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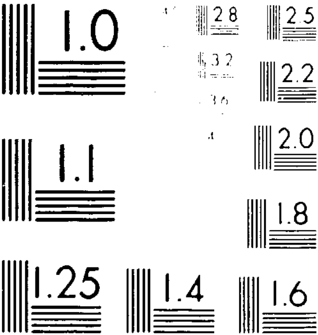
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FINANCING OF MANUFACTURING IN AFRICA *

Series on the domestic financing of manufacturing enterprises in developing countries

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in co-operation with

Regional and Country Studies Branch
Division for Industrial Studies

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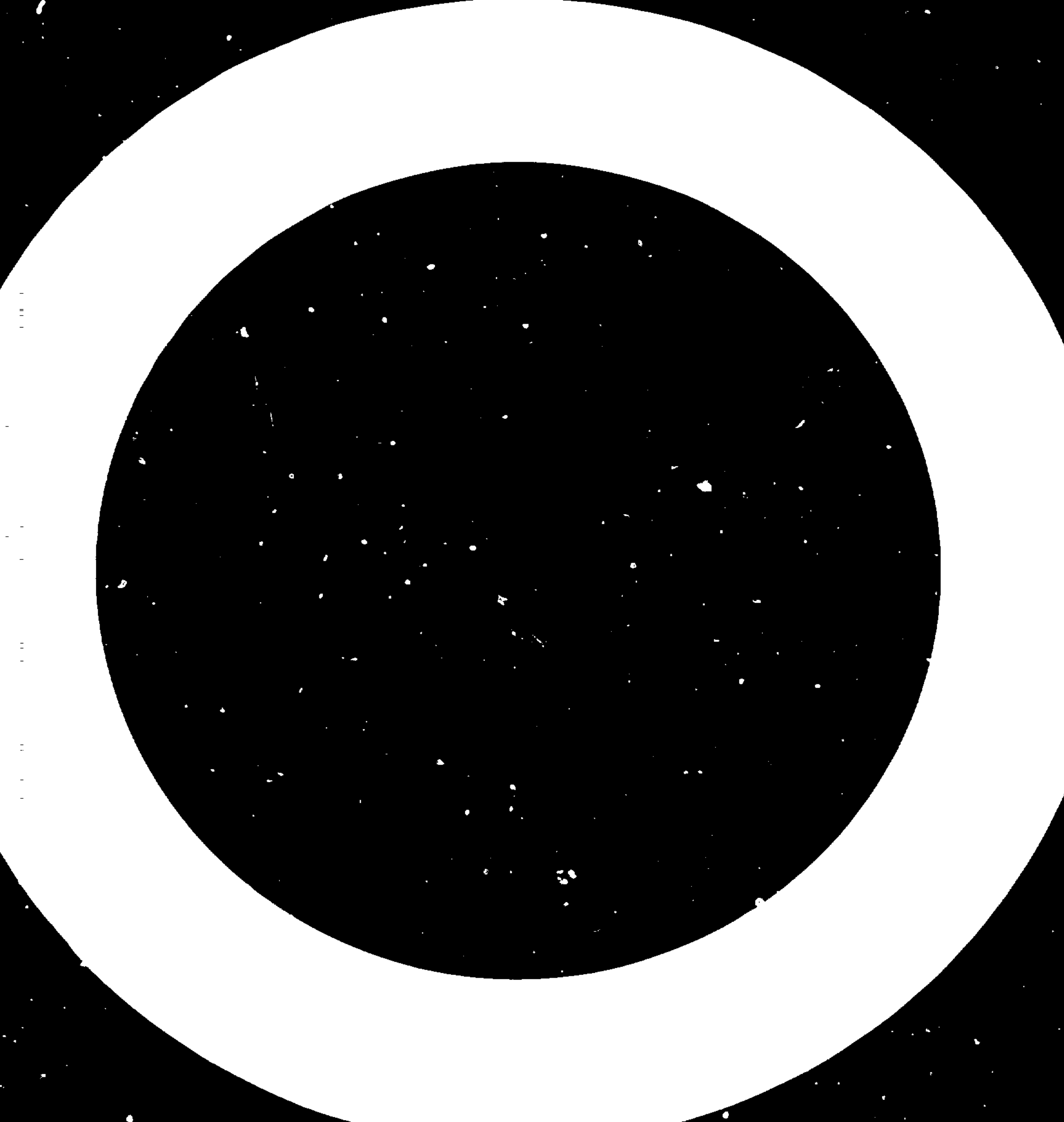

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FOREWORD

Prepared by UNIDO Secretariat's Regional and Country Studies Branch, Division for Industrial Studies.

This study is part of a series of surveys of the effectiveness of financial intermediary institutions such as banks in collecting investible funds and channelling them to manufacturing enterprises in various parts of the developing world. The purpose of the following section is to introduce the subject of the relation between financial intermediation and industrial development. Subsequent sections make a brief presentation of the surveys.

Financial systems and industrial development

Development economists usually discuss the subject of finance in terms of saving of adequate amounts of real resources to achieve given targets for capital formation. In development planning for instance, it is common to estimate the resource requirements of a desired growth rate by means of an incremental capital-output ratio. This ratio determines the investment needed to sustain the desired growth of the capital stock. To match this investment a corresponding amount of real resources must be released from consumption. Thus, financing is basically an act of saving. At the practical level this approach usually stresses the need for policies to raise the quantity of resources saved for growth.

While this conception is useful for many purposes it neglects, however, the fact that real resources have to be transformed into investment and that this transformation can be done more or less efficiently. In the present study the focus is set precisely on this process of transformation. Here financing is understood to mean the provision of purchasing power that investors can spend in advance of production. What matters here is not only the act of saving but also the transformation of these savings in a form suitable to investors.

It is only in the seventies[1/] that the intermediation procedure whereby real resources are transformed into lending was fully recognized by development economists as an important factor in capital formation. Since then it progressively appeared that the finance of development could be enhanced not only by increasing the quantity of real resources saved for investment but also by improving the effectiveness of the financial system whereby part of these resources are channelled to investment.

One could consider that in performing its intermediation function the financial system influences the amount of finance put at the disposal of industry in three respects.

To start with, there is the transformation of saving - mostly done by households but also by the government. the corporate and the foreign sectors - into financial assets. These financial assets constitute a pool of transferable funds from which the financial institutions can draw to onward lend. Such transferable funds are crucial for the financing of newly expanding sectors. The first contribution of the financial system to industrial finance thus is to offer financial assets attractive enough to compete with other uses for saving such as hoarding or speculative purchases.

1/ When the publication of two books drew the attention of development economists to questions which previously had been discussed almost exclusively among finance specialists. See McKinnon, R.I., Money and Capital in Economic Development, The Brookings Institution, Washington D.C., 1973. and Shaw, E.S., Financial Deepening in Economic Development, Oxford University Press, New York, 1973.

The second aspect is the transformation of financial savings into lending. In the industrial field investment-funding basically requires long-term finance. Thus the financial system contributes to industrial growth by transforming short-term financial assets into the long-term form of the loans demanded by industry. This "maturity tranformation" seeks to reconcile the short-term preference of the lenders to the long-term preference of the borrowers under the umbrella of the law of large numbers.

The third aspect is the allocation of investible funds. Financial savings can be made available to various alternative uses. Industrial investment is only one of these uses and it has to compete with housing credit, commercial credit, government borrowing, speculative purchases, etc. In practice there are wide inter-country differences in the proportion of total financial savings going to long-term industrial finance.[1/] This fact suggests that there is considerable room for increasing the finance made available to industry by imposing appropriate orientations to the financial system.

While acting on the financial system, which is only a set of intermediation channels, is not the same thing as increasing the amount of resources entering into the pipeline, it can attract additional savings, reduce leakages during the intermediation process and deploy the transferred funds more effectively Improving the financial system is therefore tantamount to raising the quantity and quality of investment and hence the rate of industrial growth.

1/ See Carrington, J.C., and Edwards, G.T., Reversing Economic Decline, The MacMillan Press, London, 1981. The book documents the differences among the Federal Republic of Germany, France, Japan, the United Kingdom and the United States of America.

Furthermore, it may be noted that efficient financial systems are needed not only to fully mobilize domestic resources but also to attract as much foreign resources as possible by identifying the best investment opportunities the country can offer and by creating a reassuring atmosphere of financial soundness.

The Surveys

The series comprises four surveys. Two of them offer bird's-eye-views of Africa and Latin America. The two others review selected countries: India - to which a complete survey has been devoted by virtue of her size and the sophistication of her financial system - and Bangladesh, Indonesia, Malaysia, Sri Lanka and Thailand.

The surveys examine the source and type of financing and discuss the influence of the existing patterns, as well as gaps and deficiencies in the availability and channelling of finance to manufacturing enterprises.

Finance is in part provided directly to investors by initial savers. In this study, this source of finance is only dealt with in passing when the surveys discuss self-finance or when the subjects of company deposits or security markets are touched.

The central theme of the surveys is financial intermediation between lender and borrower.

The surveys examine the three main aspects of intermediation mentioned in the preceding section - collection, transformation, allocation - and address the following questions: Does the financial system make the contribution it is capable of making? If so, what should be done to keep the system in good condition as developing countries undergo the profound structural changes that lie ahead of them? If not, how can it be brought into working order? It must be admitted that these questions have not been fully answered. The resources assigned to the task have been designed to provide background surveys, not specific solutions. It is felt however, that the diversity of experiences analysed allows for an evaluation of problems, issues and policies that will be useful not only to the countries surveyed but also to other developing countries as well as to development finance corporations and aid agencies.

Every survey contains, of course, its own insight shaped by the particular circumstances of the region or country reviewed. The survey of India, for instance, offers a detailed financial analysis based on more than 2,000 balance sheets of companies in the manufacturing sector. The analysis is extended to several groups of companies and covers the financing of fixed assets and the financing of working capital in addition to the overall financing pattern. The African survey, acknowledging that Africa is heavily dependent on foreign financing, pays a good deal of attention to the relation between domestic and international financing. The Latin American survey presents the sources and uses of funds by industrial enterprises and analyses the main financial ratios of selected groups of enterprises in a number of countries of the region. The survey of Bangladesh, Indonesia, Malaysia, Sri Lanka and Thailand stresses the role of policies, such as tax incentives and accelerated depreciation, designed to generate resources within the industrial sector itself in the context of insufficient supply on the part of the financial system.

Underlying the particular insights is a common canvas to which the substance, if not the format, of all the four surveys tends to conform. A synoptic scrutiny indicates that each survey reviews the main parts of the structure of the financial system - the financial institution, the financial instruments and the influence of background factors on institutions and instruments - in relation to the major functions of the financial system - collection, transformation, allocation.

The structure of the financial system

Schematizing a bit, it may be stated that the analytical focus shifts from one aspect to another according to the degree of financial sophistication of the region surveyed.

Financial institutions

The main financial institutions exercising an intermediary function are the banks and the development finance corporations (DFC). The paper dealing with Africa, which is on the lower part of the sophistication scale, gives emphasis to what constitutes the infrastructure of any financial system: the Central Bank and the commercial banking system. The paper on Bangladesh, Indonesia, Malaysia, Sri Lanka and Thailand gives relatively more attention to the role of DFCs and specialized banks. A cross-section of these two surveys reveals that the financial structure follows a typical pattern of change in the course of economic development.

In very poor countries the most important aspect of financial intermediation is the policy of the Central Bank in providing credit to productive enterprises.

Time and savings deposits require not only full convertibility into the means of payment but also a real return which is attractive enough to compensate for the time restriction on liquidity.

Provided these conditions are fulfilled, a relative diminution of coins and currency occurs and the commercial banking sector, broadly defined to include interest-bearing deposits of all kinds and possibly intermediate-term bonds sold to final savers, tends to gain importance in the organized capital markets. If banks are to take their due importance in the financing of industry, it is recommended that facilities should be made available throughout each country to acquire claims on banks.

As development proceeds, the rise of demand and time deposits in commercial banks is supplemented by the emergence of pension funds, insurance companies, etc.

The banking system usually is the main source of financing in the industry of developing countries, but its credit is almost entirely short-term because the banks lack the incentives, the means and the skills to deal with long-term credits or because they are prevented from doing so by law or custom.

The purpose of the DFCs is to fill the gap in medium-term and long-term credit and investment.

Financial instruments

The papers on India and Latin America, regions where a diversified institutional basis already exists, set the focus on the instrumental form of the funds provided to industry.

The Latin American survey describes the structure of financing existing in several countries of the region in terms of the importance of internally generated funds - reinvested profits plus capital utilization allowances - and funds provided by outside savers - debt and equity. This pattern is then compared to existing patterns in more developed countries and is found to be similar as far as the proportion of financing by banks is concerned. An attempt is also made to weigh short-term vis-a-vis long-term credit financing. Here Latin America tends to have a disproportionate share of short-term financing. probably as a result of high and fluctuating inflation rates.

The Indian survey, taking advantage of a wealthier stock of data. describes not only the broad financing patterns of manufacturing enterprises but analyzes more in detail various financial instruments used to finance industry. This analysis leads the author to suggest possible improvements.

Sophisticated variants of term loans convertible into equity are proposed for consideration. The idea is to find ways of circumscribing the right of conversion which, in the eyes of borrowers, appears as a major drawback.

Follow-up procedures are judged to be burdensome for the successful enterprises and ineffectual in the case of non-compliance of the loan agreement. New procedures are suggested to improve this situation.

Underwriting operations as applied in India are found not to be conducive to an efficient use of resources by the borrowers. It is, notably, suggested to replace underwriting by a loan bearing a nominal interest.

A combination of participative debentures and convertible debentures is expected to give well managed, profit-earning companies considerable flexibility in re-moulding their capital structure to suit their projected investment programmes.

Company deposits are funds obtained from directors or shareholders or employees of the company and also from other companies and individuals in the form of interest bearing, unsecured, short and medium term deposits. To protect depositors legal curbs are imposed on such deposits. It is found that risks are lower than average with manufacturing companies and it is consequently suggested to make a distinction between manufacturing enterprises and the other companies subject to these curbs.

Background factors

A common feature of the four surveys is the importance given to background factors in explaining the performance of financial systems. Background factors include inter-alia inflation, depreciation rules, tax incentives, accounting systems, financial policies, etc. All the mentioned factors are reviewed by the surveys but one of them is given particular attention. It is the policy (henceforth called "financial repression") identified as a policy of low interest rates leading to allocational inefficiency, decline in domestic saving, market segmentation and disintermediation.

