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PROPOSAL FOR SETTING UP AN INTERNATIONAL BANK FOR INDUSTRIAL DEVELOPMENT

Abridged paper*

Prepared by
THE FINANCING GROUP
OFFICE OF THE EXECUTIVE DIRECTOR
UNIDO.

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Tangible progress towards achieving the Lima target would call for vastly increased external financing on appropriate terms, to meet the needs of the developing countries. In measuring the scale of the financing requirements against prospective capital surpluses it becomes evident that there are important quantitative as well as qualitative gaps in the present international financial system, which will constrain the deployment of financial surpluses to investment in new industrial capacity in the developing countries. Even under the best assumptions, the multilateral institutions and the commercial banks will leave enormous room for further financial flows to industrial development in the South. This calls for an initiative to fill the institutional gap. Any new mechanism set up for this purpose should be based <u>inter alia</u> on the principles of providing universal participation, mutuality of interests, maturity structures and lending rates conducive to industrial development, concessionary terms for the least developed countries and the opportunity for all participating countries to influence its policies and management.

It is proposed to fill the institutional gap by setting up a new financial mechanism, called the International Bank for Industrial Development (IBID). The proposed Bank would assist the industrialization of developing countries, stimulate the world economy, and provide an additional and efficient facility for recycling surpluses. Functionally, the Bank would not only fill quantitative gaps by acting as a financial intermediary, but also remedy serious qualitative deficiencies in the existing international financial system by:

(a) Operating as a vehicle for channelling greatly needed equity investment into the developing countries as an intermediary between direct investors and demanders of funds;

(b) Promoting investment by providing a package of services such as project promotion, joint ventures, and export re-financing, taking advantage of services available within United Nations organizations such as UNIDO and other programmes or specialized agencies;

(c) Offering borrowers a choice of currencies in which they would want to borrow, to allow them to manage their exchange risk exposure;

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(d) Introducing innovative new instruments for lenders to enable them to take direct partnership in productive assets in developing countries;

(e) Performing long-term maturity transformation for industrial projects on appropriate terms;

(f) Making extensive use of the credit markets to provide bridging finance to developing countries in periods of heavily fluctuating costs of borrowing;

(g) Offering those lending through it protection against non-commercial risks, by means of undertakings embodied in its charter;

(h) Applying flexible and speedy operational procedures;

(i) Channelling additional finance, through co-financing arrangements with commercial banks and other financial institutions;

(j) Providing continuous and reliable availability of funds to developing countries by borrowing also at floating rates on a multi-currency basis whenever necessary;

(k) Providing interest subsidization at differential rates, funded through an innovative scheme linked to export orders received;

(l) Stimulating the development of domestic industrial export credit in the developing countries by offering re-financing facilities.

2. <u>The need for industrial financing in developing countries</u>

The Lima target calls for the developing countries' share of the world's industrial production to reach at least 25% by the year 2000. On the basis of present trends the developing countries' share will, by the year 2000, approach about 14%, against a level of 10.7% in 1979. If the developing countries are to reach the Lima target, they must during 1980 - 2000 increase their growth rates considerably beyond what current trends would yield: GDP from 5.3% to 7.7% and industrial output from 5.9% to 9.2%. These accelerated growth rates must be matched by a corresponding spurt in new investment in industry as well as in foreign financial flows, to bridge the foreign exchange gap created by the sharp increase in imports of capital goods and services. The respective figures (at 1975 prices) are estimated at:

Manufacturing industry in developing countries

(US $ billions)

	Investment			Foreign Finance		
	Annual		Cumulative	Annual		Cumulative
	1980	2000	1980 - 2000	1980	2000	1980 - 2000
Present trend	56	151	1790	20	53	630
Lima requirements	56	427	4030	20	149	1410

An evaluation of the prospects of mobilizing such enormous levels of international financing must start with a close look at the international money and capital markets, which since 1973 - 1974 has become the predominant source of external finance for developing countries, overshadowing official aid and lending by multilateral institutions. In adjusting to the oil price changes of 1973 - 1974, the industrialized countries went through a period of stagflation, while the non-oil developing countries ran higher current account deficits financed through borrowings from the North's commercial banking system, which recycled the oil surpluses accumulated by a few oil exporting developing countries. Of total borrowings in international capital markets, the developing countries' share rose steadily from 32.5% in 1976 to 43.7% in 1979, when over 60% of all Eurocurrency credits went to developing countries. Despite its apparent success, the channelling of funds to developing countries by the commercial banks was accomplished at a level lower than economically optimal, while the distribution, conditions and developmental effects of these funds were not wholly appropriate to the needs of the developing countries. Moreover, manufacturing industry obtained only a small share (14%) of the commercial bank lending in 1973 - 1978.

