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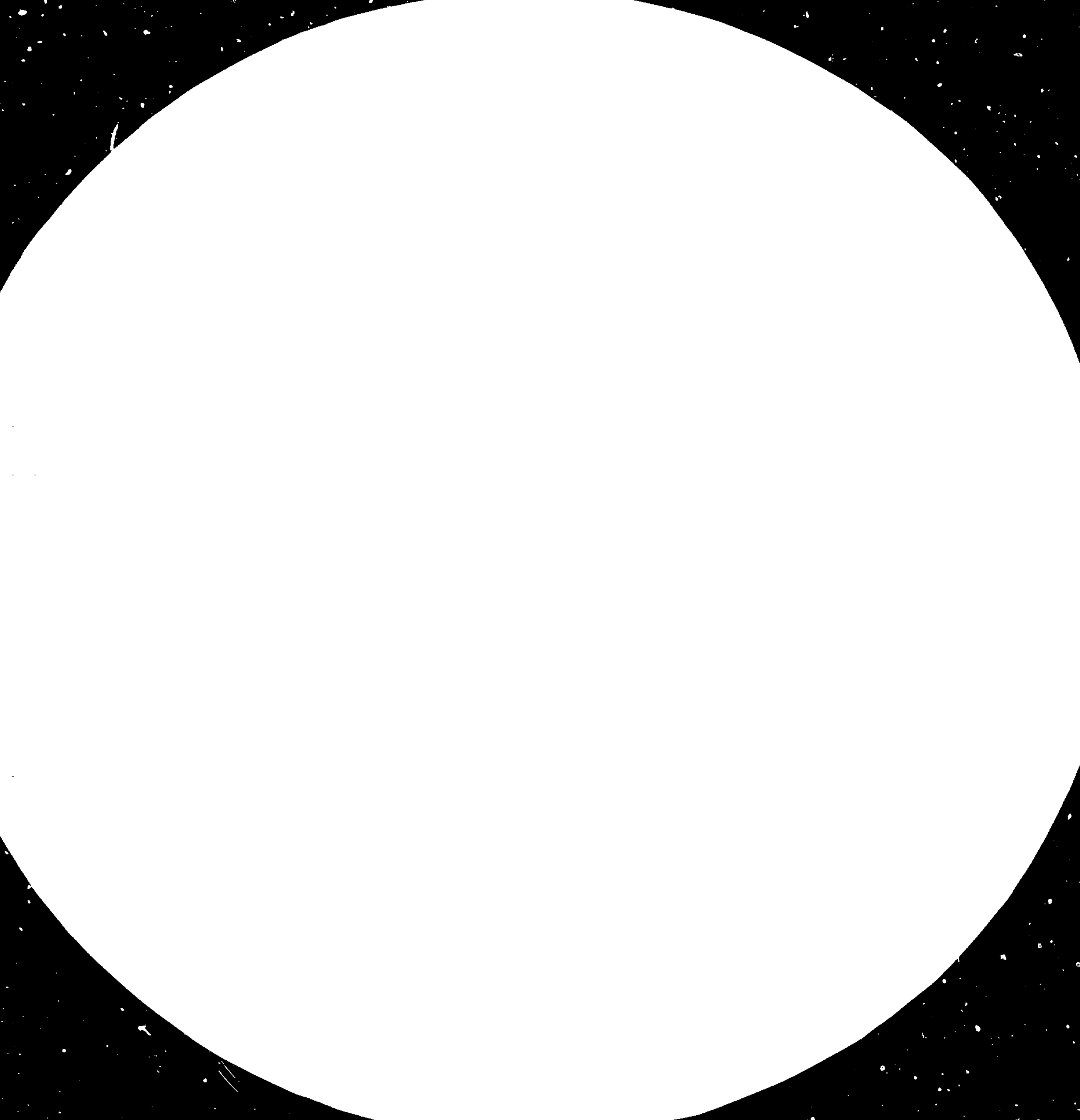

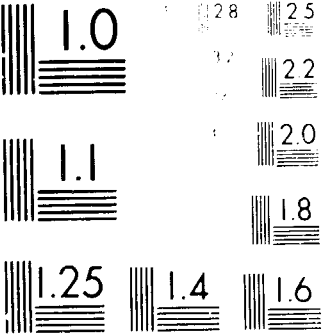
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SUGGESTED ISSUE NO. 2: ECONOMIC AND FINANCIAL CRITERIA USED BY FINANCE AGENCIES IN FINANCING INDUSTRIAL PROJECTS AND THE IMPLICATIONS OF APPLYING SUCH CRITERIA*

prepared by

the secretariat of UNIDO

* This is one of three issues suggested by the UNIDO secretariat; the participants are expected to consider these and other issues they may suggest and advise on the selection of priority issues.

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Introduction

The industrial development of virtually all developing countries can be seen within the perspective of an attempt to break with and transform the status quo from that condition known as "underdeveloped"/ "developing". This condition is characterized by inter alia an incapacity for self-sustained industrial growth. It is from this perspective of a break with the status quo and structural transformation that economic and financial criteria, i.e. decision-making rules to invest or not to invest, to change or not to change a project etc., should be examined. These decision-making rules govern recognition of the "feasibility" or "bankability" of an industrial project. The implications of this perspective raise some important issues:

(a) Can these decision-making rules be "rational" or "scientific", i.e. free of biases which run counter to national objectives of the development of a capacity for self-sustained growth and a change to less dependent international relationships?