The Latin American paper concentrates on the financially repressive context that emerged in the aftermath of 1973 when current inflationary pressures tended to increase considerably. Inflation was fought by imposing maximum interest rates and controlling the purposes of financial loans. But in real terms the interest rates became negative and this, according to the author of the survey, acted as a disincentive on financial saving and an excess of demand for loans was created. Thus, various systems and methods were successively implemented that aimed at rationing credit. In this context of rationing, the projects for which credit was obtained were not necessarily those bringing high social benefit but those which by tradition, age, size, social and political "connections", etc. came within the "guidelines" for credit rationing. To make progress, projects outside these guidelines naturally had to be based on self-financing or on access to non-institutionalized financial markets. The resultant range of financial costs according to whether or not subsidized credit had been obtained necessarily led to a low level of investment, a poor apportionment of resources and a lower rate of economic growth.

The function of the financial system

Collection

The studies reveal that in virtually all the countries surveyed there is room to mobilize more financial savings than what is actually done. Admittedly, in poor countries little can be done in the short term to enhance the total saving effort. However, a larger proportion of saving could be entrusted to industrial investors provided primary saving would accrue to a fund of uncommitted resources available for long-term investment. But this does not happen because savings tend to be realized in a form which is not freely transferable to long-term investment uses. The surveys shed light on this unused potential for industrial finance by pointing to two aspects of saving encountered in almost all the countries surveyed.

First the surveys report that as compared to developed economies only a modest proportion of total saving is held in financial assets: for instance 39 per cent in Bangladesh, 45 per cent in Malaysia, 33 per cent in Thailand.

Second, the financial assets held in the countries surveyed are generally of a type which is not suitable for subsequent long-term lending. It appears that these assets tend to be in the form of currency or sight deposits, or in deposits with the post office or entrusted to insurance companies. But money and quasi-money are not suitable for long-term credit, postal savings are offset by post-office holding of government and foreign securities, while insurance companies tend to acquire real estate or existing financial assets rather than to support new productive activities.

Time deposits, which in industrialized countries are the main contribution of households to the pool of investible resources, are negligible in most developing countries. In any case their maturity is not much longer than that of sight deposits. In the Southern Cone of Latin America, for instance, time deposits are, in over 80 per cent of the cases, for periods of less than 30 days.

Noting that a potential exists, the surveys suggest a number of measures that could be taken to attract more funds into financial forms suitable for lending to industry. Some of the measures are indirect ones. These include all the actions tending to increase the monetization of the economy. It is a well established law that as the ratio of money to income rises the ratio of all financial savings to income tends to rise more rapidly. In African countries the community's assets in the form of money and quasi-money are a remarkably low proportion of GNP as compared to industrialized countries (typical ratios would be 0.25 for African countries against 0.60 for industrialized countries). Thus, accelerating monetization in Africa would have the side-effect of increasing the source of funds suitable for financing industry. Another set of indirect measures relate to maintaining monetary stability. Money denominated assets are eroded when the general level of prices is rising. Once serious inflation emerges savings tend to divert from financial form into land, building and other durable assets that are not readily convertible to money.

More direct measures to encourage financial savings would include the development of institutions collecting fixed-term deposits. Provided deposit interest rates would rise with the maturity of deposits these institutions could attract savers and have a positive effect on the supply of long-term funds. This effect should not, however, be over-emphasized because in the countries surveyed most asset holders, used to the recurrence of inflationary bursts, seem to have a desire for liquidity which is insensitive to interest rates. In Latin America it has not been possible to alter this preference for liquidity even by indexing methods with real rates of over 12 per cent per year.

Funding the DFCs is another way to increase the supply of long-term funds. In order to promote investment, official regulations usually confine the DFC's to the lower end of the spectrum of lending rates prevailing in the country. The DFCs are consequently unable to raise significant resources on commercial terms. Hence the resources are provided by government transfer or through obligations imposed on the banks to keep part of their deposits and loan portfolios as non-interest bearing reserves with the Central Bank. This flow of resources is then channelled by the Central Bank to the various DFCs.

Additional resources at concessional terms are often made available from foreign sources (the World Bank, the regional development banks, special lending institutions of developed countries). Sometimes long-term borrowing from foreign private sources is also possible.

A common technique for giving the specialized credit agencies some independence in resource availability is to assign them rediscount facilities with the Central Bank or with ad hoc trust funds. The Spanish system of requiring banks to include bonds of other development institutions in their required reserves is mentioned as a model that might be more widely adopted.

Transformation

In most of the countries surveyed the shortage of long-term capital is greater than that of short-term capital. There is thus a case for encouraging maturity transformation.

The survey of Africa notes that, since the Central Bank's rediscounting policies have to be taken into account by the commercial banks seeking funds for onward lending to their clients, Central Banks can influence maturity transformation in countries where they are net lenders to commercial banks. As this is the case in Africa, long-term finance can be encouraged in this region by specific Central Bank rediscounting policies

Noting that banking legislation is frequently biased against long-term lending the African survey suggests that a more passive but perhaps more effective means of stimulating maturity transformation would simply consist of relaxing restrictive requirements for refinancing by Central Banks and widening banks regulatory requirements.

Commercial banking legislation overemphasizing liquidity requirements have been found to inhibit long-term assets. A re-examination of this legislation and the introduction of

German-Japanese concepts, more oriented towards venture capital, are recommended.

Similarly, insurance institutions could commit a larger share of their resources to long-term investment if they were released from "liquidity requirements" that make them captive markets for government deficit financing.

Even if legislation is not a hinderance financial institutions will tend to restrict long-term loans when funded on short-term deposits because there are interest rate and liquidity risks implied in the imbalance between the spans of deposits and loans.

The method which is being attempted in Argentina to encourage the development of a long-term market in spite of these risks is outlined in the Latin American paper. To protect financial institutions against the interest risk long-term loans are indexed to the cost of short-term money with the help of a new index-linking method which is supposed to be more stable than the method based on the inflation rate. This new system is based on the determination of the effective monthly rate paid by the financial institutions on 30 day deposits, weighed according to each institution's share of the total deposits in the financial system.

The second problem which arises when a bank makes long-term loans with short-term resources is the risk of a contraction in deposits due to a fall in the demand for money as a result of a contraction of the monetary base. As an example of a possible solution it is reported that the Central Bank of the Republic of Argentina has recently established a four year rediscounting system intended to lower the liquidity risk.

Allocation

The pattern of lending to various sectors resulting from the role assumed by financial institutions can affect the financing of industry to a considerable extent.

In support of this statement it has recently been held that the role of financial institutions is decisive in explaining why Japan directs about 50 to 70 per cent of her financial saving to long-term industrial credit while in the case of the United Kingdom the same ratio is only about 20 per cent.[1/] The difference, it is said, is basically due to the fact that in the United Kingdom financial institutions are much more oriented to consumer credits and real estate mortgages. This contrast suggests the theoretical possibility for the United Kingdom to double or treble the flow of long-term industrial credit not by increasing her saving effort but by re-designing the modus operandi of her financial institutions.

The surveys convey a similar message: there is room for increasing industrial finance in developing countries by setting new roles for the financial institutions.

It appears, however, that a significantly fruitful reform would demand a considerable array of measures, some of them directed at forces outside the financial system itself.

To start with there is the challenge of creating a stable money-and-price environment. This would be the prerequisite for attracting savings in time deposits of over, say, one year. Furthermore, the pattern of interest rates offered should be shaped so that time deposits would be inflation-proof and more rewarding in real terms than short-time deposits. Laws and customs biased against long-term loans should be removed. Finally the financial

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1/ See Carrington, J.C., and Edwards, G.T., op. cit., P.163.

institutions, particularly the banks, should be encouraged to provide industry with term finance.

It is clear that a programme so decidedly oriented towards industrialization supposes that demand for industrial funds will increase correspondingly with supply. This cannot be taken for granted. Underdevelopment means that a number of adverse factors are affecting the level of real investment that an economy could absorb, particularly in the industrial field. Some of these factors can be neutralized by cheaper and less scarce finance, but not all of them. Finance is needed to put together the men, machines and other inputs needed to implement a project. But this presupposes that an attractive project exists and that access to markets and real factors of production is not constrained by non-financial rigidities. It would be only in a very outstretched sense that qualified manpower, market entry, efficient administration, to mention only a few examples, could be considered as constrained by financial scarcity.

The question of the demand for industrial funds would not matter so much if there was not a trade-off between welfare (for instance more housing for the poor) and growth as well as between sectors of activity (for instance agriculture or energy versus industry). In non-oil developing countries redeploying funds to industry is likely to crowd-out other uses. If some harmony between alternative uses is not respected there is a danger of bringing about social unrest or economic imbalances damageable to the whole process of capital accumulation.

FINANCING OF MANUFACTURES IN AFRICA 1/

INTRODUCTION

"...they (that is, the African countries) draw a number of conclusions, including:

....

(c) the urgent need for each country to adopt a national development policy based, above all, on using its own resources;

(d) the urgent need to implement a plan for the collective industrialization of Africa based on the concept of self-reliance." 2/

"The most urgent need is for the programme of large-scale transfer of funds from North to South to be stepped up substantially from year to year...Such an effort will benefit the South and turn back the rising tide of world poverty." 3/

Any discussion of a rapid acceleration of African development, including the expansion of industrial output, must recognize that, if the poor residents of Africa are to approach even the median standards of income in the rest of the world, international cooperation, as envisaged by those who favored the dialogue that might have been stimulated by the "Brandt Report", is essential. Yet, cooperation is a mutual rather than a unilateral process. The essentiality of international cooperation is a major (frequently assumed even if unstated) theme of this essay. It, however, directs attention not on what the rest of the world should do for Africa, but on what Africa might do for itself.

Therefore, attention is directed to the problem of ensuring that surplus funds generated within the African economies are reinvested in the region, and, to the appropriate degree, invested in industry. Specifically, the steps required for the "creation of financial institutions which offer such terms and conditions as to promote industrial development and take account of the special features of emerging sectors" are considered. 4/

I. THE BACKGROUND

The Basic Problem

The fifty-three African countries north of the Orange, Molopo and Limpopo rivers (but including Lesotho and Swaziland) comprise a heterogeneous semi-continent. In some respects, the countries of the Mediterranean litoral differ from the rest of Africa. Yet, while Algeria, Morocco and Tunisia are classified by the IBRD as "middle income" countries, the wealthiest of them (Algeria) is only at the middle of this range (Libya, with its oil wealth is a special case), Egypt and Ghana fall on the borderline (in the IBRD's classification) between low and middle income. For the rest, all of the sub-Saharan countries except the Ivory Coast, Liberia, Nigeria and Zimbabwe are "low income" countries. At the same time, the rate of progress has been slow. While the low income countries were growing, in annual per capita terms, at an average rate of 1.6%, only 11 of the African countries attained this average (See Table 1.1) 5/ 6/

Part of this low rate of progress can be explained by disappointedly low rates of saving and inadequate inflows of capital on terms satisfactory to the residents of these countries. Most of the African countries have savings ratios below the average of 25% that is typical for middle income developing countries. 7/ Consequently, only limited resources are available for the expansion of output. Further, the negative or low growth rates in several of the countries with relatively high savings ratios indicate that the resources made available for domestic investment are not always being used in ways that could maximize economic progress.

Table 1.1: SELECTED AFRICAN COUNTRIES: SAVINGS RATIOS (1978) AND PERCENTAGE RATE OF GROWTH IN GROSS NATIONAL PRODUCT (1970 - 1977)

	Average Percentage Change in Gross National Product Per Capita	Gross Domestic Saving as Percent of Gross Domestic Product
I. Countries with declining GNP per capita		
1. With negative savings		
Chad	-1.0	-7
Mozambique	-4.3	-1
2. With low savings 1/		
Ghana	-2.0	6
Sierra Leone	-1.3	9
Somalia	-1.1	2
Mauritania	-0.1	7
3. With high savings 2/		
Madagascar	-2.0	21
Niger	-1.8	12
Zaire	-1.3	12
Zambia	-0.2	31
II. Countries with low growth rates of GNP per Capita 3/		
1. With low savings 1/		
Ethiopia	0.2	6
Rwanda	1.3	4
Mali	1.9	5
Tanzania	2.1	7
Sudan	2.5	2
2. With high savings 2/		
Kenya	0.9	18
Cameroon	1.0	21
Ivory Coast	1.1	30
Algeria	2.1	37
Malawi	3.1	16
III. Countries with high growth rates of GNP per Capita 4/		
Morocco	4.2	11
Nigeria	4.4	28
Egypt	5.2	14
Togo	5.3	14
Tunisia	6.5	20

1/ Arbitrarily assumed to be less than 10% per year. It would be desirable to compile a zero net savings ratio as the separation point between high (that is postive) and low (that is negative) savings ratios. Such a compilation would be the product of population growth, marginal output/capital ratios, and depreciable lives of investments in each country and would differ from country to country . Even if it were purported that adequate data existed for such calculations they would be too imprecise to make precise calculations possible.

2/ Arbitrarily assumed to more than 10% per year.

3/ Assumed to be lower than the average rate of growth for middle-income developing countries (3.7%).

4/ Assumed to be higher than the average rate of growth for middle-income developing countries.

Source: IBRD, World Development Report, 1980 and World Tables, Second Edition (1980).

The Autonomy of a Developing Country

Even if the realistically available savings in a poor country are deployed most effectively they will be inadequate to finance the investment that is a prerequisite for a satisfactory rate of growth. Foreign resources in the form of grants or concessional or other credits are essential if the low income countries are to achieve an adequate increase in the levels of per capita income. Yet, again, any resources transferred to developing countries will only contribute to growth if they are deployed effectively.

Accountancy 8/

The recognition of opportunities and the assessment of results as a background for decisions on future action are prerequisites for the essential deployment of resources. Many of the low output/capital ratios observed in developing countries reflect failures to identify depreciation and labor opportunity costs. It follows that the development, and an acceptance, of accounting techniques should be given high priority as part of any plan for industrial development, so that:

(1) entrepreneurs (and bureaucrats) may identify productive investment opportunities and determine the prospects for an expansion of their activities;

(2) financial institutions may assess the prospects for repayment, or continuing income with capital maintenance of new and expanding enterprises.

This development of accountancy is particularly relevant to the encouragement of industrial financing. As discussed below financial institutions are a major source of credit for expanding businesses. In a sense, these financial institutions are trustees for those who place funds (for example, deposits) with them. They cannot lend to borrowers unless the borrowers indicate that it is likely that they will be able to repay their debts. This means that they can indicate that a project's cash flow will include a reasonable provision for repayment. 9/ Appropriately constructed accounting records are essential for these indicators (some of the specific problems in the allocation of gross receipts are discussed below).

For small scale manufacturers, in particular, the creation of accounting records is frequently difficult and calls for a type of skill quite different from that required for the identification of opportunities for profitable investment and the establishment of manufacturing facilities. In many cases, lenders seeking creditworthy borrowers may have to undertake the basic accounting allocations in determining the viability of projects, or, more frequently, the prospects for expanding small scale established operations. Steps to improve accounting practices, such as the training of accountants operating as business advisory services may contribute to the efficiency of any economy. The development of sympathetic small- and medium-loan departments in lending agencies, often government sponsored agencies, may be even more important, particularly where the manufacturing development process is largely the expansion of already established businesses.