It is widely believed that the rules of supervisory authorities, capital ratio limitations and overexposure to high individual country risks will constrain commercial banks from expanding their recycling function much further. Multilateral institutions will also be limited by their size and structure, their difficulties in changing statutes and regulations, and by their restricted country memberships. Therefore, while the prospective supply of funds in the eighties and nineties looking for secure and profitable investment in the capital markets is likely to increase appreciably, a gap in the present international financial structure will constrain its deployment, particularly for financing new industrial capacity in the developing countries.

Any new mechanism that may be set up for channelling additional funds to manufacturing investment in developing countries, would also provide an economic stimulus to the industrialized countries, since they would be the main exporters of the capital goods and services required by the developing countries. In these countries the increased exports would have a multiplier effect on production and employment and without costing anything to their tax-payers, would generate a considerable amount of additional public revenue. For the OECD area as a whole, the multiplier is estimated at 3 . In other words, each increase in demand of $15 billion would lead to a production increase within the OECD area of more than $45 billion. The resultant increase in production would generate additional revenue for the public sector estimated at between 40 to 70 percent of the increase in exports.

3. The basic proposal for an International Bank for Industrial Development

Upon a multilateral base provided by member countries from all Groups who would subscribe to its equity capital, the proposed Bank would function to make project loans primarily, and in some circumstances programme loans, to industry in developing countries. The Bank would perform its function of financial intermediation by borrowing funds from the money and capital markets, transforming their maturities and lending long-term to industrial projects in developing countries. It would be designed to give tangible benefits to all participating groups of countries. Through an equitable system of benefit sharing between the borrowing countries and countries which receive additional export orders from the lending, it would be possible to offer attractive lending rates to borrowers, particularly the least developed countries. The Bank would be a small and compact organization. It would channel its resources to industry largely through regional and national development banks and through co-financing with existing financing institutions.

The Bank would be set up as a legally independent body either within or outside the United Nations system, as negotiated and decided by the member countries. It is recommended, however, that it should seek a special relationship with the United Nations family, rather similar to that of the World Bank. Most importantly, the Bank should be non-political in its nature and functioning.

The capital base of the Bank would consist of a relatively small proportion of called-up capital (say 20%) subscribed by the member countries, but it would be able to borrow against the security of the called and uncalled capital, with a gearing proposed eventually to exceed 1:1. An annual lending target of $15 billion (by 1995) with an average maturity period of twelve years would necessitate peak borrowings and loans outstanding of almost $100 billion. Although it might be prudent to start with a considerably more modest level of annual lending and a debt/equity ratio of 1:1, it is recommended that the legally authorized capital of the Bank be fixed at $50 billion within which the subscribed capital and the debt/equity ratio may be increased in stages by decisions taken at annual meetings of the Bank itself. On this basis the capital structure of the Bank might evolve as follows:

	1985	1990	1995	2000	2005	2010
		($ billions)				
Authorized Capital	50	50	50	50	50	50
Subscribed Capital:	10	20	50	50	50	50
Called	(2)	(4)	(10)	(10)	(10)	(10)
Uncalled	(8)	(16)	(40)	(40)	(40)	(40)
Total Borrowings	10	40	100	200	250	250
Debt/equity ratio	1:1	2:1	2:1	4:1	5:1	5:1
Annual Lending	1.5	6.0	15.0	30.0	37.5	37.5

Recognizing the large financial flows which must be mobilized by the new institution, it might be useful to consider allocating capital subscriptions and voting rights (which would be non-proportional) to five groups of countries. The following scenario may serve as an illustration:

	Called Capital Contribution			Voting Rights
	Initial US $ bill.	Eventual US $ bill.	%	%
Group B	1.0	5.0	50	40
Oil exporting developing countries a/	0.4	2.0	20	16
Other developing countries	0.2	1.0	10	28
Group D	0.3	1.5	15	12
China	0.1	0.5	5	4
	2.0	10.0	100	100

a/ Some OPEC plus other oil exporting developing countries.

