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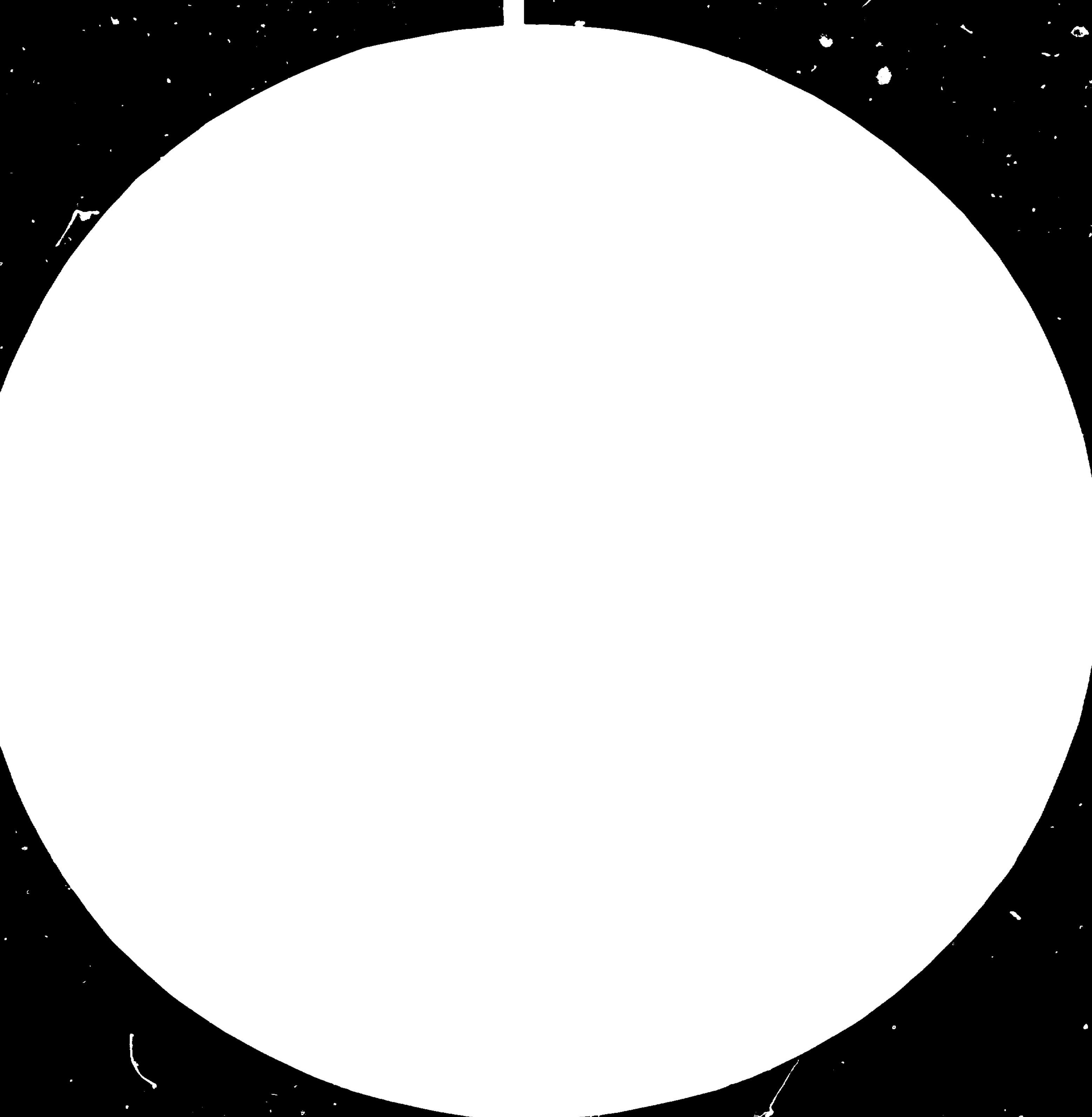