Monetary Stability

Any programme directed to the acceleration of industrial development to a rate higher than that which might be reached without policy encouragement will not be easy to implement even if domestic prices are rising at a reasonable rate, and, hence relative prices are altering by tolerable amounts. If the general price level is rising rapidly, with the consequent large shifts in relative prices 10/ it becomes more difficult to encourage investment in those areas where social productivity is high rather than in those areas where short-term private gains are greatest.

Inflation may have relatively little effect on a small scale entrepreneur, he cannot afford to accumulate large stocks of raw materials and make a profit from costing them at replacement rather than historic cost, his output prices may reflect little more than increasing current costs. The large scale entrepreneur may do better. However, a true speculator such as some of those in Alexandria, Cairo, Kinshasa, Lagos, Maputo, Nairobi, and Salisbury, may benefit dramatically from rises in land prices. Investment in urban and agricultural land becomes the road to riches. The energy that might go into the search for manufacturing opportunities goes into exploration for potentially profitable sites. Similarly, the profits to be made from holding inventories associated with trade come to outweigh those to be made from the conversion of materials through manufacturing. Commerce benefits at the expense of industry.

As yet, there are few opportunities for the majority of the population to acquire assets, other than housing and land, for protective purposes that are not denominated in money. Only a few can effectively acquire foreign exchange—and they do so. Money denominated assets (money itself, deposits with banks, savings banks, or credit cooperatives) all decay in constant price terms during an inflation. This erosion may, for a while, have the perverse effect of encouraging saving 11/—but only for as long as inflation remains relatively mild. Once serious inflation emerges, saving in financial form evaporates and the opportunity for domestic financing of industry is dissipated. At the same time, foreign investors are likely to avoid the pitfalls of inflation with the consequent exchange rate depreciation.

A low rate of inflation may stimulate entrepreneurial activity. 12/ Beyond a certain point, already exceeded in many African countries inflation can only divert resources away from entrepreneurial investment. It is significant that for the very high inflation rate countries in Table I.2 manufacturing production declined in the 1970s. The containment of inflation may be regarded as the foundation element for a set of policies designed to stimulate investment in manufacturing.

Relative monetary stability will not ensure that manufacturing investment will prosper. It is only a prerequisite for this prosperity.

The Role of Finance

The basic function of finance

Any economy may be roughly divided into those units that tend to save more than they invest and those that tend to invest more than they save. 13/ In general, manufacturers, particularly those that are expanding, tend, at certain stages of their development, to invest more than they are able to save. In most cases, the acquisition of adequate physical capital is beyond their current saving potential. They are required to borrow in order to acquire the capital necessary for their operations. A village blacksmith may just be able to build up his capital. Most agricultural equipment repair shops (for example, tractor garages) must borrow or lease (that is the same thing) if they are to provide the necessary service. So the process develops. Usually, a construction contractor is profitably in debt. Any multinational corporation is heavily indebted.

At the same time, most members of the community wish to save. Some,

Table I.2: AFRICAN COUNTRIES: AVERAGE ANNUAL INFLATION RATES AND AVERAGE ANNUAL RATE OF INCREASE IN MANUFACTURING OUTPUT, 1970-1978

	Inflation Rates	Rate of Increase of Manufacturing Output
Ethiopia	4	1
Guinea	6	9
Zambia	6	1
Egypt	7	8
Morocco	7	7
Tunisia	7	11
Chad	7	6
Senegal	8	4
Malawi	9	7
Upper Volta	10	2
Madagascar	10	-
Liberia	10	9
Cameroon	10	5
Burundi	10	5
Mauritania	10	3
Congo	11	2
Sierra Leone	11	5
Mozambique	11	-6
Kenya	12	12
Lesotho	12	9
Tanzania	12	4
Algeria	13	7
Ivory Coast	14	8
Nigeria	18	13
Angola	22	-13
Zaire	26	-1
Uganda	27	-5
Ghana	36	-6

Source: IBRD, *World Development Report*, 1980 who are very poor cannot save (to suggest that a resident of the Sahel saves is ludicrous—his family would starve), but most of those who have risen above subsistence levels try to save. Entrepreneurs' tend to direct their savings to the acquisition of some of the physical capital that they use. For most individuals, however, saving for housing (often in the form of mortgage repayments) and financial savings, either in the form of currency hoards or balances with financial institutions (possibly in the form of balances with cooperative societies) are the only forms of savings readily available to them.

A financial system performs a major role because most savings take forms that are largely limited in response to asset holders' desires, while borrowers wish to accept quite different forms of liability. Most individual asset holdings or savings flows are relatively small, while most debts are relatively large (even an individual who saves in the form of mortgage repayments has a small annual flow of saving compared to his relatively rare mortgage borrowing). Savers wish to acquire liquid assets or claims with some protective value (life assurance policies, claims on pension funds, etc.) Borrowers wish to accept illiquid fixed commitments (often on terms related to the life of the investment that these finance).

<u>The role of financial institutions</u>

The financial aspects of industrialization policy relate primarily to the bringing together of net lenders (those who save more than they invest) with net borrowers (those who invest more than they save). In a [illegible] planned economy, this conciliation of borrower and lender desires is a bureaucratic problem. On the other hand, when even a reasonably small proportion of the community is granted freedom to choose between different types of financial assets, and where some borrowers are free to choose between alternative sources of finance, the efficiency of financial markets becomes an important element in the efficiency of the allocation of savings among alternative investment opportunities. In some of the more esoteric literature, it is assumed that primary security markets perform this function with minimal transactions costs. In practice, it is generally performed by financial institutions. 14/

If financial institutions offer a range of assets to lenders on reasonable terms, the lenders have freedom to distribute their savings between self-investment, direct loans to entrepreneurs, and obligations of financial institutions. If, at the same time, these institutions are free to extend credits in response to borrowers' desires, they can tailor their financing to the requirements of industrial and other investment. Other things being equal, the more competition there is among borrowers to bid for credit the greater will be the power of profitable investors to acquire funds for expansion and the greater will be the returns to savers. That is, the wider the range of borrower-lender transactions that pass through financial institutions, the greater the probability that the community's savings will be devoted to highly productive enterprises.

This general argument should be accepted with some reservations. Some investments have greater social benefits than those that are apparent to private individuals: some have social costs not borne by private investors. Here there is a case for government intervention by direct investment, subsidies, or taxes. Some plausible financial intermediaries lack integrity and their promises are not fulfilled. Here, there is a case for government supervision of intermediaries. Some financial institutions profit from monopolistic positions. Here, there is a case for extending competition among financial institutions.

Yet, on balance, the greater the freedom given to financial institutions to compete in a given economic climate, the more cost-effective are financial relations likely to be.

Financial Repression

Limits on interest rates are frequent elements in national regulations. In a world of stable prices and extreme inequality in income distribution there are good reasons for limitations on interest charges. Similarly, they may be relevant where there are severe limitations on entry into banking.

However, even with limits on entry into banking, usury laws (as distinct from requirements that borrowers be informed of the real cost of debt) lead to a substitution of personal rationing for market allocation of capital.

It is frequently argued that small borrowers can not bear the cost of high interest rates and must be helped over this cost barrier if they are to succeed. This argument fails to recognize that markets allocate a given supply of capital among competing users. The allocation may be based on the prospective profitability of investment as seen by borrowers and lenders, or it may be allocated by the personal whim of those who control its supply. A good case can be made for taxing privately profitable but socially low-priority investment (luxurious housing and other real estate speculation).

Unfortunately, interest rate ceilings are seldom joined to this type of taxation and the large (low transaction cost) borrowers are able to borrow at limited rates, while the smaller industrial (high transaction cost) borrowers have to compete with the speculators. Even among industrial borrowers, the large multinational corporation with a foreign guarantor is likely to have an advantage over the smaller local entrepreneur. When the demand for capital is high, limits on lending interest rates do not protect the small borrower. They create a barrier that he cannot overcome.

There is a convention, sanctified by Keynes, 15/ that the long-term cost of risk-free capital should approximate 2.5% per year, and interest ceilings have tended to be set with this target in view. This target evolved out of the worlds of Wicksell (the 1890's) and Keynes (the 1930's) when prices were falling. It is to be hoped that the 1980's will not be marked by the inflations of the 1970's when African prices tended to rise by over 10% per year. But, if stable-price risk-free capital should be expected to earn 2.5% net of losses arising from inflation erosion, the current minimum nominal return should be approximately 12.5% per year. If transactions costs on medium size industrial loans are set at a reasonable figure of 2.5% per year, the risk-free cost of capital should approximate 15% per year. Any allowances for risk would lead to higher market rates.

Lenders are, in a sense, trustees for their depositors and cannot lend to risky borrowers (there is a certain risk in loans to the most respectable ingenious entrepreneurs) without some insurance allowance. If an interest rate limit is to be a ceiling, and not a floor, some loans to innovative entrepreneurs should be made below it. Therefore, for the immediate future any ceiling of less than 20% per year is likely to be a barrier to development rather than a protection for small entrepreneurs.

Interest rate data are among the most unsatisfactory of financial statistics for most countries. The African data are little worse than those for other areas. The data in Table I.3 must be accepted with caution. They record the stated lending rates by commercial banks for those countries for which these statistics are published. In many cases, commitment fees, insurance charges, etc. may be added to stated borrowing charges. Even allowing for such charges, it seems clear that, in a number of African countries, at least, bank lending charges are very low. In several instances, bank charges appear to be lower than inflation rates. That is, borrowers are charged a negative constant-price interest rate. Borrowers who contribute no value added through the transformation of products from one stage of processing to another are able to compete for funds with those who contribute value by manufacturing.

More complete statistics are available on central bank discount rates. These record the rate at which deposit-money banks can obtain funds (often within quantitative limits) for relending to their clients. Here, the contrast between nominal and constant-price interest rates becomes dramatic in many instances. In most of the countries for which data are readily available, the banks have been able to borrow on terms that are negative in constant price terms (Table I.4). This assumes that they are able to lend at less than market-equilibrium rates. Personal rationing must have replaced market criteria in the allocation of funds for industrial as well as other development.

Table I.3: SELECTED AFRICAN COUNTRIES, COMMERCIAL BANK LENDING RATES AND INFLATION RATES

	Commercial Bank Lending Rates /1	Average Inflation Rate 1970-1978 /2
The Gambia	12.0 - 13.0 /3	6
Ghana	11.5 - 12.5 /4	36
Libya	7.0 - 7.5 /5	21
Malawi	11.5 - 12.0 /6	9
Mauritius	10.0 - 14.0 /7	...
Morocco	4.5 - 11.0 /7	7
Tunisia	6.5 - 8.8 /4	7

/1 Source: Central Bank Bulletins of the countries concerned.

/2 IBRD World Development Report, 1980.

/3 December 1979.

/4 December 1977.

/5 June 1978.

/6 December 1979

/7 December 1978.

Table I.4: SELECTED AFRICAN COUNTRIES: CENTRAL BANK DISCOUNT RATES, AND INFLATION RATES

	Discount Rate End-1979 /1	Implicit GDP Deflator (1970-1977) /2	Difference
Benin	8.0	7.8	-0.2
Egypt	9.0	6.9	-2.1
Ghana	13.5	30.9	15.4
Ivory Coast	8.0	13.6	5.6
Malawi	8.0	8.8	0.8
Madagascar	5.5	9.7	4.2
Mauritania	5.0	10.8	5.8
Mauritius	10.5	17.9	7.4
Morocco	4.5	7.3	2.8
Niger	8.0	10.6	2.6
Nigeria	5.0	18.1	13.1
Rwanda	9.0	15.1	6.1
Senegal	8.0	8.6	0.6
Togo	8.0	7.8	0.2
Tunisia	5.8	7.4	1.6
Upper Volta	8.0	8.9	0.9

/1 Source: IMF, International Financial Statistics.

/2 Source: IBRD, World Tables 1980.

On the other side, interest ceilings on lendings are frequently associated with limits that may be paid on deposits. Savers can choose to entrust their funds to financial institutions, that will agglomerate them for industrial development, and see these precautionary balances eroded by inflation; or they may choose to entrust them to cousins or others who are ready to pay market-reasonable rates. Retained earnings and borrowings from relatives have always been a source of finance for small enterprises and should not be discouraged. Yet, they should be alternative channels of finance to more generalized financial institution channels. They should not be channels actively encouraged by interest rate regulations.

It is often argued that interest rates have little effect, and even that their effects may be perverse, on saving. This is probably true. Yet comparable interest rates can have strong effects on the distribution of saving. If, as argued above the conglomeration of saving in the financial system, and its allocation on market criteria (subject to appropriate social incentives) is likely to maximize the social returns to a community, financial institutions should be free to compete for the savings if they are relatively free to compete in the lending markets.

It would be unrealistic to propose a pure libertarian approach, freeing all financial institutions (often oligopolistic groups) from interest rate restraints to which individual non-financial economic units had adjusted over perhaps lengthy periods of time. Yet, if resources are to be directed to their most productive uses, any freeing of financial institutions from usury restraints, will be likely to work in the direction of a more market oriented direction of resources.

In brief, interest ceilings, that are usually intended to protect the struggling entrepreneur from rapacious usurers frequently become barriers that struggling entrepreneurs cannot cross. Much has been written regarding the repression of financial institutions in developing countries, 16/ yet the plea for financial freedom can not be repeated too often.

Government Financial Policy

Government intervention to stimulate investment can take the forms of regulation, taxation and subsidization, or direct financing. Only the latter channel is of direct concern here. Yet its examination should be set in a proper context. If governments borrow to cover current outlays, they impose a drain on the community's savings that are diverted from possible physical investment to the covering of consumption and similar expenditures. In these cases, the resources available for investment are reduced. It follows that governments, desiring to encourage investment, and contain inflation, should attempt to, at least, balance their current receipts and expenditures.

However, governments can adopt a more positive approach. If a government's lendings are equal to its fiscal deficit this involves a diversion of savings to ends that are considered to have a high social value, and may accelerate the speed of development. It should be remembered, however, that in such cases, other investment can be crowded out. If a government's lendings exceed its overall fiscal deficit, the government is adding some tax revenue to the net savings that would otherwise take place (unless additional taxes are fully matched by decreased savings). In this way the process of development becomes accelerated, provided that government investment expenditures are directed to economically efficient ends.

Conclusion

It follows that there are several heads under which industrial financing problems may be examined. These may be conveniently ordered as

(1) Influence on financial institution development.

(2) The role of government financial policy.

(3) The relation between domestic and international financing.

