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SOME ASPECTS OF THE FINANCING OF INDUSTRIALIZATION IN DEVELOPING COUNTRIES

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We regret that some of the pages in the microfiche copy of this report may not be up to the proper legibility standards, even though the best possible copy was used for preparing the master fiche.

1. In developing countries - whose economies often have an agrarian bias - there has been a marked tendency during the past decade to look to increased production as a means of attaining a higher level of prosperity. Efforts have been directed towards neutralizing the one-sided reliance on agricultural production, and this accounts for the growing interest in industrialization.

2. This urge towards industrialization is one for which due allowance will have to be made by the developed countries, where the view is sometimes put forward that, since conditions in the developing countries (climate, soil) are generally favourable for agricultural production, it is precisely that type of production on which they should concentrate. Industrialization can, of course, only lead to the desired goal if it is based on planning.

3. The authorities responsible for planning industrialization will have to take a great many points into consideration, including:

(a) Which industries should be given priority?

(b) Which areas within the national boundaries should preferably be earmarked for industrialization?

(c) Within what period will it be possible for certain plans to come to fruition?

(d) By whom will the projects be carried out (public or private sector)? Are there in the country itself sufficient entrepreneurs, i.e. persons able to take the necessary initiatives and to provide the leadership to make those initiatives successful? Are foreign entrepreneurs to be admitted?

(e) Assuming that manpower is available in sufficient numbers, what steps must be taken to provide the right training?

(f) From what sources can be found the financing for industrialisation?

(g) What measures is the central Government able and willing to take to encourage entrepreneurs and financiers?

On these last two points particularly, some observations will follow:

4. Let us assume that in a developing country an industrialisation plan has been

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drawn up; that is, concrete objectives have been formulated concerning:

(a) The industries meriting priority;

(b) The areas (places) eminently suitable for the establishment of industry;

(c) A time-table indicating what objectives ought to be attainable within specific periods.

We will also assume that the authorities have decided:

(d) To bring in private enterprise and to encourage entrepreneurs, both at home and abroad;

(e) To adjust the educational programme to the needs of the industrialization plan;

(f) To admit foreign capital;

(g) To create a favourable climate of investment, i.e., to take measures specially designed to attract entrepreneurs and financiers from other (developed) countries.

5. The co-operation of these financiers will be indispensable for the realization of major projects - essential to the development of a country or of a particular region, because the developing countries themselves usually have neither the technical and managerial know-how nor the capital to tackle such projects.

6. On their part, entrepreneurs and financiers in developed countries will, in principle, be prepared to consider whether they can co-operate in establishing an enterprise in a developing country, provided that not only are the commercial prospects favourable, but in addition, the Government gives evidence of a positive attitude towards the establishment of foreign businesses, financed with foreign capital and towards the prerequisites for such investments.

7. Such a positive attitude may be reflected, inter alia, in:

(a) Taking measures to safeguard monetary stability;

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(b) Adoption of a flexible attitude towards the transfer abroad of interest, payments on foreign loans, distributions of profit, management fees, royalties, and savings of foreign experts;

(c) Granting tax facilities (e.g., exemption from import duties on plant and equipment, exemption from income tax for the first few years, and exemption from taxation at source on interest due on loans from abroad);

(d) Flexibile policy on the degree of control that may be exercised by non-residents in newly formed companies;

(e) Flexible policy on admission of foreign experts for new enterprises and the issuance of operating permits and the like;

(f) Carrying out infrastructural works needed for industrialization;

(g) Making arrangements to enable foreign lenders to secure their loans.

8. It is not only with a veiw to attracting entrepreneurs from outside that it is important to create a favourable climate, but also in order to maintain the interest in the developing country of the foreign entrepreneurs already operating there so that they do not reduce or withdraw their investments, a very real possibility if they find themselves compelled, on commercial grounds, to reduce or terminate their activities. But if, despite such an unfavourable turn of events for them, they still have confidence in the country and its future, they may perhaps be prepared to use the funds released by the liquidation of their original operations for investment in some other activity (redeployment). This is dealt with in greater detail in a separate paper.

9. It is perhaps appropriate to mention at this point that the matter of guaranteeing investments against political risks, important though it undoubtedly is, will not be gone into in the present paper.

10. Let us now assume that a foreign enterprise has decided, after extensive studies, to take part in establishing a venture in a developing country, not only by making know-how and management available but also by helping to finance it. On the basis of experience, it will determine the most desirable financial set-up for the venture; that is, in what proportions permanent capital (share capital) and longterm and short-term outside capital will be required.

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11. It will not be able or willing, in our hypothesis, to finance the venture entirely from its own resources, but will confine itself to participating in the share capital, usually preferring a majority interest in order to insure control; the remaining funds will be drawn from other sources. The founding enterprise now will have to consider whether it is desirable and possible to raise these other funds in the developing country itself or whether it will (have to) import them from abroad.

12. It would appear desirable that at least part of the share capital should be in local hands. This will to some extent insure that the new enterprise has native roots in the country, while it will enable the foreign founders to have ready and permanent access to indispensable knowledge of local conditions that they themselves lack.