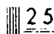

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First Consultation on Industrial Financing
Madrid, Spain, 18 - 22 October 1982

BACKGROUND PAPER*

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the secretariat of UNIDO

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PART I. INTRODUCTION TO THE ISSUES

1. A recurrent theme identified in Consultations at the level of industrial sectors, e.g. iron and steel, food-processing, fertilizers and petrochemicals, has been the critical importance of financing the development of these sectors in developing countries. For this reason, the Industrial Development Board requested the secretariat to initiate the consultation process on the subject of industrial financing.

2. The Global Preparatory Meeting for the First Consultation on Industrial Financing identified a number of questions which required examination under the subject area "the nature and conditions of access to international industrial financing in developing countries".

3. In order to facilitate the examination of these questions in a structured way, the UNIDO secretariat felt it would be appropriate to group them under the head of three issues. These issues are as follows:

<u>Issue no.1</u>: <u>Is there a quantitative and qualitative gap in external financial flows for industrial investment in developing countries?</u>*/

<u>Issue no.2</u>: <u>How and to what extent can existing mechanisms and institutions provide additional industrial financing to developing countries?</u>*/

<u>Issue no.3</u>: <u>Can the possible industrial financing gap be overcome by the elaboration of innovative concepts leading to the acceptance of new mechanisms and/or institutions?</u>*/

The treatment of these issues has one overriding theme: global solutions by consensus have to maximize benefits to all countries - global solutions are <u>not</u> a zero-sum game. The most important questions arise from the dynamic nature of interdependence in growth, trade, industrialization and capital flows.

<u>Issue no.1</u> identifies the following facts:

(a) A large and growing international capital market has emerged.

(b) Developing countries face three major problems vis-à-vis that market:

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*/ In order to give greater clarity, the wording of this issue has slightly been amended from that adopted in the aide-mémoire dated June 1982.

(i) It is short-term oriented, thus not optimal for development finance;
(ii) The claims of industrial countries absorb two thirds of the funds;
(iii) The cost of borrowed funds is high enough to eliminate "good" projects.

(c) It would have been possible for developing countries to live with these problems, but for the:

(i) legacy of heavy indebtedness;
(ii) higher cost of import of food, manufactures and energy;
(iii) lower earning of exports due to terms of trade effect and protection;
(iv) competition for funds with developed countries

both groups have an external gap.

(d) Even if they overcome these difficulties, funds are drying up: ODA is declining in real terms and the commercial banking system is close to the limit of prudent lending.

(e) Strong, usually conservative, voices are calling for bold international action. In the spirit of these calls for bold actions, the LIMA scenario for world development is presented to indicate potential demand in the future for external funds, and estimates are made of finance required for industry in developing countries.

(f) The targets appear feasible, since:

(i) Per capita income in developing countries would reach under LIDO some $1,370 in 2000 which is 15 per cent of projected per capita income in industrialized countries at that date;
(ii) The implementation of LIMA export targets would mean that the share of developing countries in industrialized countries markets would reach a maximum of 5.5 per cent.

(g) Some reservations are presented regarding absorptive capacity, project preparation, higher domestic resource mobilization etc. in developing countries.

Issue no.2 considers:

(a) Ways of narrowing the external financing gap through changes and improvements in financial instruments and modalities which are currently used within the existing institutional framework;

(b) Whether the commercial banks and other market-related mechanisms are at the limits of their expansion as presently constituted;

Issue no.3:

(a) Reviews some of the elements which have provided a basis for a number of innovative proposals for major change in international financial arrangements as these relate to increasing financing flows to industry;

(b) Considers some of the uses of finance in industry, with particular reference to the terms and conditions of finance.