II. Financial Institutions

The Structure of Institutions

Financial institutions are more than passive recipients of funds that are casually made available to borrowers. They are active seekers of borrowers, and institutional lending creates credits that are spent by borrowers and become assets to their holders. Banks are the clearest examples of these asset (in this case, money or quasi-money) creating institutions. Financial institution liabilities are liquid assets for the community, and changes in community liquidity are important determinants of an economy's demands (including demands for investment goods and foreign resources) that influence the levels of income and prices, as well as further investment demands. Hence, there is a circulatory to financial operations; institutional lending creates assets that are entrusted to institutions, whose reactions further influence the level of credit.

For all countries, but particularly for developing countries, it is convenient to classify the financial institutions as banking (that is monetary or quasi-monetary) or other financial institutions. For certain purposes it is also convenient to separate governmental institutions (that are established to influence the course of development so that it differs from that which would be experienced in the absence of government influence) from other usually (but not necessarily) private institutions.

The Banking System

The role of the banking system

The banking system (including, inter alia, government currency issues, central banks, deposit-money banks, 17/ savings and similar banks, 18/

and deposit accepting activities of post-offices) are typical financial intermediaries; and, in many African countries, the most important. Money and quasi-money 19/ are the most important liabilities. Money is one of the first of the financial assets to be held as an economy progresses from being very poor to being less poor, and the ratio of money to income tends to reach a peak at a rather advanced stage of development. 20/ Further, as an economy progresses, asset holders shift the distribution of their holdings towards other forms of financial asset (such as life assurance policies, etc.). Hence a low level of money relative to income, by itself, indicates a low level of financial saving; but as this ratio rises, the ratio of all financial saving to income tends to rise more rapidly.

In many African countries, the community's assets in the form of money and quasi-money are a remarkably low proportion of GNP (Table II.1). McKinnon 21/ observed typical ratios of 0.60 for the industrialized countries, and of more than 0.70 for rapidly growing developing economies (Singapore for instance. In most African countries the banks do not have resources to lend for industrial development on a large scale. This is one aspect of the problems associated with accelerating the pace of development in poor countries. t, the very paucity of available funds makes it even more important that they be allocated to the most productive ends.

Table II.1: SELECTED AFRICAN COUNTRIES: MONEY AND QUASI-MONEY AS PERCENTAGES OF GROSS NATIONAL PRODUCT

(1973-1977 Averages)

Mauritius 1/ 2/	16
Gabon 1/	17
Zaire	17
Uganda 1/	18
Sierra Leone 3/	19
Cameroon 1/	21
Malawi 4/	22
Benin 1/	23
Sudan 1/ 5/	23
Madagascar 1/ 6/	25
Ghana 1/ 5/	26
Senegal 1/ 3/	26
Togo 1/ 5/	26
Tanzania	30
Ivory Coast 1/	32
Zambia 6/	37

1/ As percentages of gross domestic product.
2/ 1975-1977 averages.
3/ 1974-1978 averages.
4/ 1975-1979 averages.
5/ 1973-1976 averages.
6/ 1973-1978 averages.

Source: IMF, International Financial Statistics.

It is true that many poor people can not afford to hold financial assets. Yet, any extension of opportunities to hold such assets should, to some extent, encourage their accumulation. Increased monetisation of any economy involves private accumulation of financial assets, that is, increased saving. It also involves the entrustment of general community saving to investment credit specialists. Hence, it should not only make the funds available for industrial and other investment larger, but it should increase the efficiency of their allocation.

The Central Bank

The deposit-money banks are important not only as direct intermediaries, but prudential considerations require most other financial institutions to maintain reserves with the deposit-money banks. Hence, deposit-money bank expansion exercises an influence on the entire financial system. These banks, in turn, are dependent on their central banks. In many African countries, particularly where the currency circulation is a large part of the total money stock, the commercial banks are, very largely, channels for the transmission of central bank credit to the non-banking sectors of the economy.

Hence, monetary policy is very largely central bank policy. In a number of instances, the obligation of the central bank to meet the government's budgetary requirements limits the freedom of the central bank to initiate policy. However, this is not a limitation in those countries where the central banks is a net lender to the deposit-money banks.

In most African countries, the deposit-money banks are now importantly indebted to their central banks. 22/ This central bank-commercial bank creditor relation is an important element in most effective systems of central bank influence over the commercial banks. The central banks' conditions for credit extensions to the commercial banks are important determinants of commercial banks' policies towards their clients. If central banks will only lend against the collateral of certain types of commercial bank assets (for example treasury bills or ninety-day export bills), the commercial banks will offer preferable terms for these types of paper. If central banks are prepared to lend on the basis of the general solvency of commercial banks assets, the commercial banks will be more competitive in their own credit policies and more willing to embark on their important intermediation roles. Hence, central banks should look to the solvency of a bank's assets—and this may mean the solvency of a client's balance sheet—rather than to the formal nature of a client's paper that is offered as security for central bank credit.

While central bank preferential discounting policies can influence deposit-money bank lending policies, these influences should not be overestimated. Banks have a wide range of assets, and unless they rediscount almost all of their assets, they have choices regarding those that will be offered as collateral for central bank credit. Therefore, for example, if a central bank limits its rediscounts to advances on short-term commercial bills, unless the banks are required to hold a minimum proportion of their non-discounted assets in such bills, banks desiring central bank credit will offer these types of bill as collateral for central bank credit. These credits may then be utilized to meet the bank's general portfolio desires. Therefore, a central bank policy of giving preference to industrial credits in its rediscounting policy could have a much greater effect on the choice of paper offered as collateral for central bank loans than on the distribution of bank credit among competing demands.

Similarly, the statistical classification of bank credit is not unequivocal. Industry needs credit for long-term investment and for working capital. If commercial credit is given preference by bank supervisory authorities, suppliers to industry and merchants disposing of industrial products, both of whom may give trade credit to industrial entrepreneurs, will be favored; and inventories will be in a preferred position compared to long-term investment. Obviously, if long-term investment is favored, the entrepreneurs will be in a preferred position. In either case, there may be very little effect on the final uses of bank credit.

However, small effects are effects. The Anglo-American tradition has been one of favoring commercial as distinct from long-term credit. The inflations of the last quarter-century have encouraged the extension of credit for investment in marketable real estate rather than investment in manufacturing enterprises that can only be amortized over a number of years. 23/ Restrictions on lending for real estate speculation 24/ can shift bank portfolios into other types of asset, including industrial development and bank supervisory authorities should consider these as an element in industrial development strategy.

Directives regarding preferences that should be given to particular types of industrial development also face the problem of fungibility of credit. Many African entrepreneurs are engaged in a wide range of activities. It is not uncommon for an individual to be a large landowner (by African standards), an urban real estate speculator, an industrial entrepreneur, a merchant, and (perhaps) a civil servant. 25/ In all these activities he is dependent on bank credit. His banker, willing to lend to him, will statistically allocate any credits to those of his activities that are favored by regulatory directives. If industrial investment is fostered the maximum amount that a bank manager can allocate to his industrial activities will be classified as investment in industry, even though it is understood that any marginal accretion to the borrower's funds will be used for real estate speculation. It follows that specific provisions regarding central bank

rediscounting policy, or directive regarding the statistical classification of bank assets for strategic development policy objectives, must be adopted with extreme caution.

Yet, an Anglo-American tradition regarding responsible bank lending policies persists in many African countries. This discourages investment in the long-term finance of industrial development. Any positive actions to encourage this type of investment are likely to have less effect than might be apparent immediately. A relaxation of restrictive requirements for central bank refinancing and a widening of bank regulatory inspection requirements might be more effective. That is, a move towards a more permissive (and less restrictive) attitude to deposit-money bank activities could have a positive effect in the encouragement of industrial investment.

In many countries, particularly those with a large proportion of their exports in the form of primary commodities—a structural aspect of many African countries—foreign current account receipts tend to vary markedly from year to year. There is also some tendency for private international credit to be more readily available in years when domestic prosperity, based on high export incomes, is attractive than in years when the outlook, taking a short-term view, is less propitious. This means that the international reserves of the banking system tend to fluctuate markedly with changes in short-term export fluctuations. Consequently, in the absence of central bank stabilizing policies, the liquidity positions and the lending freedom of the banking system tends to vary markedly with changes in the banking system's foreign reserve position. If the economic system operated without lags this would raise few problems. However, any system has a large number of lagged relations. Thus, if banking system reserve assets increase markedly, banks will tend to expand loans rapidly. After a period, the expanded loans will lead to expanded expenditure, including expenditure on imports. Unless export receipts remain high--and, if they fluctuate, they may decline--the rise in imports will drain the banking system's reserves, leading to credit restriction. That is, if credit is a function of banking system reserves, with total reserves largely influenced by changes in foreign reserves, a banking system's credit creation will tend to fluctuate even more erratically than foreign reserves fluctuate.

On the other hand, industrial entrepreneurs planning for a continuing expansion of activity, require a fairly steady growth of credit. Especially, a programme of manufacturing development should not be temporary frustrated by a sudden cessation of credit availability.

Consequently, central banking policy should be set in a long-term context. The domestic liquidity consequences of changes in international reserves should be equalised. Periods of rapid reserve accumulation should be periods of restrained central bank credit expansion, and periods of reserve stability, or decline should be periods of countervailing central bank credit expansion. Such a policy requires finesse. It is politically attractive to expand credit and assume that the future will take care of itself. Yet, if an environment of stable progress is conducive to the growth of manufacturing investment, it is incumbent on the central bank to work for an environment of non-erratically expanding credit availability.

Deposit Money Banks

In most OECD countries, the deposit-money banks are the core of the banking system, and many African countries (not improperly) have adopted banking systems based on the OECD pattern (in many cases, banks with headquarters in OECD countries have established African branches). Yet, the banking system in an economy with per capita incomes of $5000 per year need not be the appropriate model where incomes are $500 (or less) per year. Many high-income countries have contributed to the efficiency of domestic African banking (for example, the activities of the (UK) Institute of Bankers is one instance of productive private technical assistance). Yet, non-OECD bankers inspired by OECD examples tend to follow OECD practices. With banks accustomed to commercial credit lines of $25,000 or more, or to personal clients with family incomes of more than $10,000, it is difficult for them to adjust to south of Sahara conditions. This means that branches outside large urban centers are considered to be unprofitable. At the same time, loans to large enterprises (often subsidiaries of foreign creditworthy enterprises) or to urban real estate developers entail low transactions charges. Local entrepreneurs (usually small by international standards, and often unversed in accounting presentations are frequently at a disadvantage when facing loan officers trained to meet OECD country standards).

In many African countries, there is still a persistent problem arising from the origins of many of the local deposit-money banks (including subsidiaries of foreign banks). Particularly, the older European banks established African branches primarily to finance the trade between Africa and the rest of the world; their business was based primarily on export and import credits. There is a tendency for this outward orientation to persist.

In recent years the financing of multinational activities and the facilitation of African foreign investment has been added to the original merchanting activities of the banks. It follows that, in many African countries, banking attention tends to be heavily foreign oriented, while manufacturing finance must often be domestically oriented.

Very few African countries provide classifications of bank credit that identifies the proportion devoted to manufacturing enterprises. For these few, it is clear that manufacturing investment has received a relatively small share of the communities' savings intermediated through the banking system. (Table II.2). These data are probably not strictly comparable and they understate the provision of capital to industry. At least some industrial working capital will be classified in these countries as commercial financing of purchases and sales. However, they are sufficiently dramatic, and in line with general impressions for other countries, to be worthy of consideration.

Table II.2: SELECTED AFRICAN COUNTRIES: DISTRIBUTION OF DEPOSIT MONEY BANK ASSETS
(December 1979)

	Percentage of Total Assets Claims on Private Sector	
	Total	(of which to Manufacturing Industry)
Mauritius 1/	63	26
Kenya 2/	71	15
Ghana 3/	29	6
Malawi	67	4
Liberia	63	4
The Gambia	57	2

Source: National Central Bank Bulletins, etc.

1/ December 1978.
2/ June 1979
3/ December 1977

These considerations lead to a number of conclusions:

First, facilities should be made available for individuals throughout each country to acquire claims on banks. In particular, these facilities should be made available in non-urban areas (perhaps in the form of mobile agencies operating only one or a few days per week). In those African countries that already have a developed banking system (for example, Kenya or Nigeria) new banks might be chartered only on condition that they establish a wide branch network, and banks already established might have reserve and other requirements related to the size of their branch network or average size of their deposits (that is, reserve requirements relating to small deposits (with all deposits by one holder consolidated) might be lower than those relating to large deposits).

Second, development-oriented loan criteria could be promulgated. As indicated above it is difficult to make credit-directional lending requirements effective. Yet, any steps in this direction have some influence.

If investment funds are to be directed to industrial development, the monetary authorities should encourage bank investment in this direction. In many respects, this encouragement could be passive rather than active. The late nineteenth century tradition that deposit-taking institutions. assets should be "self-liquidating" over the short-term has motivated the banking legislation in many African countries. Outdated precepts have had a strong hold on the legal advisors who have come from such institutions as the International Monetary Fund, the Bank of France, and the Bank of England to advise emergent African countries on domestic banking legislation.

An approach that it is the responsibility of a banking system to transform savings that are liquid in the views of their holders into liabilities that are illiquid in the views of the debtors would have been much more applicable to the African environment.

Partly on International Monetary Fund advice, several African countries have established bank inspection procedures, frequently modelled on U.S. practices. The criteria adopted by these inspectorates should be based on the total financial position of borrowers, insofar as these data can be obtained (allowing for their frequent unreliability). Target balance sheet ratios might be established that would make it "respectable" for banks to extend credit to entrepreneurs who are engaged in manufacturing (or agriculture). Reserve ratios might be developed on an asset basis, so that bank loans up to a specified percentage of an entrepreneur's manufacturing (or manufacturing plus agricultural) assets would entitle a bank to some lowering of its required cash or liquid assets. Such a policy would probably require the establishment of a central credit register similar to that maintained by the French Counseil de Credit to ensure that a borrower did not obtain total bank credit related to his total assets in excess of the objective. In practice, such a register (that might be compiled by the bank inspectorate) might only cover loans above a certain limit (there would be little danger in a single borrower obtaining a number of small loans—but the problem of one borrower obtaining loans under a number of names might create difficulties).

On this logic, it follows that banking legislation should be examined to ensure that it does not restrict banks (and other financial institutions) to excessively short-term assets. The Anglo-American concept of the role of banks should be modified by the introduction of German-Japanese concepts.

Savings Banks

Commercial bank liquidity requirements that inhibit longer-term investments reflect the view that prudent trustees relate the maturity of their assets to that of their liabilities. For the financial system as a whole there is little validity in this view; and one of the roles of a central bank in a multi-unit financial system is to ensure the system's liquidity. In most countries, savings banks or similar institutions have evolved offering only limited liquidity to their depositors in the belief that such institutions can make relatively long-term loans. Many deposit-money banks also segregate fixed-term or notice deposits and allocate comparable lending funds for long-term purposes.