13. It is questionable, however, whether sufficient local savings will be available for investment. There are valid reasons for doubt, since savings in developing countries are, on the whole, modest owing to the relatively low level of incomes; the local capital market will be modest, having regard to the foregoing; readiness to invest in (unknown) industrial activities scarcely exists as yet. It must at once be added, however, that the idea of letting small savers have a direct participation in the share capital of new enterprises is not one that can be commended whole-heartedly, certainly as long as those enterprises have not yet proved their viability. In short, it will be no easy task to attract private (local) savin s for direct investment, nor will other enterprises in the country of establishment, which in many cases already will be thrown back on self-financing for their own operations, be able to release substantial sums (internal savings) for this purpose.

14. There then remains whether the central Government can do anything by budgetary means. But in this respect, too, expectations should not be pitched too high. It must be pointed out, moreover, that although State participation would undoubtedly serve the aim of establishing local roots (provided that the régime is a stable one), it is open to question whether foreign promoters would consider such direct State participation desirable. All this leads to the conclusion that, in addition to the foreign promoters, other foreign financiers will probably have to

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furnish part of the share capital of the new venture since savings for participation will be insufficient locally.

15. As regards the choice of these foreign financiers, thoughts may turn to other enterprises and to international financial institutions.

16. Other foreign enterprises will, of course, only be interested if the investment in the developing country is in the same line of business; they will, moreover, want to have a say in the new venture's policy, the question is whether the promoters will consider this acceptable.

17. For international financial institutions, however, the main question will be whether the project is sound and likely to contribute to the economic advancement of the developing country. They will not, on the whole, much concern themselves with the day-to-day running of the enterprise but usually will be content to follow the conduct of its affairs from a distance. This makes them attractive partners.

18. A further factor, and one that we consider to be of cardinal importance, is that with international financial institutions it may be possible to come to an arrangement whereby they undertake to offer their interest, in whole or in part, to the local saver at such later date and on such terms as may be agreed upon. An arrangement of this kind not only helps to build up the capital market in the developing country, but also gives the local saver an opportunity of following the progress of the business for some time, specifically, during the critical initial period, as an interested bystander, without running any risk. One thinks particularly, in this context, of the useful function that can be performed by the International Finance Corporation in Washington.

19. Summarizing then, the picture that emerges is one of actual or potential participation in the share capital of the new venture by:

(a) The foreign enterprise promoting the venture (majority interest);
(b) One or more other foreign enterprises;
(c) An international financial institution;
(d) Local savers (at first only on a limited scale).

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20. A similar picture presents itself as regards the provision of medium or long-term loans. Local savings will be limited; the Government of the developing country may possibly be able and willing to do something but, in general, the new venture will have to rely on loans from abroad and hence on the facilities provided by financial institutions operating internationally. In many cases the Government will welcome the prospect of loan capital being attracted from abroad, especially where it will finance imports of the means of production. For, in that event, there will be no immediate call on the country's foreign exchange reserves while in due course it will be possible for the loan to be repaid from the savings in foreign exchange brought about by the project (through increased exports or the replacement of imports by local production).

21. Finally, as regards meeting the need for short-term credit, a commercial bank in the developing country will have to offer a helping hand with an overdraft to supplement the credit customarily allowed by commercial creditors.

22. So far, no mention has been made of the part that might be played in the financing by a development bank in the country in which the venture is being established.

23. It is only during the last ten or twenty years that development banks have been set up in various countries on a fairly large scale. Although a number have already gained considerable experience and can look back on a clear line of development, many are still at the beginning of their "careers". For this reason, development banks do not always play a part in the financing of major projects. The projects will therefore have to rely mainly on the sources of finance mentioned earlier. Nevertheless, development banks perform a very useful function in financing small and medium industry, and at a later stage they can be expected to play a more substantial part in the financing of major projects.

24. The specific value of these banks for the financing of such industrial enterprises lies in the fact that whereas foreign investors will not be prepared to make funds available directly (high cost of handling the application and follow-up) to small enterprises in a developing country, they may be willing to furnish relatively large sums to a development bank which will distribute them over a number of enterprises and make available its knowledge of the local situation.

25. In addition, the development bank can perform a useful task in channelling local savings, small though they may be, into productive activities. We envisage the possibility that savings banks in developing countries may be able to persuade private individuals not to hoard savings but to deposit them in interest-earnings saving accounts. These banks will then furnish loans to development banks, perhaps under State guarantee. This would therefore amount to an indirect instead of a direct transfer of private savings to industry. The funds thus made available need not even be genuine savings; an arrangement is conceivable whereby, for instance, salaries would be paid through (savings) banks, so that those institutions would have permanently at their disposal funds which could be used for investment through appropriate channels. The Government itself could also help to stimulate industrial development by placing at the disposal of the development bank budgetary funds earmarked for that purpose. In these two ways, the development bank would acquire the local funds that it needs, in addition to foreign currency, to perform its task effectively.

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