4. External flows can be viewed and an important component of import demand for capital goods purchased for the most part from industrialized countries. Unemployment rates in many industrialized countries are around 10 per cent (an indicator of unutilized industrial capacity). With 10 per cent of GDP foregone as a result of present policies, the alternative of providing 0.8 per cent to 1.0 per cent of GDP as a net resource transfer which would revive the engine of growth is a good but as yet a challenging choice.

PART II: DEBT AND INDUSTRIAL DEVELOPMENT

A statement of the problem

5. The rate of economic growth and of industrialization in the developing countries proceed at a rapid pace over two decades, the 1960s and 1970s. The fruits of this progress as well as progress itself is now threatened. As we shall see, most of these threats are external to the developing world and, one way or another, revolve around the tension between growing trade gaps and the ability to finance them. In 1960-1980, the gross domestic product of developing countries grew at the rate of 5 to 6 per cent per annum. In 1970-1980, manufacturing output (value added) of developing countries grew at the rate of 8 per cent per annum and 7.6 per cent per annum in the 1960s. This shift was a part of a structural transformation of these ecomomies, so that whereas in 1960 agriculture comprised 30.9 per cent of GDP and manufacturing 16.2 per cent, by 1978 the contribution of both sectors was almost equal.[1/] This structural transformation was reflected outside by the increase in the developing world's share in world manufacturing output (manufacturing value added) which advanced from 7.6 per cent in 1970 to 10.2 per cent in 1980. However current prospects are poor, for more recent events suggest that these trends of the past cannot be sustained under present institutional arrangements. Even if these poor current prospects can be overcome, the maintenance of this rate of shift toward industrialization over the next two decades to the year 2000 would elevate the manufacturing share of developing countries to 15.4 per cent, a figure well beneath the 25 per cent target set by developing countries in the Lima Declaration and Plan of Action.

6. Historically economic growth and industrialization necessarily have been accompanied by an expansion in domestic capital formation - in structures, machines and tools. The bulk of such capital for the developing countries has been imported from the developed ones. These necessary connections are displayed in Table 1. Gross domestic saving comprised the main source of such investment for all but the least developed nations. The last margin, that received from foreign sources, was nevertheless critical in the progress of industrialization. Developing countries were able to increase their investment to GDP ratios from around 10 to 12 per cent in the 1950s, to about 18 per cent in the 1960s, and to about 24 per cent in the 1970s. If the groups of non-oil exporting developing countries and least developed countries are considered separately over the 18 years, 1960-1978, the non-oil exporting

developing countries financed on average about 88 per cent of their investment through domestic savings, while that figure was about 64 per cent for the least developed countries.[2/] When industrial growth and economic growth are analyzed in greater detail by groupings of developing countries, the rate of both industrial and economic growth was low in those countries where the rate of investment was least. This observed connection is not unique to developing countries. High growth developed countries also exhibit high rates ' investment.

Table 1: Savings and investment in non-oil exporting developing countries (as percentage of gross domestic product)

	1960-1978	1960-1969	1970-1978
Non-oil exporting developing countries			
Gross domestic capital formation (i.e. investment)	21.6	18.3	22.9
Gross domestic saving	18.9	16.7	19.9
Foreign saving	2.7	1.6	3.0
Least developed countries			
Gross domestic capital formation	12.8	11.4	13.5
Gross domestic saving	8.2	10.2	7.1
Foreign saving	4.6	1.2	6.4

Source: UNCTAD, Trade and Development 1981

We should also consider the relationship between saving and investment from the other direction in order to close the national income circle. Increased investment and the sale of products from new productive capacity raise incomes and thus enlarge the sources of domestic savings. In short, saving and investment tend to reinforce each other.

7. The reliance of the non-oil exporting countries on external funding nevertheless grew despite the rapid increase in gross domestic saving. As suggested above, this extra margin is more important than the numbers alone imply. External saving flows of non-oil exporting countries increased from

about 9 per cent of total domestic investment in the 1960s to about 13 per cent in the 1970s (to 1978). These external funding sources served the essential function of filling the gap between gross domestic saving and the gross domestic capital formation necessary to sustain the observed rate of industrialization. Whereas the external sources were essential for the non-oil exporting developing nations as a group, they were critical for the least developed nations.