Most of the arguments used to propose the establishment of savings banks in general terms fail to stand up to close scrutiny. An institution with liabilities nominally maturing in a few months or years is little less protected than one with liabilities that are in fact payable on demand. It is hardly less liquid if these liabilities are in fact payable on demand (usually with an interest foregone penalty)—as is commonly the case.

The desire of most asset holders, particularly poor asset holders, for liquidity has already been discussed. Therefore, any development of institutions with true fixed term obligations will probably add little to the long-term funds available for investment. However, if interest rates are raised to effective levels as proposed above, the interest income has to be allocated. There is no reason for it to accrue to the owners of the financial institutions who are intermediaries rather than money lenders (not that money lenders should be free to be usurious). It could be taxed. A clear case can also be made for passing a large part of it on to the depositors with financial institutions. Most savings held in the form of financial assets are probably rather insensitive to interest rates. Yet any steps that encourage saving and encourage holders to voluntarily immobilize their savings (such as interest rates that rise with the maturity of deposits) can only have a positive, albeit small, effect on the supply of funds for long-term investment.

Savings banks are frequently limited in their freedom to lend for industrial investment (for example, building societies in the United Kingdom, or savings and loan associations in the United States). In many African countries, the post office is the major financial institution outside the deposit-money banks gathering personal savings, particularly small savings. Most postal savings deposits are offset by post-office holdings of domestic government or foreign securities. That is, any domestic allocation of these savings is transferred to the government. There is a tradition, that finds expression, for example in the policies of the Cooperative Bank of Kenya, that savings bank credits (other than agricultural credits) should be largely restricted to real estate loans. This tradition reflects social policy that housing for the poor should be stimulated (it often means that office building speculators are subsidized).Housing is a severe social problem in African countries, particularly in those that are experiencing rapid urbanization. Policy directions regarding savings bank investments must recognize that there is a trade-off between the social benefits of housing investment (provided that the directives do not subsidize luxury housing and office speculation) and the economic benefits of agricultural and industrial investment. The determination of investment guidelines must be a national government responsibility.

Credit Cooperatives

Credit cooperatives are sometimes viewed as a source of investment finance. In some African countries agricultural cooperatives have had limited success. Housing cooperatives have great potential. Most members of these societies are either saving to provide a deposit for a mortgage or repaying outstanding mortgages. Therefore there is a flow of finance to cover the construction costs, or purchase prices, of those members taking out new mortgages.

Industrial cooperatives may be effective methods of organisation in certain branches of industry, such as in those countries where private entrepreneurship is regarded as exploitive rather than efficient, or in industries where there are economies in material purchases and sales efforts, but not in manufacturing transformation (for example some handicraft industries). Yet there are likely to be few advantages from financing cooperatives rather than possible reductions in transactions costs when dealing with lenders--that may well be offset by transactions costs within the cooperative.

As indicated above manufacturing enterprises tend to be net borrowers, and profitable entrepreneurs contending with expanding markets tend to be large borrowers. Hence, it is likely to be only inefficient entrepreneurs who will have surplus funds to lend to profitable entrepreneurs-- and inefficient entrepreneurs usually suffer from cash-flow shortages rather than surpluses.

It follows that industrial cooperatives may well be fostered for production and marketing efficiency, but not as a path for stimulating the finance of industrial development.

Life Assurance

In the OECD countries, assurance is an important source of investment finance because OECD countries are wealthy. Poor Africans have only limited opportunities to provide for contingencies. In the Sahel, starvation may be the cost of assurance. Yet, taking a long range view, assurance provides a means for accelerating investment. It may contribute little to immediate investment, but it may be a long-term channel for development financing.

Insurance takes two forms:

(1) The insurance against casualty risks.

(2) The assurance of future benefits for the policy holder or his heirs.

Insurance may be regarded as a service with few long-term investment implications. Assurance involves the accumulation of premium funds to meet the loss of income from death, disablement, or retirement. As such it is assurance rather than insurance that is important for financial analysis.

Assurance is a means of satisfying one of the liquidity desires that individuals have. Ignoring the possibilities of borrowing on assurance policies (and this possibility gives a liquidity value to assurance policies that have been in effect for a number of years), assurance policies have a definite liquidity value. While premiums are being paid, and individuals are likely to have limited liquidity needs, they have a minimal liquidity value. Once the eventuality that is insured occurs (death, disablement, or retirement), they have a high liquidity value. Hence assurance can satisfy part of the community's demand for liquidity.

In an economy where money incomes had been static for several generations and there had been no shifts in liquidity preferences, assurance would provide no finance for investment: premiums would equal benefits plus transactions costs. In an economy where money incomes are rising, assurance holders will be likely to enlarge the nominal value of their premiums to provide increased protection to meet contingencies. In an economy where constant-price incomes are rising individuals will be able to shift their expenditures from subsistence and basic needs to protection against contingencies, and premium payments will exceed benefits and transaction costs. In many (but not all African countries) constant-price incomes are rising, and in all of them money incomes are rising. Hence, assurance provides a means for accumulating funds in the hands of assurance institutions.

Assurance institutions are not faced with the balance sheet constraints imposed on deposit taking institutions. They can make actuarial estimates of their likely liabilities over human life spans. Hence, they can commit a large part of their resources to long-term investments. If governments refrain from imposing "liquidity requirements" on assurance companies that make them a captive market for government deficit financing, assurance funds can be devoted to development finance. But, this returns discussion to the importance of limiting government deficits for macro-economic objectives.

Again, any regulation of assurance investments returns discussion to the general question of a government's development strategy. Assurance institutions are often stimulated to make real estate loans. The relevance of these regulations should be assessed concurrently with the regulation of saving bank and similar investments.

Securities Markets

In many theoretical expositions, markets for primary securities (direct transactions between borrowers and lenders) are assumed to be important channels for the settlement of individual economic unit financial surpluses and deficits. In the more developed countries, they have been unimportant in this role for the last half-century,26/ and they never were important in Africa. (Some small transactions were negotiated in Nairobi and Salisbury, but they probably provided more income for journalists than finance for industry.)

Organized security markets can be important means of settling balances between financial institutions facing stochastic drains. But as such, they tend to be relatively closed membership clubs. Competitive forces may operate within these associations, and they can serve a purpose similar to that fulfilled by the London Discount market. However, they should not be regarded as important agencies bringing primary borrowers and lenders together.

It is sometimes suggested that securities markets operate as channels for the financing of government requirements primarily by the financial institutions (such as the central bank and the deposit-money banks). If this is the justification for the establishment of stock exchanges, etc., these markets become little more than oligopolistic groups that could easily be superseded by arrangements for the direct financing of government requirements.

Programmes for the development of primary security markets as channels for transferring savings to final investors are likely to be based on romanticised views of capital markets as they operated at the turn of the century. Programmes looking to the development of industrial investment should look to the twenty-first rather than to the nineteenth century.

Parastatal Organisations

Many developing countries, including those in Africa, face two specific problems.

First, a banking system in a country where more than 80% of the population lives outside urban areas faced organisational problems quite different from those in a country where three-quarters of the population is urbanised (the average ratio for developed countries). It is facile to suggest that African banks should provide savings facilities and credits for rural areas. In the first place, the operation of small savings accounts can be very expensive, particularly if urban clerical wages have to be paid for those servicing these accounts. At the same time, a line of credit for an important foreign importer of African products involves less effort than a much smaller revolving credit for a domestic manufacturer. Even in industrialised countries, it is widely agreed that small businesses face special difficulties in obtaining expansion finance. 27/ These problems are accepted as serious in developed countries. When most of the population is non-urban, industrial establishments (other than some isolated capital-intensive units--such as paper mills, mineral processing plants, or hydro-electric facilities) tend to be small by developed country standards. Hence, the small business credit gap 28/ that is important in developed countries tends to be serious in developing countries. OECD country banking systems may not be most appropriate for the African environment.

Second, foreign direct investors are interested in specific projects. Deposit-money banks, quite rightly, look to the interests of their clients. Some IBRD projects are directly oriented to obvious investment deficiencies. Individual government departments are concerned by their own requirements (roadway departments wish to have adequate supplies of concrete, education departments wish to have adequate supplies of building materials, etc.). Quite properly, governments require financial institutions to hold government debt as part of their liquidity reserves, but these portions of the community's savings should be channelled to investment rather than current expenditure. There are competing claims on the community's resources.

Consequently, many countries have established parastatal organisations to overcome these cost barriers or to fill these gaps. Such an organisation may be called a development corporation, a development bank, or be given any other title. The responsibility for determining the mix between agricultural development, housing investment, industrial growth, and social development must lie with the government. It is suggested here that industrial investment should be given high priority, but not an overwhelming position. Yet, unless the sources of foreign and domestic investment funds fortuitously match the demands of general development strategy, allocation of funds available from domestic financial institutions, government lending and foreign sources calls for coordination.

Some of these institutions are important parts of the financial system; some are less influential. Logic suggests that they should be crucial. 29/ If industrial investment is to be an element in shifting the profile of progress, the flow of investment must be "distorted" towards industrial investment. Yet, the object must be to assess the total flow of funds in the absence of strategic considerations, and add to it funds available from the government and foreign official financing so that the final composition of investment meets the strategic requirements. A development institution that can make marginal 30/ additions to flows of funds can be an important instrument in this strategy.

In a multi-institutional financial system 31/ development institutions can perform an even more important role. Frequently, one financial institution does not wish to become too heavily reliant on credit to one industrial borrower. A development institution can borrow from many private financial institutions and lend to many industrial enterprises. If loans to one enterprise are repudiated, the risk falls not on one institution, but on the entire system, and can be absorbed with little impact on each member of the system. It must be remembered that efficient financial investment inevitably includes some losers. The Spanish system of requiring banks to include bonds of the development institutions in their required reserves is a model that might be more widely adopted in countries wishing to foster development.

The preceding comments relate largely to countries with a predominantly free enterprise approach to financial intermediation. In countries with a more dirigiste approach, development corporations can play a larger role in the coordination of investment policy. In a completely dirigiste economy there could be only one bank that allocated all financial savings to enterprises that implemented the government's objectives. This approach to development investment has been adopted in only a few of the African countries.

Development banks can, perhaps by institutional accident, perform an important role in the channelling of official international finance to strategic development. The IBRD and the IFC have, for many years been sympathetic to the financing of these institutions. In part this reflects a quite proper approach to the view that these agencies should support developmental investment, but should not get too intimately involved in loans to individual entrepreneurs. If African countries wish to draw on foreign resources but retain independence in implementation of national policy, the fostering of development banks provides a route to this end.

Further, the IBRD and the IFC have observed the operation of development banks in many countries. Their expertise in development bank operations should be used to the maximum extent by African countries. This does not mean that African countries must take instructions from international institutions: it only means that they might listen to opinions based on comparisons between successful and dismal operations.

Finally, the legal organization of development banks must be a pragmatic point determined by national authorities. The IFC prefers that these banks be privately incorporated. Yet, it is argued here that they should be instruments for a national strategy. This problem should be soluble. The US Federal Reserve Banks are privately owned: the US Federal Reserve System is an instrument of national policy. On the face of it, it would seem most appropriate that national development banks should be government owned. If they draw, in large part, on private bank credits they might well be legally owned by private institutions, <u>provided that they were required to implement national strategy</u>.

III. GOVERNMENT FINANCIAL POLICIES

General Protection

There is a widely-held belief that governments should insofar as possible limit their purchases of goods and services to those produced domestically. Some manufacturing enterprises may be stimulated by contracts that are not subject to foreign competition. Undoubtedly, such policies may help to establish infant industries; there is a danger that they will maintain senile establishments. It is not unreasonable to provide domestic bidders with a 10-15% preference over foreign bidders, but beyond something of that order, protectionism encourages inefficiency rather than innovative entrepreneurship.

12.2 Fiscal Policy

Fiscal policy has macroeconomic and microeconomic aspects and it is frequently difficult to differentiate between them. At the macro level, government capital requirements can be an important determining factor in the environment for industrial development. With limited funds released for saving in many poor countries, government deficits can exert a crowding-out effect on alternative uses of these resources, or they can lead to balance of payments difficulties that induce import restriction responses, rather than exchange rate adjustments. These produce limitations on innovative investments (importers are usually restricted to purchases based on earlier imports rather than on those appropriate for new investments). Conversely, government surpluses release resources that may be deployed towards socially desirable ends.

In fact, most African countries have been fiscally conservative, and, in only a few have government deficits absorbed a large proportion of national savings (Table III.1). Yet, faced with less prosperous conditions in the late 1970s than in the late 1960s governments deficits have been tending to rise in many African countries. The situation at the opening of the 1980s calls for caution but not serious concern.

Table III.1: SELECTED AFRICAN COUNTRIES: GOVERNMENT DEFICITS RELATED TO NATIONAL SAVINGS

	Government Deficits as Percentages of Gross National Product 1/	Gross National Savings as Percentages of Gross National Product 2/
Egypt	24 3/	13
Ethiopia	29 3/	4
The Gambia	6 4/ 5/	3
Morocco	13 3/	17
Botswana	2 4/ 5/	27
Kenya	3 4/	17
Liberia	1 6/	18
Mauritius	8 4/	28
Nigeria	5 3/ 5/	28
Tunisia	3 4/	20

1/ From International Financial Statistics
2/ 1972-1977 data from IBRD World Tables.
3/ 1973-1977 Averages
4/ 1973-1978 Averages
5/ Percentage of GDP
6/ 1974-1978 Averages

Most African countries are heavily dependent on income taxes as a source of revenue (Table III.2) and therefore income tax administration including taxation of company (foreign-owned as well as domestic) profits, has an important influence on entrepreneurial investment decisions.

Tax holidays are often used as means of encouraging investment, particularly as competitive inducements to foreign investors. Such remissions may be useful as a form of infant industry encouragement for domestic producers. Their influence on foreign investors is usually small. Taxes on profits earned in foreign countries are, in most administrations, allowed as credits against home taxes. Hence a tax holiday granted by a poor African country ends up, in effect, as a tax contribution to a rich OECD country.

Discriminatory taxation policies of the infant industry type must be adopted with caution. Insofar as they apply to industry in general, they may encourage manufacturing investment at the expense of other types of investment and have desired distributional effects. Insofar as they choose between different types of industry, they call for extremely sophisticated analysis. They are open to abuse that is close to, if not actual, corruption, and can lead to industrial planning being determined on political rather than economic criteria. They have often tended to foster prestigious rather than profitable projects.