(b) If these rules are biased, can they be changed or can the biases be overcome?

(c) Providing the issues raised under (a) and (b) above can be satisfactorily settled, can these rules be applied in an unbiased manner by operational staff and decision-makers and more particularly by operational staff and decision-makers serving different national and/or private interests?

(d) What part does "judgement", i.e. decision-making based on evidence which is not measurable, play in investment decision-making?

Structural transformation

The attempt at structural transformation of the economy which comprises industrialization for many developing countries is a process incorporating many effects: for any single industrial project there is a network of upstream and downstream linkages with other industrial projects and activities, i.e. goods and services which are bought and sold by the single project so that there is an impact on the producers and consumers of these goods and services. There are also "externalities", i.e. benefits which are obtained by the national economy such as the availability of skilled and experienced workers. As the structural transformation proceeds this network becomes increasingly dense as these linkages increase. Moreover, this transformation takes place over a longer or shorter period of time, and there are significant and changing increases in efficiency to the transformation in terms of skill formation, the transferability of skills, the development of technological capability, absorptive capacity etc., some of which may increase more quickly than the rate of industrial investment.

This process of structural transformation over time, i.e. the building of an economic and social infrastructure to support industrialization, involves costs, and the question arises of how these costs can be charged against particular industrial projects, as convention seems to suggest, or whether some proportion of these costs would be better charged against the totality of industrial projects which constitute an industrial programme. Alternatively, would it be better to associate these costs as going towards the financing of the "development period" through which developing countries have to pass if they are to attain their goals of self-sustaining industrial capacity and a lessening of external dependency? Equally, how can the benefits of increased efficiency be attributed to particular projects? It would also appear that without a minimum "critical mass" of industrial investment being sustained over a longer or shorter period of time, these advantages of increased efficiency in industry cannot generally be expected to accrue to a developing country, does this have implications for external financing agencies?

Dependency and national vulnerability

With respect to the objective of a reduction in dependent external relationships, the question arises of what types of products should be manufactured and which industries should be given priority in a particular national context, i.e. the question of output composition and of the costs attached to "vulnerability" in various industrial sectors would need to be examined outside the sphere of the conventional economic and financial criteria for investment decision-making. It would appear that the broad composition of product output may need to be independently decided in accordance with not easily quantifiable national objectives, as well as the need to consider the macro-economic matching of demand and supply. Conventional economic and financial criteria might then only have the far more restricted role of influencing the method of production or choice of technology for a given manufactured commodity, i.e. the choice of industry, and the pattern of industrial development, may have to be decided upon apart from project-oriented economic criteria such as "economic cost-benefit analysis": it would appear that the application of project analysis techniques is no substitute for industrial planning, and comparison should be made only between "close projects" and not between (say) steel and fertilizer. The question which should be raised here is whether external financing agencies are interested in the merit or viability of a particular project or in a country's capacity to repay loans? The answer may be that commercial banks are interested inthe second question and multilateral agencies (e.g. the World Bank, the regional development banks etc.) more in the first question. Are the export credit agencies of the developed countries interested in both questions or are they more interested in the supply of and payment for capital equipment?

In connection with the use of international product prices in conventional economic cost-benefit analysis, it is recognized that these prices reflect the existing international pattern of trade and international division of labour. Given the objectives of industrialization, above all to move away from the international status quo, would not overreliance on such prices in project selection indirectly impede structural change? Moreover, countries may aim at reducing their dependence on external suppliers of certain products considered "strategic" and may perceive that such dependence may make their economies "vulnerable". Indeed, such countries may perceive that too open an international trade policy may itself increase the vulnerability of their economies. How can solutions to "vulnerability" avoid leading developing countries to isolationist policies in international trade? Would such isolation to world trade not be uneconomic? Costs arising from the foregoing require fine judgements of perceptions of reductions to national vulnerability, but can such judgements be made by external decision-makers?

Information and Judgement

With respect to the application of economic and financial decision rules, it should be noted that where commercial banks and export credit agencies are involved, the approach to and successful negotiation with such agencies may require access to information on equipment costs and alternative loan conditions not easily available to many developing countries, particularly those who are only infrequently in the market for such loans. Where can countries obtain unbiased advice in this area? Equally, successful negotiation with the multilateral agencies require skills which are very scarce or non-existent in many developing countries (economic cost-benefit analysis in a complex subject), and also access to information and statistical data which may be scarce or non-existent. In this situation, how can such countries avoid an overdependence on the perceptions and judgements of the decision-makers at these agencies, given that in the absence of hard information judgements become more subjective, including judgements about the future? More particularly, how can the poorer developing countries and those developing countries with particularly acute skill constraints prepare themselves to negotiate with multilateral finance agencies? A related question is the extent to which dependence on essentially the judgements of multilateral finance agencies in the past have proven to be correct, given the changing fashions and policies espoused by such agencies.