8. The external funding figure alone does not tell the whole story; the composition also is significant, and increasingly so. As late as 1965, the terms of loan commitments from external sources (official and private) averaged a grant element of 40 per cent at an average maturity of 19.9 years amidst an era of relatively stable exchange rates and low interest rates. By 1979 these loan terms had been transformed into an average grant element of 7 per cent,[3/] and an average maturity of only 14 years amidst a new stage of violently fluctuating exchange and rapidly rising interest rates. Indeed, this mutation reflected an acceleration in the privatization of development financing. Official flows on concessional and non-concessional terms were the major component of development financing during the 1960s, but by 1980 this trend had been reversed. The general "tightening" of financial terms is reflected in the changing share of financial flows on concessional terms; they fell from 57 per cent of total flows in 1965 to less than 35 per cent in 1979. At the same time interest payments on debt by developing countries greatly increased.

The balance of payments deficit, the investment gap, debt service and growth

9. In the development process long-term external capital flows normally are required to finance the trade deficit based on the investment gap arising from the need for capital goods from abroad. That is, developing countries usually are net capital importers. This external financing requirement, though increasing, has been met by the increased saving of the developing countries as a whole, including the net transfers of the OPEC members and the increased saving efforts of the non-oil exporting developing countries. Thus, it is not for the lack of effort and sacrifice that the balance of payments deficits of developing nations have grown so large and continue to grow. However, the recent stagflation in the industrialized countries has resulted in a diminished value of developing-nation exports even as interest rates, the cost of external borrowing, have soared. The trade balances of

these countries are worsening even as the terms to finance current account deficits are becoming harsher. The 1980 deficit on current account of the balance of payments of the oil-importing developing countries was $82 billion; the 1981 deficit originally estimated by the IMF to be $80 billion (in September 1980) is now expected to be $100 billion. At the end of 1980, the outstanding disbursed debt of developing countries with a maturity of one year or more was $456 billion. Significantly, private sources of capital including export credits comprised $300 billion of total of outstanding debt at the end of the same year, up sharply from $44 billion in 1974.[4/]

10. Any debt is serviced with interest payments, external debts not excluded. Indeed, unpaid interest becomes a part of the external debt, a growing share during periods of interest rate increases. Recently, the interest or servicing cost of the debt of developing nations has been rising rapidly even as the average maturity of their debt has fallen drastically. This trend can be expected to continue. The servicing of this debt in 1980 amounted to about $55 billion repayment of principal and $37 billion of interest, according to OECD. If the servicing cost of the external debt rises faster than the disbursement of loans, the net transfer of funds for financing industrialization must diminish, which means that the net transfer of resources must decline. The net transfer of resources is comprised of the value of loans disbursed minus the sum of the values of the repayment of principal and interest. Mostly as a result of soaring interest costs, net transfers to the developing nations declined about 65 per cent between 1979 and 1980. Debt service costs will have increased greatly and net transfers diminished in 1981 and 1982 for several reasons:

(a) The average maturity of much of this external debt will be even shorter because of the shift to private commercial bank sources (e.g. Table 2).

(b) Private interest rates continued to climb in 1981 and remain stuck at high levels in 1982.

(c) The creditworthiness of borrowers is declining in the face of increasing protectionism and falling commodity prices that reduce export receipts.

