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Background Paper 1/

I. Introduction

1. The problems of financing industrial development projects are being considered by UNIDO as business transactions between entities in developed and developing countries. However, the objectives of each party to the transaction may differ considerably; for the Third World countries this objective is to gain access not only to the financial resources which may be available in developed countries, but more importantly to the technological know-how and other knowledge and experience accumulated by those countries. It goes without saying that this transfer of know-how depends equally on the absorptive capacity of developing countries. The acquisition of equipment, engineering and other services, training, technical assistance need to be purchased by developing countries if they are to accelerate their industrialization process and achieve the Lima target by the year 2000. The Expert Group Meeting on Industrial Financing is being organized with a view to discuss firstly the financial resources required to pay for the acquisition of such knowledge and know-how, and secondly to discuss the present and possibly improved terms and conditions applied to loan and equity financing.

II. The supply and demand of financial resources for industrial projects in Third World countries

2. It is necessary at this stage to have an order of magnitude of the financial resources required. Estimates made at UNIDO indicate that the total investment in industry from 1980 to 2000 would have to be approximately $2,000 billion, 60 per cent of which would be used to finance imports of capital goods, technology, engineering services,

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training and technical assistance. Official transfers are not expected to contribute any more significantly than in the past to the industrialization of the Third World; firstly, the absolute amounts are small and are not likely to increase; secondly, such funds have been earmarked mainly for agricultural and a few social purposes.

4. However, loan financing from both multilateral and bilateral sources might present relatively better prospects. This may be brought about through the increased activity of export financing and guaranteeing agencies, and commercial banks. The generalization of a system of programme financing should also be considered in order to provide a framework for the combination of financing alternatives. Additionally, funds from capital markets in developed countries are likely to continue to be made available in increasingly large quantities particularly for those developing countries whose credit-worthiness is considered to be sufficient. With regard to direct foreign investment, the main recipients of such funds are likely to be the 10 to 15 developing countries who appear to provide the necessary investment climate for foreign investors. Finally, it is expected that financial flows from socialist countries towards the Third World for industrial purposes will continue to be allocated within the framework of enterprise-to-enterprise co-operation arrangements.

III. The terms and conditions applied

Loan financing

1. It should be recognized that many developing countries face difficulties in issuing long-term financial paper in international capital markets and in the domestic capital markets of OECD member countries. To date, bond issues, in terms of volume and countries, have been of limited importance. Barriers to placing paper internationally may be considered to be market and/or government-oriented; in the former case, improvements may be made through appropriate information flows, modifications to market mechanisms, etc.; in the latter case, improvements are subject to intergovernmental negotiation and consultation when considering long-term finance for industry. It should also be borne in mind that there are opportunities

for intensifying market-created capital flows between developing countries; this may be facilitated by issues of financial paper where funds from various sources are fungible amongst developing country users; special arrangements may be made for the regional multilateral development banks (or groups of banks) to issue paper in one or more of the capital surplus developing countries.

5. Developing countries can rely on borrowing from commercial banks or from a combination of borrowing sources; however, this is often restricted by the generally hard terms and lack of grace periods. It should be borne in mind that industrial projects have special characteristics such as: some grace period before repayment begins is usually required since it takes three to five years to create an industrial plant; the normal period of loan repayment may extend over a period of ten years or more since the plant itself will normally have a life of 15 to 25 years; repayment may be possible through a buy-back arrangement involving export deliveries of the goods thereby produced. Discussion at the four sectoral consultation meetings held so far has shown that such considerations are not always taken into account, export credits and loans from commercial banks being often too short in duration and with inadequate grace periods.

6. The provision of industrial and export finance by public multinational development finance institutions could be expanded through an increase in the financial resources available and through an improvement in lending policies and the terms and conditions. For example, in programme financing, lenders are concerned with such criteria as efficient overall policies and management in the particular sector or economy; the borrower is less dependent on outside regard to project choice and feasibility. Loan instruments may take the form of concessional or non-concessional medium and long-term bank loans and financial paper, together with new instruments such as medium-term quasi-equity notes. It may also be possible to use and improve the conditions of co-finance arrangements, whose advantage lies in the presumed coverage of official institutions with commercial sources of funds. However, an issue of interest resides in the apparent unwillingness among official institutions to adopt more often this mechanism of financing industrial projects.

It is also worthwhile to consider schemes involving the extension of full or partial guarantees by the official financing institution participating in multi-lateral co-financing.

Equity financing

7. Direct foreign investment is likely in the future to continue to face the problems of lack of confidence on the part of partners from both developed and developing countries. It would therefore, be important to focus attention on a system of guarantees which facilitate the flow of private sources of finance to the Third World for industrial purposes; these guarantees would have to include improvements in investment protection arrangements as well as more effective performance guarantees and insurance schemes in order to benefit both partners.

8. The role of export financing and guarantee agencies (for example, ECGD, COFACE, Hermes, etc.) merits further examination; it is considered that there could be additional responsibility of these agencies to ascertain the conduct of the export business under proper terms and to assist in protecting developing countries from the supply of faulty equipment and inappropriate technology. It is recognized that this creates a problem of competence and a conflict of interest. Additionally, it may be necessary to consider the desirability of a multilateral investment guarantee scheme to complement those at the national level and which would include the participation of developing countries.

9. The important trend in contractual arrangements for industrial co-operation is the increased use of compensation or buy-back clauses not only on an East-West basis but also between North and South. An advantage of such clauses is that partners from developing countries obtain stronger guarantees that industrial plants will perform in accordance with the supplier's undertakings, since the output of the plant is to be sold in the market of the latter. Such compensation or buy-back arrangements are implicitly an additional performance guarantee, because they ensure that if the products have been designed in accordance with international standards, the output of the plant will meet those standards. Furthermore, it should be borne in mind that industrial co-operation is becoming increasingly

complex and of longer duration, while the links between industrial and commercial operations become much closer. These trends stress further the need for governments to be involved in arrangements for industrial co-operation at the enterprise level.

10. It is thought useful to examine the extent to which inter-governmental framework agreements may contribute towards improving the investment climate in host countries for contractual relationships at the enterprise level. It is considered that an additional guarantee may thereby be provided against malpractices by either pattern; they may be of assistance in ensuring that interfirm contracts are compatible with the host country's development strategy and policies. Additionally, such framework agreements may contribute towards the improvement of procedures for solving differences between partners by clarifying the extent to which the use of national or international jurisdiction contributes positively or negatively to the establishment of an investment climate which is acceptable to foreign investors.

New arrangements for financing industry in the Third World

11. A number of new channels of financing from commercial sources have developed since 1973. Many of these sources are willing to lend to industrial projects, but the terms and conditions on which they lend need careful appraisal to ensure that they are suitable for such projects. Some important new approaches, not hitherto discussed in a global forum, could be considered, such as trilateral co-operation with one partner supplying technology, one finance, one the remaining factors; ways of spreading the risk attached to compensation or buy-back agreements; industrial leasing.

IV. CONCLUSION

Given the present sources of industrial financing, the preliminary work undertaken by UNIDO indicates that larger quantities of funds could be made available to industry in developing countries if appropriate terms and conditions were adopted by the institutions concerned. It is hoped that the Expert Group Meeting will identify those problem areas or issues which would benefit from in-depth study by the UNIDO secretariat and from discussions at a global consultation meeting.

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

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