In this scenario, Group B, the oil exporting developing countries, Group D and China each yield 20% of the votes accruing from their respective equity shares to the other developing countries.

In order to protect not only the Bank's borrowers, but also surplus country lenders to the Bank, from a large part of the exchange risk inherent in single currency transactions, it is strongly recommended that the Bank adopt the technique of lending as well as borrowing in SDRs, or until such time as the SDR gains currency, by operating its own basket of multiple currencies.

The proposed Bank would be based on the concept of mutual benefits to all groups of countries. Developing countries would benefit from having additional equity and loan finance for industrialization on appropriate terms, with possible subsidies of e.g. 3% in the interest rate particularly for least developed countries and 0.5% for other countries. As borrowers, they would also get some shelter from exchange risk as explained above. Capital surplus oil exporting countries lending to the Bank would derive several benefits. First, their loans to the Bank would be sheltered from exchange risk through denomination in terms of the Bank's currency basket. Second, the Bank would attempt to give their investments protection against inflation. Funds raised from these countries could be invested by the Bank in prime industrial projects in developing countries against debentures convertible into equity shares of the enterprises financed. During the life of the debentures, or upon redemption, the lending governments would have the option of converting them into equity shares of the borrowing industrial undertakings at par; if the industrial undertakings prospered, these equity shares should be standing at substantial premiums. By routing their funds through the Bank, the oil exporting countries would be protected initially from a large part of the risk inherent in direct equity investment. Third, the Bank would also have a crucial function to perform as a search mechanism and enforcer of quality control by identifying, preparing and evaluating industrial projects suitable for direct foreign equity investment which capital surplus oil exporting countries are keenly looking for. The Bank would thus give the oil exporting countries - at their own choice - the opportunity to enter into direct partnership in productive industrial enterprises in the other developing countries. Group D countries would have the advantages of being able to use all the facilities offered by the Bank, and share in some of the additional exports of capital goods and services which would accrue from the Bank's lending, particularly through trilateral co-operation between the West, East and South. In certain circumstances, Group D countries might also wish to borrow from the Bank. Group B countries will clearly gain from the additional exports of capital goods and services that would be generated by the Bank's lending. It is estimated that the economic benefit to Group B countries of the additional business would be several times the Bank's annual lending level apart from savings on subsidies presently granted to export credit agencies. Since the additional exports generated by the Bank would offer relief to the present depressed economic situation, the industrialized countries might agree to share a part of the economic and fiscal benefits which would accrue to them. Such benefit sharing would be used to build up an interest subsidy account as explained below.

4. Sources and methods of borrowing

It would be crucial for the Bank to be able to borrow sufficiently from the capital market at the lowest possible cost, and to procure capital bilaterally from governments, including the oil exporting countries. Successful achievement of this objective would depend primarily on the market perception of the Bank and the credit-worthiness it would be able to establish. If it is first established by a few countries, direct bank credits might be the best initial route. If it were set up as a multilateral institution with wide membership it would more quickly be able to issue fixed rate bonds on prime terms and conditions.

The Bank would borrow from four main sources: the Eurocurrency market, the national capital markets in industrialized countries, the national capital markets in certain oil exporting countries, and direct placements by the Bank with surplus countries. Although no market is entirely free from regulation, the Eurocurrency market is relatively open and therefore should be more accessible at an early stage of the Bank's activities than the national capital markets.

Two separate segments of the Eurocurrency market are available, namely, the market for syndicated bank credits (the Eurocredit market) and the market for bonds (the Eurobond market). The Bank would probably first tap the Eurocurrency market by raising syndicated medium-term Eurocredits and lending to developing countries on longer terms, performing maturity transformation through the roll-over technique. The interest payable on syndicated Eurocredits will float, being linked to the London Interbank Offered Rate (LIBOR) with a fixed spread. As soon as the Bank has established its rating in the market, it would issue straight fixed-interest Eurobonds on prime conditions. A third alternative would be to issue the presently popular Floating Rate Notes (FRNs). Although the cost of these funds fluctuates considerably, they represent for developing countries an alternative to borrowing in the syndicated credit market and they also offer the possibility of entering the Eurobond market.