The sophisticated analysis required for their implementation is frequently more complex than appears at first sight. One example of the sophistication required may be used to make this point. It is widely believed that the "effective protection" on processed products is a serious hindrance to developing countries' exports. 32/ On this argument, it

Table III.2: GEOGRAPHIC AREAS 1/, DISTRIBUTION OF GOVERNMENT REVENUES, PERCENTAGES OF REVENUE (1972 - 1978 AVERAGES)

	Taxes on Income and Profits	Social Security Contributions	Taxes on Domestic Outputs	Non-Tax Revenues	Taxes on International Transactions
I. Percentages of Total Revenues					
Industrial Countries 2/	41	30	17	9	3
Oil Exporting Countries 2/	42	2	7	40	10
Other Western Hemisphere	22	22	30	13	13
Other African Countries 3/	36	2	23	18	21
Other European Countries	18	22	23	25	12
Other Middle East 4/	18	8	15	43	16
Other Asian Countries	21	-	38	20	21
II. Percentages of Total Domestic Revenues 5/					
Industrial Countries	73		17	10	
Oil Exporting Countries	49		8	44	
Other Western Hemisphere	50		35	15	
Other African Countries	49		29	22	
Other European Countries	45		26	29	
Other Middle East	31		18	51	
Other Asian Countries	26		48	26	

1/ Country data weighted by gross domestic product at official exchange rates.
2/ As defined by the International Monetary Fund.
3/ Including South Africa, but excluding Egypt and Nigeria.
4/ Including Egypt.
5/ Excluding taxes on international transactions and considering social security taxes to be allocable to income.

Source: International Monetary Fund, Government Finance Statistics Yearbook, Vol.IV, 1980.

would appear reasonable to provide countervailing support for the processing of primary products in the country of their origin. There are many cases, where processing reduces the transport cost of the effective component of primary products (for example, the alumina in bauxite, or the beverage essences of coffee beans), in these cases the present levels of "effective protection" on processed primary products provide very little, if any, effective protection calling for countervailing subsidization. In other cases where processing markedly increases the real transport costs of the effective component (for example, the conversion of many types of logs into squared timber, or the conversion of some types of raw sugar into refined sugar) most examples of "effective protection" are, in fact, examples of redundant protection. In any event, the"effective protection" argument is, in a large number of instances, a superficially attractive one that does not bear examination. In fact, there are a number of instances where the "effective protection" in importing countries declines with the stage of processing. 33/

The discussion of this point has been included here to indicate only one example of the analytical problems that must frequently be faced in any decision to provide tax incentives or other discriminatory financial assistance to particular types of industry. In some instances,infant industry assistance to domestic producers may be appropriate, provided that clear provision is made to ensure that adolescent producers become independent rather than senile and eligible for retirement.

Tax administration can have an important effect on the ability of industrial producers to undertake self-financing. With taxation of company income an important element of total taxation in many African countries (Table III.3), the definition of income is important. This definition is complex for any administration, even in an atmosphere of stable prices. With inflation being fairly rapid in many countries, this definition becomes more complex. Traditional historic cost depreciation conventions result in offsets to gross revenues being based on the original cost of capital equipment and inventories. Yet proper accounting for the continuing operation of an enterprise should base costs on replacement rather than original cost. 34/ As yet, many accountants are still wedded to the traditional historic cost conventions. 35/ Consequently, costs are frequently underestimated in determining taxable income so that this tax base is overstated in economically significant terms and thus taxable profits are in effect overstated. The result is that nominal tax rates are inflated in real terms and entrepreneurs are deprived of effective income. With their incomes reduced, their saving ability is reduced. Funds that should be available for reinvestment on the basis of nominal tax schedules are diverted from industrial growth to general tax revenues.

Table III. 3: SELECTED AFRICAN COUNTRIES: TAXES ON COMPANY PROFITS AS PERCENTAGES OF TOTAL TAX REVENUES, (1977 or 1978)

Togo	55	Egypt	11
Gabon 1/	54	Sudan	11
Malawi	32	Ghana	10
Kenya	29	Burundi	10
Congo 1/	24	The Gambia	10
Niger	21	Senegal 2/	9
Swaziland	20	Chad 1/	9
Sierra Leone	18	Nigeria	9 6/
Zaire	17	Madagascar 3/	8
Zambia	17	Tunisia	7
Liberia 2/	17	Benin 4/	7
Mali	16	Cameroon	6
Morocco	16	Somalia	5
Rwanda	12	Mauritania	5
Seychelles	12	Upper Volta	4
Mauritius	12	Lesotho 5/	3
Ethiopia	11		

1/ 1976
2/ 1979
3/ 1973
4/ 1975
5/ 1974
6/ 80% if the petroleum profits tax is included.

Source: International Monetary Fund, Government Finance Statistics Yearbook, 1980.

If all firms had similar investment structures, this problem might not be too serious. However, manufacturing firms usually have a higher proportion of their investment in long-lived assets than are maintained by trading firms. Therefore, the historic cost of industrial investments tend to be a smaller percentage of their replacement cost. Hence, the inflation effect on company profits tends to be more serious for manufacturing enterprises than for trading enterprises in an inflationary environment. -Historic cost depreciation conventions for the computation of company taxes tend to discriminate against manufacturing investment during period of inflation.

Government Lending Policies

Governments, as tax gatherers, have relatively large agglomerations of funds in all the African countries and can use some of these for lending to domestic producers. In general, African governments have used a relatively small amount of their available resources for these purposes (Table III.4), and the proportion of total lending devoted to manufacturing, mining, and construction tends to be quite small. 36/ Insofar as any increases in taxes are likely to have a less than completely offsetting effect on savings, increases in government lending would be likely to increase the resources available for investment. On the other hand, if government lending only increases the cash deficit that must be financed from domestic borrowing, increases in government lending are likely to have a neutral effect on resource availability. In any event, careful consideration might be given to increasing the credit available through official channels for industrial investment in many African countries. As indicated above this aim can frequently be achieved most effectively by the financing of development institutions.

Table III.4: SELECTED AFRICAN COUNTRIES; NET LENDING AS A PERCENTAGE OF TOTAL GOVERNMENT OUTLAYS, 1973-1978 AVERAGES

	Total	Of which to Manufacturing etc. 1/
Burundi	1	-
Morocco	1	-
Ethiopia	2	-
Tunisia	5	1
The Gambia	6	-
Liberia	7	1
Mauritius	8	2
Kenya	9	-
Botswana	10	-
Egypt	12	...
Nigeria	20	-

1/ The IMF consolidates lending to manufacturing, mining and construction (other than housing community services) and transportation.

Source: International Monetary Fund, Government Finance Statistics Yearbook.

IV. INTERNATIONAL FINANCING

Africa's Balance of Payments

As an area, Africa is heavily dependent on foreign financing. Official aid and all borrowing (that is, the net deficit on goods and services plus private transfers accounts) tends to be equivalent to more than one-third of commodity exports and slightly less than one-third of all non-official current account receipts (Table IV.1). Over three-quarters of this deficit tends to be covered by official grants and loans (excluding financing to cover short-term balance of payments deficits). An important amount of this official aid still goes to the former French colonies where it is associated with other policies such as those under the Lomé and Yaoundé conventions.

In some respects, foreign financing may be regarded as a semi-residual that permits domestic investment. If an economy is absorbing more resources than it creates there is a current account balance of payments deficit. If it wishes to accelerate development the absorption of resources by investment will be larger than the release of resources through saving. Foreign financing can make this excess of investment over saving possible. Excess current consumption over production contributes to short-term welfare but not to future progress. It can be argued that, in a growing economy, current consumption should be covered by current production, but that there should be an excess of production to provide resources for investment for future growth. In poor countries, such as most of the African countries, there are limited opportunities for this type of accumulation. If progress is to be achieved, resources must be drawn from abroad. It is clear that some resources are available for this purpose. It should be the aim of policy to ensure that they are used in the most economical manner.

Table IV.1: SELECTED AFRICAN COUNTRIES 1/: BALANCE OF PAYMENTS ESTIMATES, 1975-1978.

(billions of SDRs)

	1975	1976	1977	1978
Merchandise Trade				
Credits	21.1	25.4	29.7	27.4
Debits 2/	25.4	27.9	35.0	37.8
Balance	-4.3	-2.5	-5.3	-10.4 3/
Services				
Credits	3.6	4.7	5.9	6.6
Debits 2/	6.1	7.1	6.6	5.7
Balance	-2.4	-2.3	-0.7	0.9 3/
Income (Net) 4/	-1.1	-1.7	-2.4	-2.5
Private Transfers (Net)	0.5	0.4	0.4	0.5
Current Account Balance	-7.3	-6.1	-8.0	-11.5
Official Transfers (Net)	2.5	2.7	3.7	4.3
Official Borrowing (Net)	3.0	2.7	3.7	4.2
Official Financing	5.4	5.4	7.4	8.5
Direct Investment 4/	0.5	0.6	0.6	0.7
Deposit Money Bank Borrowing (Net)	0.2	-0.1	-0.6	0.2
Other Private Capital 5/	1.9	1.5	-0.7	3.2
Private Financing	2.6	2.0	-0.6	4.1
Errors and Omissions	-3.8	-2.5	-1.6	-4.7
Change in Reserves and Other Reserve Financing 6/	-3.1	-2.1	-2.8	-3.7

1/ Countries for which the IMF publishes balance of payments data other than Libya (because it is an capital-exporting surplus country). That is Benin, Cameroon, Central African Republic, Chad, Congo, Ethiopia, Gabon, the Gambia, Ghana, Ivory Coast, Kenya, Madagascar, Malawi, Mali, Mauritius, Mauritania, Morocco, Rwanda, Sao Tome and Principe, Senegal, Sierra Leone, Somalia, Sudan, Swaziland, Tanzania, Tunisia, Uganda and Zambia are included. Data are not available for several important countries, such as Angola, Liberia and Zaire. The IMF, Direction of Trade data for the countries included here include approximately three-quarters of the total imports of all African countries.

2/ Import data recorded here are at estimated c.i.f. values, based on International Financial Statistics.

3/ The estimated insurance freight element in the c.i.f. valuation may be too high for 1978.

4/ Excluding reinvested earnings on direct investment. (Conceptually, because these may be regarded as part of domestic savings. In practice, they are incompletely recorded by many countries).

5/ Including trade credit on non-official imports.

6/ Increases in reserves minus official financing (for example drawings on the IMF that enable countries to delay reserve-depletions).

Source: IMF, Balance of Payments Yearbook, Supplement to Vol.30, December 1979 and International Financial Statistics.

Intergovernmental Aid

Intergovernmental grants are still important for Africa, particularly for some of the poorest countries. There is no doubt that there is a need for a major initiative in favor of the poverty belts of Africa and Asia ...(and that)...the removal of poverty requires...substantial resource transfers from the developed countries. 37/ It is clear that a continued flow of intergovernmental aid at least at its present levels in constant-price terms is essential if development programs are not to be cut back in the face of balance of payments stringencies. Pious declarations to this end are not inappropriate. It is particularly appropriate to recognise that there is a "low income country" problem.

Yet there is little that African countries can do, by themselves, to augment this aid. A general consensus is required, to stimulate the international transfer of resources to the developing countries. This can only be achieved by the donor countries. The African countries can adopt policies that will ensure that all available aid is deployed in the most productive manner. To this end, the stimulation of industrial activity can contribute to the acceleration of growth. When almost everyone is poor, growth-oriented rather than distributional policies must have priority, provided that the poorest receive a reasonable share of the benefits.

Private Capital

Direct Investment

Recently, direct investment flows to Africa have been relatively small (the estimate of SDR 700 million for inflows into Africa during 1979 may be compared to the estimated SDR 4,000 million to non-African non-oil exporting developing countries). It would be unreasonable to expect this flow to rise markedly (say to SDR 1.5 billion) in the immediate future. Yet the appropriateness of direct investment for some types of manufacturing investment should be acknowledged. In part, there have been important inflows of direct investment of an enclave nature in some African countries such as Gabon and Liberia. These flows may be appropriate for resource exploitation but they are largely irrelevant for industrial development. Aside from a few possible free-port developments, manufacturing requires a home market, and in most African countries there is some home market for manufactures. This does not mean that industrial development should not be partly based on export production (the question of processing raw material exports is considered above. Yet, the relatively small national African markets and the still inadequate transport facilities between separate parts of the continent place limits on the size of establishments that are in some cases below the productive optimum. Hence, infrastructure investment can facilitate economic expansion. However, many opportunities remain open for direct investment.

It must be recognized that foreign direct investment involves transfer of technology as well as transfers of finance. Most foreign investors now recognize that this technical knowledge must be diffused in the host country rather than reserved for expatriates. Some countries, such as Kenya, have encouraged joint ventures with foreign manufacturing firms not only to help in the diffusion of technical knowledge to Kenyans and therefore strengthen their entrepreneurial potential, but also to encourage the flow of investments in directions considered to be in the national interest.
Foreign investors should be subject to reasonable conditions (for example, they should be required to contribute investment finance and not pre-empt local borrowing facilities). Yet, where local financing or technical skills are not available to meet apparent domestic or potential export demands, the possibilities for foreign direct investment should be explored. 38/ Africa certainly deserves more than the estimated 16% of total private foreign direct investment in developing countries that it had accumulated by 1976. 39/

It is true that "to obtain full benefits (from international direct investment) the developing countries, particularly the poorer ones (as exemplified by many African countries), need to improve their bargaining strength" 40/ The Brandt Reports recommendations regarding policies relating to transnational corporation investment 41/ deserve careful consideration. Agencies such as the Canadian International Development Agency (CIDA) and the Norwegian Aid Agency (NORAD) are prepared to finance exploratory surveys as they have done in the Ivory Coast.

The approach to foreign direct investment for industrial production should be pragmatic rather than ideologic.

International Banking Markets

The international banking system expanded dramatically in the 1970's and will probably be an important source of finance in the 1980s. Residents of the OECD countries are likely to continue to save more than they invest domestically and the capital-surplus oil exporting countries will continue to accumulate surpluses for foreign investment, largely in the form of deposits with the international banking system. In the 1970s, the African countries, other than Libya received a considerable share of these funds. (Table II. 5). None of them participated in this flow on the scale achieved by Brazil, Mexico, Argentina or Venezuela. Yet Algeria, Cameroon, Egypt, Ivory Coast, Liberia, Morocco, Nigeria, Tunisia and Zaire, had each been able to borrow more than $1 billion from international banks by the end of 1980.

Table IV.2: DEVELOPING COUNTRIES: LIABILITIES TO AND CLAIMS ON BANKS COVERED BY BIS 2/ 1/

(December 1979, $US billion)

	Liabilities to	Claims On	Net Liabilities to
	International Banking System		
Latin America	123	52	70
Africa	34	22	12
Asia	35	31	4
Caribbean Area	17	17	-
Middle East 3/	9	23	-15
	218	145	72

1/ Excluding Middle East oil exporting countries (Bahrain, Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and United Arab Emirates) and excluding other (e.g. Bahrain) off-shore banking centers (Bahamas, Cayman Islands, Hong Kong, Lebanon, Panama, and Singapore).

2/ That is, banks in Austria, Belgium-Luxembourg, Canada, Denmark, France, Germany, Italy, Japan, Sweden, Switzerland, the United Kingdom, the United States, and branches of US banks in Bahamas, Cayman Islands, Lebanon, Hong Kong, Panama, and Singapore.

