sell their shares, while firms have permanent access to the capital invested by the initial shareholders.²

¹ Bencivenga, Smith and Starr, The World Bank, May 1995, pp.8-13

² Levine, The World Bank, October 1996, pp.11-15

1.3.2 A negative relationship between stock markets and economic development

The role of stock markets in economic growth has been highly questioned in some studies. These studies are basically based on questioning the effects of stock markets' liquidity on different aspects of the economy, such as savings and investments rates, attraction and allocation of funds, and information acquisition.

-Mayer (1988) explained that increased liquidity of stock markets could be a burden to economic growth, at least through three channels:

1- Liquidity of stock markets increases the returns on investments. This can reduce savings rates through income and substitution effects; for savers receiving higher returns on investments will probably direct a larger part of their income to a new consumption patterns. If saving rates fall enough and if there is an externality attached to capital accumulation, then active stock markets could slow economic growth.¹

2- Stock markets tend to decrease the uncertainty associated with investments, which may reduce saving rates due to the double-edged effect of uncertainty on savings. While less uncertainty makes an investment more attractive to risk averse agents, less uncertainty also lowers demand for precautionary savings. Thus the ultimate effect of lower uncertainty on saving rates, produced by greater stock market liquidity, is uncertain.

3- Stock market liquidity may adversely affect corporate governance. Liquid stock market may encourage myopia, because it makes it easier for dissatisfied investors to sell their equities. Accordingly, this might weaken investors' commitment and reduce investors' incentives to exert corporate control by overseeing managers and monitoring companies' performance, which will eventually lead to retarding economic growth.²

Stiglitz (1985,1994) argued that developed stock markets quickly reveal information about companies through price changes. This quick public revelation reduces incentives for investors to expend lots of resources in obtaining information about companies' performance and potentials, because investors can get the information simply by observing prices.³

Besides, Kyle (1984) mentioned that excessive euphoria and optimism can result in high volatility in stock markets, and as evident in 1929 and 1987, might lead to an inevitable crash. Figure 2 shows that emerging stock markets in developing countries can strongly suffer from high volatility as measured by the percentage change in the local market indices.

Gooptu (1993) and Turner (1991) criticized the role of stock markets that offers extraordinary returns, thus attracting tremendous foreign capital flows, which might lead to general macroeconomic instability. For many of the developing countries that receive foreign capital inflow, and equity flows in particular, investigations were raised on whether these flows are volatile and potentially destabilizing to financial markets and the economy.

This argument has been raised with the increase in the level of capital inflows directed to developing countries during the last ten years emphasizing on the importance of equity flows as a major component. Table 1 shows the portfolio flows to developing countries during the period 1989-93.

The conventional wisdom is that short-term flows to developing countries are inherently unstable, usually referred to as "Hot Money". Many developing countries have actively tried to discourage short-term flows or encourage longer-term flows. Claessens, Dooley & Warner used data for five developing countries and five industrial countries, and showed that there are no significant differences between the time series properties of short-term flows and long term flows.

¹ Price, 1994, pp.6-21

² Dooley and Warner, The World Bank, May 1995, p.40

³ Kunt & Levine, The World Bank Economic Review, May 1996, p.203

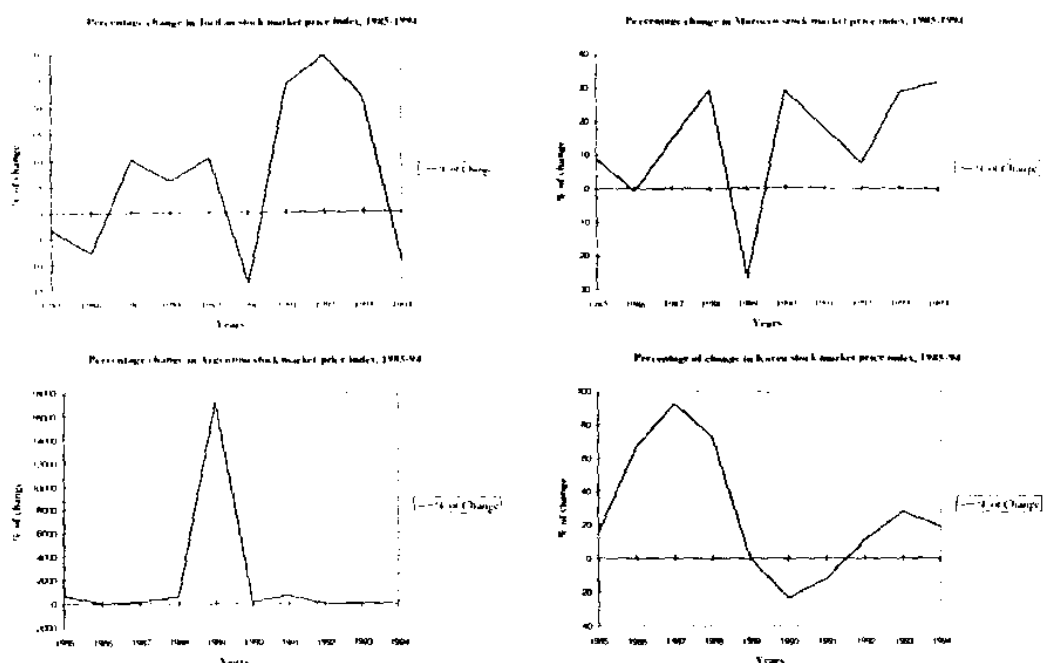


Figure 2 Percentage Change In Some Developing Stock Markets Price Indices

Source: Emerging Stock Markets Factbook 1995 - International Finance Corporation

Table 1 Annual Private Capital Net Flows, All Developing Countries

Net Flow	1978-81	1982-89	1990	1991	1992	1993	1990-93
<i>Long Term</i>							
Billions of \$	53.5	34.6	44.5	57.6	99.0	157.7	89.7
% to GNP	2.7	1.2	1.1	1.4	2.4	3.7	2.2
<i>Short Term</i>							
Billions of \$	22.6	5.4	13.1	23.4	28.9	33.7	24.7
% to GNP	1.1	1.2	0.3	0.6	0.7	0.8	0.6
<i>Total</i>							
Billions of \$	76.1	40.0	57.6	81.0	127.8	191.2	114.4
% to GNP	3.8	1.4	1.4	2.0	3.1	4.5	2.8

Source: The World Debts, The World Bank, 1996

They also showed that because there is so much substitution between the various flows, only an analysis of the aggregate capital account is meaningful. This implies that any capital control program or other policy aimed at discouraging a particular type of flow may be ineffectual.¹

On the other hand, equity portfolio flows can benefit developing countries by diversifying the sources of external finance, increasing the risk bearing by investors, reducing the cost of capital, improving incentives for managing the investment process, assisting in the development of domestic capital markets, and enhancing the mobilization of domestic resources. However, the motivating force, for effective results from these flows, is the

¹ Kunt & Levine, The World Bank Economic Review, May 1996, p.144