Penetration of the national capital markets in the industrialized countries would depend on fulfilment of regulations, but can take the form of either direct bank credits or bond issues on either fixed or floating rate basis. Borrowing in some of the national capital markets would be important if the Bank were to operate its own basket of currencies as suggested above.

Similarly the Bank could issue bonds in the capital markets of some of the oil exporting countries, denominated in their national currencies. More importantly, however, the Bank would attempt to make direct placements in these countries, especially in realizing the proposed scheme for linking such borrowing with the Bank's lending to prime industrial projects in developing countries, on debentures convertible into equity shares of the industrial enterprises financed.

5. Modes of lending for industrial development

Any discussion on modes of lending must start by addressing the question of programme versus project lending. The payments imbalances created in the developing countries since 1973-1974 have supported the call for flexible programme financing. The need for increased programme financing is recognized. However, because of its need to gain and maintain a prime rating in the capital markets, it is felt that the Bank should concentrate on industrial project financing, while taking some steps in the direction of programme financing, perhaps through lines of credit granted to national development banks.

The emphasis on industrial project financing will bring the Bank face to face with the problem of increasing the absorptive capacity of the developing countries, particularly in the least developed countries. Project identification and preparation is a bottleneck in many developing countries, which find it difficult to organize and finance the necessary studies. Bilateral and multilateral financing institutions are often unable to contribute because of the high risk factor connected with the activity.

The new Industrial Project Preparation Facility (IPPF)[1/] proposed by UNIDO could be used effectively to fill this need. In identifying and preparing viable industrial investment proposals the Facility would draw heavily on UNIDO's field organization as well as its technical assistance capability. Although the IPPF ought to be set up as soon as possible through voluntary contributions from member countries, it could become a window of the Bank once the latter is constituted. Thereafter the Facility would be funded from the interest subsidy account of the Bank and administered through a "special relationship" arrangement with UNIDO.

While it is recognized that pure project lending must be the nucleus of the activities of the Bank, the possibility of other forms of lending would also be considered. Lending against debentures convertible into equity shares has been mentioned above. Other possibilities would be project lending with borrower discretion over sub-projects as practiced by the World Bank, lending to industrial sectors or sub-sectors against a composite plan, opening credit lines for development banks or institutions, and finally co-financing activities with other multilateral, and with public and private financing institutions.

The proposed concessions in the lending rate as well as funding the Industrial Project Preparation Facility would require the creation of an interest subsidy account. It is recommended that this subsidy account be operated apart to allow the Bank to charge a lending rate which would cover its average cost of borrowing, in order to maintain a strong balance sheet. One way of funding the interest subsidy account would be by obtaining a share of the economic or fiscal benefits which would accrue to countries, both industrialized and developing, receiving the new export orders from the Bank's lending. An estimate has been made of the possible size of the interest subsidy at the initial annual lending level of $1.5 billion, which would involve total outstanding loans in the pipeline of $10 billion with an average maturity of twelve years. Assuming that 20% of the lending will go initially to the least developed countries, the total annual interest subsidy would amount to $100 million, or to $120 million including a margin for the Industrial Project Preparation Facility.

1/ See "Proposal for an Industrial Project Preparation Facility" submitted by the Executive Director of UNIDO, Document ID/B/245, April 1980.

Since the Bank's lending would cover perhaps half the foreign exchange cost of the capital goods and services, the rest being covered by co-financing, the value of the actual new export orders could be double the annual lending of the Bank. Similarly, for the OECD group of countries, the economic benefits accruing from the additional export orders would be about two to three times the value of the additional orders, leading also to an increase in public revenue. The countries receiving the new orders would be expected to share some of these additional benefits with the interest subsidy account of the Bank. On the basis of these estimates the countries receiving the new orders would share about 4% of the value of the new orders, amounting to 2% of the economic benefits accruing to their economies, or 5% to 10% of the additional public revenue earned. The central feature of this method of raising the subsidy is its direct link to the receipt of orders; countries not in receipt of orders would not be required to contribute in any way.