3/ Excluding the oil exporting countries.

Source: Data provided by the Bank for International Settlements.

In general, Africa is not starved of international bank credit. Despite hand-wringing to the contrary, the terms on which these credits are available have not been onerous; they tend to be only slightly above world inflation rates.42/ Some countries may experience some difficulty in raising funds because of actions of regulatory authorities in the OECD countries to limit their own banks' country exposure. With the international banks continuing to accumulate OECD and OPEC surplus funds, they will be searching for borrowers in foreign markets. Many African countries should be able to raise funds in the international banking markets if th-- so desire.

Inflows of banking capital to Africa have largely taken two forms:

1. Commercial credit to African importers.
2. Eurocredits for government-sponsored enterprises (appearing as either official or private capital in the balance of payments statistics).

On the basis of available statistics, it is difficult to separate these two flows. It is clear from Table IV.1 that they have been important in some years. It is practically impossible to identify trade credit and the available international banking statistics combine rather than identify official and private balances.

On the basis of not completely comparable statistics (Table IV.3) it appears that African residents other than governments and banks (that is private residents and government agencies such as development institutions) had borrowed over approximately 25 billion dollar equivalent from the

Table IV.3: SELECTED AFRICAN COUNTRIES: APPROXIMATE TOTAL BORROWING FROM AND LENDING TO INTERNATIONAL PRIVATE BANKS BY RESIDENTS OTHER THAN GOVERNMENTS AND BANKS

(December 1979, $US Billions)

	Claims on Foreign Banks	Liabilities to Foreign Banks	Net Borrowing
North African Countries			
Algeria	- 1/	3400	3400 2/
Egypt	510	810	300
Morocco	250	2750	2500
Tunisia	100	700	600
	860	7660	6800
Liberia	2200	6700	4500
Other Sub-Saharan Countries 3/			
Botswana/Lesotho	30	100	80
Burundi	-	5	5
Cameroon	105	635	530
Central African Republic	15	5	- 10
Chad	-	20	20
Congo	100	230	130
Ethiopia	-	20	20
Gabon	100	700	600
The Gambia	5	15	10
Ghana	20	150	130
Ivory Coast	700	1700	1000
Kenya	600	600	-
Madagascar	5	140	135
Malawi	5	105	100
Mauritius	5	65	60
Niger	5	205	200
Senegal	65	150	85
Sierra Leone	65	45	- 20
Sudan	200	670	470
Swaziland	5	30	25
Togo	70	265	195
Zaire	540	1130	590
Zambia	110	445	335
	2750	7440	4690
TOTAL	5810	21800	15990

1/ Clearly an underestimate.
2/ Clearly an overestimate.
3/ Excluding Nigeria (see Appendix IV.1).

Source: Rounded estimates derived from Appendix IV.1.

international banking system by the end of 1979 (allowing for the exclusion of Nigeria from the data for statistical reasons). Approximately one-third of this credit had gone to the North African countries, one-third had gone to Liberia—with one-third of this passed on to other international borrowers, and an unknown amount to the finance of transnational companies—and one-third had gone to the rest of sub-Saharan Africa. In only a few countries, such as Kenya, the Ivory Coast, and Zaire 43/ had residents used the international banking markets as a channel for capital flight.

In some cases, for example Kenya, this low recourse to foreign credit reflects domestic monetary policies. In order to make central banking control effective, the deposit-money banks have been prohibited from extending their foreign indebtedness beyond certain limits. If the banks cannot borrow abroad, their ability to lend domestically is restricted to that ordained by central bank policy.

Whatever the reason, it is clear that direct borrowing by African banks (including African branches of foreign banks) has been very limited in recent years. This is probably mainly a reaction to the repression of many African banking systems. A release of banks from lending limitations would probably induce an inflow of foreign funds for development, including industrial development, uses.

The prospects for further banking capital inflows to Africa are the subject of much discussion, largely related to the general prospects for these markets. On balance, "the recycling problem" should stimulate third-world investment. The OPEC and other surpluses, that can create other balance of payments problems, are diverting funds to ultimate lenders. The financial intermediaries receiving these deposits will be searching for investment opportunities. Africa could be a fertile field, if the African countries follow policies that will make investment opportunities profitable for domestic borrowers so that they can attract investment funds from those who will lend at nominal rates below the real rates of return on investment.

Almost paradoxically, the distortions in the international monetary system arising from the large additions to international liquidity can produce benefits for the poor countries comparable to those that can come from any increases in inter-governmental aid. Banking funds flow to investment rather than to consumption uses. The problem for Africa is to advertise investment opportunities so that the pace of development may be accelerated.

International Bond Markets

The international long-term bond markets have expanded dramatically since the 1960s. However, only limited funds have been directed to Africa through these markets (Table IV.4). The few African issues have been raised almost entirely by North African countries. Sub-Saharan Africa is not isolated from these markets *per se*. They have, in practice, been almost completely closed to all low-income countries. This is partially an aspect of market size influences. Transactions costs, per issue, are large, and, therefore, only borrowers able to justify large borrowings for single projects have been able to cover these transactions costs. Small poor countries have been effectively excluded. It is possible that there might be some change in this market structure in the 1980s, but little hope should be laid on this prospect.

Table IV.4: NEW ISSUES ON INTERNATIONAL BOND MARKETS, 1/ 1975-1979
($US billion)

Issues by	1976	1977	1978	1979	1980 (P
Industrialized Countries	23.1	22.8	22.4	24.0	24.8
Developing Countries	2.3	4.8	6.1	4.0	3.1
(of which Africa)	(0.2)	(0.2)	(0.9)	(0.2)	(...)
Centrally Planned Economies	0.1	0.3	-	-	0.1
International Organizations	8.3	7.2	8.4	8.5	7.8
(of which ADB)	(-)	(-)	(-)	(0.1)	(...)
Unallocated	0.5	1.1	0.4	0.5	0.1
TOTAL	34.3	36.1	37.3	37.1	36.0

1/ Including both "foreign" and "international" bond issues.
(P) Preliminary.
Source: IBRD, Borrowing in International Capital Markets, Fourth Quarter, 1979, (Document EC-131/794), and later IBRD data.

The International Institutions

One of the major themes that dominated the Bretton Woods Conference was the fact that international private financial markets did not always operate in a socially optimal manner. In particular, they failed to meet the legitimate aspirations of poorer countries for long-term capital. As a consequence, the International Monetary Fund was established to underwrite the liquidity position of member countries, and the International Bank for Reconstruction and Development to supplement the long-term capital requirements of the developing countries (and, originally the needs of the war devastated ones). Since then, regional development banks, such as the African Development Bank have been established to accommodate the particular needs of the regional geographic areas. In more recent years, a number of special organizations have been established to make finance available to developing countries. Among these are the Arab Fund for Economic and Social Development, the Arab Fund for Economic Development in Africa, the European Investment Bank, The Islamic Development Bank, the Islamic Solidarity Fund, The OPEC Special Fund, and the Special Arab Aid Fund for Africa.

The transactions with most of these latter institutions other than the European Investment Bank tend to fall under the classification of inter-governmental aid discussed above.

By its very nature the IMF does not make loans for specific projects. Rather, it provides compensating finance 44/ to meet balance of payments fluctuations and therefore supplements the reserve stabilising responsibilities of national central banks. It also provides finance to support the implementation of general macroeconomic policies discussed here. Except insofar as its activities, when successful, support on environment conducive to industrial investment, consideration of its policies lie outside the scope of an analysis of industrial investment.

The "World Bank Group" (The International Bank for Reconstruction and Development, The Industrial Finance Corporation, and The International Development Association) is directly concerned with financing project, development institution, and similar national investments. Hence it is concerned with industrial investment. Since its inception, the Group has made over $80 billion available to borrowing countries (Table IV.5), which over $15 billion has been devoted to Africa. In recent years, the Group has tended to shift its lending more towards the poor countries including sub-Saharan Africa. However, as yet, only some 10% of the Group's African financing has been devoted to industrial development or development institution financing. As with inter-government aid, African countries alone can not determine the allocation of World Bank funds. In part, at least, the low level of industrial financing reflects the lack of justifiable projects indicated in the earlier discussion of absorptive capacity. This is an example of the quasi-entrepreneurial role that is open to development finance companies, and the technical advisors that they might enlist. The more projects that are presented to the Bank, the more finance that could be available for industrial development. It may be one of the Bank Group's responsibilities to search for opportunities, it should, however, be a national responsibility to guide the Bank to its possibilities.

Table IV.5: "WORLD BANK GROUP": TOTAL FINANCING UP TO JUNE 30, 1980
($US millions)

	IBRD	IDA	IFC 1/	Total
Latin America and Caribbean	18932	562	1390	20884
Asia and Pacific	17387	13446	715	31548
Europe and Middle East	12487	835	658	13980
North Africa	4403	909	135	5447
Sub-Sahara Africa	6132	4816	206	11154
of which to:				
Industry	(395)	(55)	2/	
Development Finance Cos.	(324)	(148)	2/	
TOTAL	59341	20570	3105	83013

1/ Including IFC financing projects syndicated to other lenders.

2/ Almost all IFC financing is for industrial investment, development finance companies, with some going to tourism, etc. projects.

Source: World Bank Annual Report, 1980 and International Finance Corporation Annual Report, 1980 .

All of IFC's credits are to, at least technically, 45/ private borrowers and a small portion is in the form of equity participation rather than loans. On the other hand, the IFC acts as a broker as well as an intermediary. Of the $3 billion total credits that it had organised by June 1980, over $1 billion had been sold to private lenders. That is, the

IFC has contributed on a small scale to the diversification of risk discussed above.

The IBRD and some of the regional banks have engaged in active roles as intermediaries bridging the gap between the hesitancy of the international securities markets to provide finance for more than a few developing countries and the needs of many of these countries for long-term funds for industrial and other development. For example, in 1975-1979 the IBRD raised over $20 billion, and the IADB approximately $1.7 billion on these markets. These funds were then passed on to borrowers in developing countries. In this way, these institutions provided a diversification of risks (and guarantees) to indernational leaders and finance for development. By contrast, the African Development Bank has issued only approximately $200 million of international bonds, relying instead largely on direct intergovernmental credits. Part of the problem facing poor countries is that they can not offer a sufficient diversity of risks to satisfy the institutions that are large holders of international bonds. The international development banks can provide, not only official guarantees, but also, with their portfolios spread over many projects, they can offer risk diversity. Hence, if bond markets are ineffective direct sources of capital for poor countries, banks such as the ADB can fill part of the gap. In brief, the ADB should be more aggressive in its search for this type of international development capital.

In practice, the European Investment Bank had made more funds available for African countries than the African Development Bank. By the end of 1978 it had extended 311 million units of account (approximately equivalent to $US 350 million) to African countries (all south of the Sahara). In addition it had disbursed 185 million units of account (approximately equivalent to $US 210) from the European Development Fund.

The poverty of Africa is reflected in the distribution of its financing between IBRD sources (where interest rates are strongly influenced by world market conditions) and IDA sources (which are based on concessional terms). Insofar as IDA funds, the sub-Saharan countries should press for access to them. Similarly, in international discussions, they should press for the augmentation of IDA resources as a channel for obtaining finance without bilateral conditions.

Monetary Integration

It is sometimes suggested that "developing countries should give special attention to the establishment and extension of payments and credit arrangements among themselves to facilitate trade and to ease balance of payments problems".[46/] That is, it is proposed that currency unions, usually regional ones, could facilitate the financing of development. There may be some arguments for regional preferential customs arrangements that enlarge the size of the market and therefore facilitate the achievement of economies of scale, particularly in manufacturing. Even here, the evidence is unclear, some studies suggest that these arrangements as developed in the past have encouraged capital intensive investment at the expense of labor intensive[47/] - not an appropriate objective for countries faced with the absorption of an underutilized labor force. In many cases they have enabled regional white elephants to be adopted in place of smaller and less uneconomic national white elephants.

In any event, a customs union is quite independent of a currency area. The European Community obtained the advantages of a customs union long before the EMS was made operative (in fact, the EMS has been described by one of its designers as being 'primarily a political event" not an economic one).[48/]

The currencies of most of Africa's important suppliers and important markets are now effectively convertible into all other currencies.

The BEAU (Banques des Etats de l'Afrique Centrale) and BCEAO (Banque Centrale des Etats de l'Afrique de l'Ouest) arrangements are now almost unique in that they, almost alone, give their participants access to preferred credits in an OECD country. The rest of the major credit extending countries are committed to a system of IMF convertibility. Therefore, any possible currency areas could not obtain the advantages still enjoyed by the BEAC and BCEAO countries. Even within a customs union, African countries should wish to see their exports providing funds that can be used in the world's cheapest markets. No country should risk its resources being tied up in inconvertible balances. On the other hand, if a country is looking to the accumulation of non-repayable debts, it is also envisaging policies that are not likely to foster its development over the near future.

Appendix

Table A.1 combines the data for all the countries that are covered in both the BIS and IMF statistics except for Nigeria, and a few others, such as Upper Volta, where there are clear discrepancies between the BIS and IMF data. That is, it covers 82% (93% excluding Nigeria) of the claims on international banks and 91% of the liabilities due to these banks by African countries that are identified by the BIS.

The official foreign exchange reserves of countries are a major part of the liabilities of the banks covered by the BIS statistics. In Table A.1 it is assumed that, except for the countries that are members of the BEAC and the BCEAO, and those that hold their reserves in South African Rands, all foreign exchange reserves are held with the BIS banks. This is obviously an overstatement. Some relatively small working balances are held with central banks; but these can not be identified on a country basis; and some are held in centres not covered in the BIS data, such as Bahrain, and with non-reporting banks in the Caribbean. Some reserves are also still held in the form of securities issued by governments of the reserve centres, but with the structures of interest rates in the major money-market centres, these are probably quite low by now.

The domestic banks in African countries are assumed to hold all their foreign assets with banks covered by the BIS data (including foreign head offices of African bank branches) and to have all their liabilities to such banks. Again, this is an overestimate, but the error on this account is probably quite small.

Table A.1: ALLOCATION OF CLAIMS ON AND LIABILITIES TO INTERNATIONAL BANKS BY AFRICAN COUNTRIES AS RECORDED BY THE BANK FOR INTERNATIONAL SETTLEMENTS
(December 1979, $U.S. billion)

	Claims on BIS Banks				Liabilities to BIS Banks		
	All Residents1/	Official Reserves2/	By Domestic Banks2/	Other Residents3/	All Residents	Domestic Banks	Other Residents
Algeria	3372	2518	1000e/	-	7103	3700e/	3400
Benin	28	- 4/	28e/	-	27	27e/	- e/
Botswana/Lesotho	198	- 5/	- 6/	28	110	- 6/	110
Burundi	75	77	8	-	10	3	7
Cameroon	138	- 4/	32	106	755	120	635
Central African Republic	28	- 4/	12	16	7	1	6
Chad	16	- 4/	16e/	-	35	15	20
Congo	114	- 4/	16	98	267	35	232
Egypt	3784	529	2745	510	2046	1228	818
Ethiopia	241	172	70	-	35	15e/	20
Gabon	141	- 4/	33	108	843	129	714
The Gambia	14	24/	6	6	23	7	16
Ghana	295	274	1	20	157	11	146
Ivory Coast	779	- 4/	100	679	2057	350e/	1700
Kenya	1170	520	70	580	680	73	607
Liberia	2304	46	36	2222	6766	63	6703
Madagascar	57	5	47	5	147	5	142
Malawi	80	65	8	7	173	69	104
Mauritius	40	28	8	4	71	12	62
Morocco	1007	537	215	255	2831	83	2748
Niger	36	- 4/	20e/	6e/	236	40e/	200e/
Senegal	112	- 4/	50e/	65e/	310	160e/	150e/
Sierra Leone	125	46	11	68	47	-	47
Sudan	486	54	194	238	740	73	667
Swaziland	78	- 5/	6	72	29	-	29
Togo	83	- 4/	69	14	325	61	264
Tunisia	643	545	105	-	1068	352	716
Zaire	875	207	132	536	1176	48	1128
Zambia	282	74	97	111	492	48	444

1/ As reported by banks reporting to the BIS.
2/ Derived from International Financial Statistics
3/ Largely a residual.
4/ All assumed to be held in French Treasury Settlement Accounts.
5/ All assumed to be held in South African Rands.

The accounts of other African residents with the BIS are derived as residuals. The overestimation of the official reserve and deposit-money banks' elements in the BIS data imply that these residual estimates are understatements. However, the underestimation is probably not large enough to invalidate the above conclusions.

Nigeria has not been included in Table A.1 because its official foreign exchange holdings are more than twice the reported liabilities of the BIS banks to Nigeria. Evidently, Nigeria still holds a major part of its official reserves in government securities. Therefore the assumptions on which Table A.1 is based are clearly incorrect for Nigeria.

As the BIS data record total assets and liabilities in U.S. dollar equivalents, changes in these totals reflect exchange rate movements (assets and liabilities are denominated in many currencies) as well as transactions. Therefore, these data can not be used to estimate flows during any period.

V. SUMMARY

18. This review is based on several propositions:

It must be recognised that a policy of industrial stimulation implies an encouragement of long-term investment based on reasonable expectations regarding investment costs and probable returns on investment.49/ Inflation creates uncertainty regarding relative price relations, and, specifically, makes short lived investments (including inventory accumulations) preferable to long term ones because such investment decisions may more easily be reassessed in the atmosphere of uncertainty created by inflation. Therefore, the containment of inflation is a prerequisite for a policy of balanced industrial development.

The containment of inflation is difficult in countries where aspirations are high and resources are limited. It calls for responsible fiscal policies and a realization that financial institutions are primarily intermediaries rather than engines of growth.50/

Investment can only be financed by domestic savings or foreign borrowing. In poor countries, such as most of those in Africa, the community can not save large amounts. Institutional arrangements should be made so that these savings are deployed in the most efficient manner. However, if material progress is to be accelerated, foreign borrowing must be accepted. Sovereign countries can rightly impose reasonable conditions on foreign lenders. In this respect, official multinational sources of credit, subject to international surveillance should be enlarged. Even so, foreign direct investment and international banking supplies of credit should be stimulated.

Banking and other institutional regulations should be examined to ensure that they do not inhibit industrial investment on the basis of outmoded conventions regarding liquidity concepts.

While banking, insurance, and similar regulations should not discriminate against industrial development, there is an important role for development finance institutions that can garner government lending funds, bank and other financial institution credits, and foreign (particularly multinational institution) borrowings, in order to implement a coherent long-term investment strategy.

In brief, there is an expected path for economic growth that most African countries are not willing to accept. This growth path may be accelerated by the stimulation of industrial investment. Appropriate financial policies can contribute to this stimulation. The choice of policies is not easy—it is complex. Sophisticated rather than simplistic analysis is required. In many respects, African development in the 1980s will reflect the choices that are made. The apparent easy remedies will make progress in the 1980s less satisfactory than that achieved in the 1970s. Realistically considered choices could lead many countries from the IBRD classification of "low income" into the "middle income" group and also raise the material welfare of members who remained in each group.

FOOTNOTES

1/ This presentation is, very largely, an application to the African economies, with additions, of the arguments presented in Chapter IX, of UNIDO World Industry Since 1960: Progress and Prospects (Special Issue of the Industrial Development Survey for the Third General Conference of UNIDO) New York, United Nations, 1979; and Ronald I. McKinnon "Financial Policies" in John Cody, Helen Hughes, David Wall (eds.) Policies for Industrial Progress in Developing Countries, Oxford (for UNIDO and IBRD),1980.

2/ Organization of African Unity, Plan of Action for the Implementation of the Monrovia Strategy for the Economic Development of Africa ("The Lagos Plan of Action") p.21.

3/ North-South A Programme for Survival, The Report of the Independent Commission on International Development Issues ("The Brandt Report"),London, Pan Books; Boston, The MIT University Press, 1980, p.237.

4/ These two considerations are, in part, slightly broader, and, in part, slightly more restricted than stated in the "Lagos Plan of Action", p.25.

5/ Unless indicated otherwise, the data in this survey are taken from International Bank for Reconstruction and Development sources, for example, World Bank Tables 1980, World Development Report, 1980, 197[illegible] World Bank Atlas, Borrowing in International Capital Markets (various issues) and World Debt Tables (various issues); or from International Monetary Fund sources, for example, International Financial Statistics, Balance of Payments Yearbook (including monthly issues), and Government Finance Statistics Yearbook; and data provided to the author. Most of the tables are selective either so that they may provide reasonable comparisons, or because of data limitations.

6/ See World Development Report 1980, pp.110-111.

7/ It should be emphasized that the savings ratio referred to here include depreciation as part of savings.

8/ Many of the points indicated in this section are discussed in A.J.H. Enthoven, Accountancy and Economic Development Policy, Amsterdam, North Holland, 1973.

9/ This argument does not require that every borrower must always repay all his indebtedness to financial institutions for years (even for a century). In these cases, the financial institutions become a source of permanent capital for investment. Provided that the constant-price value of a borrower's capital remains intact, and that it produces income adequate to meet interest payments, an outstanding debt can be productive for both the borrower and the lender. Yet, the prerequisite for this productivity is the identification of capital maintenance and income adequacy.

10/ If most prices are rising rapidly, some of them will rise either more or less rapidly in response to influences arising from the general movement (house prices will rise because housing becomes an asset that is preferable to money or money-denominated assets as protection for the future rather than as accommodation; inventories become attractive as hedges against an uncertain future rather than as potential inputs for consumption or investment) or as a consequence of differences in the bargaining power of differing sectors of the economy.

11/ See G.S. Dorrance, "Personal Saving in the United Kingdom and the United States in the 1970s", Lloyds Bank Review, No. 138, October 1980.

12/ For a discussion of this point, see G.S. Dorrance, "Inflation and Growth: The Statistical Evidence", I.M.F. Staff Papers, Vol. XIII, March 1966.

13/ For a discussion of this division of an economy see J. Hicks, The Crises in Keynesian Economics, Oxford, Basil Blackwell,1974, pp.50-54. This point is also discussed in G.S. Dorrance, National Monetary and Financial Analysis, London, Macmillan, 1978, Chapter 2.

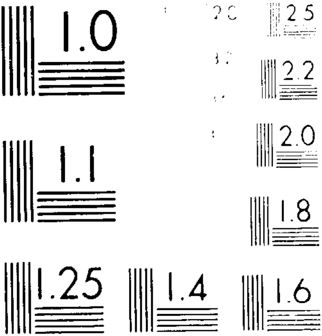
14/ As used here, "financial institutions" are ones that issue their own liabilities and accept responsibility for all of them. This stock of resources is then pooled into credits, none of which are directly hypothecated to individual liabilities. Institutions that bring borrowers and lenders together ~~for direct~~ lending operations are regarded as brokers rather than financial institutions (see Dorrance op.cit., p.14 for a discussion of this point).

15/ J.M. Keynes, The General Theory of Employment, Interest and Money, London, Macmillan, 1936, p.202.

16/ See, for example, McKinnon, op.cit.

17/ The term "deposit-money" banks is accepted by the International Monetary Fund as describing institutions that provide a major part of the community's deposit-money (for example, commercial banks, but also including savings banks and development banks where these have important demand liabilities to private individuals and businesses).

18/ But excluding development banks that receive most of their resources from the government for distribution to industrial and other borrowers.


1.0
2.5
2.2
2.0
1.1
1.8
1.25
1.4
1.6

19/ Money comprises currency outside the banking system and demand deposits of non-government holders with banks transferable by cheque or other instrument (for example, giro transfers); holdings by non-residents are also excluded in some estimated of money (M_1 in current terminology). Quasi-money comprises other essentially demand-encashable liabilities of financial institutions (that is, money plus quasi-money is M_3, or preferably M_4, in current terminology).

20/ See for example, J.G. Gurley "Financial Structures in Developing Countries" in D. Krivine (ed.), Fiscal and Monetary Policies in Developing States, New York, Praeger, 1967, pp.99-116; J.O. Adekunle, "The Demand for Money: Evidence from Developed and Less Developed Economies", Staff Papers, XV (1968) pp.220-266; and H.C. Wallich "Money and Growth: A Country Cross-Section Analysis", Journal of Money, Credit and Banking, I, 2 (May 1969), p.5.

21/ Op. Cit., pp.99-100.

22/ The deposit-money banks in all the African countries other than Botswana, Libya, and Swaziland, where the banks have large foreign assets and in Zaire and Zambia where the banks are heavily committed to government financing; and in Ethiopia, Ghana, Kenya, Sierra Leone, and Uganda are all importantly dependent on central bank refinancing for the conduct of their operations.

23/ It should be remembered that the first effect of building an industrial establishment that will be highly profitable over a period of, say, twenty years, is to convert new bricks and steel beams, etc. into used bricks and scrap steel. There is a greater risk in industrial investment than in accumulation of standardized inventories. Inflation increases these risks. Yet, development strategy should be directed towards investment in product transformation rather than into price-speculative withdrawal of resources from fairly short-term utilisation.

24/ In many cases, real estate investment is fostered in the guise of supporting housing development to meet urgent needs in poor countries. Unless policies are very sensitively developed, this usually means that residences for the rich, or office building for foreign transnationals are subsidized at the expense of urban development for the poor.

25/ An individual African, known to the author, who is engaged in this range of activities and heavily dependent on bank credit must remain anonymous.

26/ Large company borrowers and governments still obtain funds in such markets as the London Stock Exchange. However, in these markets, most of the purchases are made by financial institutions. Consequently, even though primary markets may be used by some borrowers, their relations with primary lenders are indirect.

27/ See for example, U.K. Committee to Review the Functioning of Financial Institutions, (Wilson Committee), Progress Report on the Financing of Industry and Trade, London, H.M.S.O., 1977, p.33.

28/ The so-called "Macmillan Gap" that was identified in the Report of the Committee of Finance and Industry (The "Macmillan Committee") (UK. Cmd. 3897, 1931) half a century ago.

29/ In assigning this role to development institutions it can not be ignored that some of them have proved to be channels for preferential lending to politically influential individuals that could be termed corruption. This is not a question related to the responsibility of development institutions. It is one related to the general probity of national governments.

30/ "Marginal" is used here in the sense of "additional" rather than "unimportant". Marginal investments are those that fill gaps that would otherwise not be covered, and, in many cases, the filling of these gaps may be crucial to the elimination of bottlenecks that could otherwise frustrate a development programme.

31/ For example there are approximately 25 private independent financial institutions in Nigeria.

32/ See "The Brandt Report", p.143.

33/ This point is made by Michaël Michaely "The Income Level of Exports and Tariff Discrimination" in Peter Oppenheimer (ed.), Issues in International Economics, London, Oriel Press, 1980, pp.156-177. It is also made by David Wall, "Industrial Processing of Natural Resources", World Bank Commodity Working Papers, No.4, that also discusses many other aspects of primary product processing policies.

34/ This point is discussed in the context of developing economies by Enthoven in op.cit. pp.84-86.

35/ See for example, the resistance of the accounting profession to proposals such as those put forward in U.K., The Report of the Inflation Accounting Committee ("The Sandiland's Report") HMSO, Cmnd 6225, 1975.

36/ The data in Table III.4 underestimate the effective lending to manufacturing insofar as government credit is made available for general economic development such as that provided by government development finance corporations and passed on to industrial concerns.

37/ "The Brandt Report", p.22.

38/ There are signs of changes in attitudes by developing countries towards transnationals (see Isaiah Frank Foreign Enterprise in Developing Countries, World Bank Staff Working Paper No.348, July 1979.

39/ K. Billerbeck and Y. Yasugi, Private Direct Investment in Developing Countries, World Bank Staff Working Paper No. 348, July 1979.

40/ "The Brandt Report", p.191.

41/ P.200.

42/ At the end of 1979 African countries were borrowing on international banking markets at 1.25-2.00% above LIBOR (London Interbank Offer Rate) which tends to be below expected inflation rates, based on adaptive considerations arising from past experience (for an explanation of this shortfall of market interest rates below expected inflation rates see R. Mundell, "Inflation and Real Interest" Journal of Political Economy, LXXI, 3(June 1963) pp.280-283. By the end of 1979, these spreads had declined to 1.25 - 2 per cent. (See IBRD, Borrowings in International Capital Markets, Fourth Quarter 1979, May 1980. By the end of 1980, these spreads had risen to 2.0 per cent or slightly more Still a yield of less than 2% in constant-price terms). (This observation is based on information obtained from the Bank for International Settlements.)

43/ Despite all the discussion relating to Zaire's repayment problems it is a small borrower, hardly endangering the international banking system.

44/ The IMF has a wider compensating role than that part of it covered by its compensatory financing facility.

45/ In many instances development finance companies are technically privately owned, even though they may, effectively, be parastatal agencies of governments.

46/ "The Brandt Report", p.285.

47/ See, for example, Anne Krueger, "Alternative Trade Strategies and Employment", forthcoming in Proceedings of the Sixth World Congress of the International Economic Association.

48/ Otmar Emminger (President of the Deutsche Bundesbank), LSE Society Special Lecture, 7 December 1978. Reprinted in Lloyds Bank Review, July 1979, No.133.

49/ The emphasis in this exposition should be placed on the word "probable". Many industrial investments will prove to be unprofitable. An assessment of industrial investment policy should be based on the benefits evolving from the complete programme rather than on those associated with its individual components.

50/ This does not mean that monetary policy should be passive. It should encourage financial institution lending that stretches an economy to its non-inflationary limits, but does not push it over the brink of irresponsible credit expansion.