By 1981 commodity prices had fallen to their lowest point in real terms (i.e. relative to import prices) since the 1950s and were continuing to slump so that to date (June 1982) commodity prices are on average about

16 per cent below their levels of June 1981.[5/] Higher risk borrowers must pay still higher rates of interest. Messages from these bad tidings already are being received. The estimated developing countries' debt service ratio (repayments of principal and interest as a percentage of export earnings) reveals an increase from 30 per cent in 1977 to 50 per cent in 1981. Last year, therefore, debt services absorbed half the export earnings of developing countries.[6/]

11. We began by saying that progress in the developing nations is threatened by growing trade deficits increasingly difficult to finance (at the margin) from traditional sources. We proceeded to show that reliance for external financing has shifted from long term to short term, from public to private sources. This transformation in a way diminishes the importance of the financing function. Some 14 developing countries accounted for more than 75 per cent of total debt outstanding at the end of 1980 with four of these countries accounting for more than 50 per cent of the debt outstanding from commercial banks.[7/] These same 14 countries also accounted for more than 77 per cent of developing country production of manufactures in the 1970s: the significant increase in the developing countries' share of world manufacturing output from 7.6 per cent to 10.2 per cent would have been impossible without the access of these 14 countries to large-scale external financial flows.

Table 2: Estimated outstanding debt of selected developing countries (disbursed, end 1980)

	Total debt $ billion	Debt from commercial banks
Brazil	55	43
Mexico	47	41
Argentina	21	19
Venezuela	22	21
Democratic People's Republic of Korea	21	14
Yugoslavia	15	10
India	17	-
Algeria	16	13
Indonesia	15	6
Egypt	13	3
Peru	7	4
Philippines	9	7
Chile	10	8
Pakistan	9	1

Sources: World Debt Tables, December 1981; Bank for International Settlements, July 1981.

12. We cannot leave this graphic picture without shading in some compositional detail in the external financing landscape. Certainly the considerable external resource flows to these developing countries were necessary for their industrial expansion. So too was the increased indebtedness of these countries essential, even though this external debt has led to a crisis. This is not to say, however, that these external financial flows went directly and exclusively to manufacturing or even mainly to industry. Developing countries, particularly those determined to industrialize, have considerable needs for development finance for many distinct purposes for which funds are in the accountants' jargon "fungible". A cash flow into one department of a business (or sector of a country) may release resources for use in another part of the business (or the country) for purposes only indirectly related to the particular department or in the case of a country, the particular economic sector. Thus a loan for an extension of rural literacy or a foreign direct investment in

a textile plant may release finance for investment in the nation's road network.

13. The main shift toward private external financing has occurred among what the World Bank describes as "middle-income countries". Again, the cause-effect moves both ways: these countries borrowed to grow and are able to borrow privately because of their industrialization success. No one grew exactly alike another, especially in the sense that their borrowed funds were allocated directly to a variety of projects culminating in the growth of manufactures.

14. We have established the importance of external financing of real capital investment on favourable terms in the overall industrialization strategy for the developing world. Moreover, we have traced recent trends toward rising external debt of the developing countries even as net transfers to them diminish. As of now, the size of the external debt and the magnitude of debt servicing costs comprise a global financial crisis. As adverse as present conditions seem, they pale in contrast to projections for 1990. Most such projections have been overtaken already by events. For example, current balance of payments account forecasts by the World Bank ("low economic growth" projections) for the oil-importing developing nations in 1990 probably will be reached in 1981.

15. Simulations for 1990 by the UNIDO model which more or less extrapolates current conditions are dominated by the persistence of large payment imbalances to finance growth rates less buoyant than in the past. The imbalances are particularly severe for Latin America and East Asia. The simulations show all the developing regimes having long-term debts of colossal dimensions in 1990. Outstanding debts in Latin America, South Asia and Tropical Africa would range between 32 per cent and 60 per cent of their GNP and in East Asia 64 per cent. Interest payments on outstanding debt would be as large as the current-account deficits of all developing regions, excluding West Asia. These levels of debt and interest, perhaps in error on the low side, are frightening because they are not sustainable. Innovative ideas, new policies and altered institutions are required, and quickly. Each day of inaction takes the global economy closer to the debilitating conditions and dangers of the 1930s.

FOOTNOTES:

1/ Trade and Development 1981, pp.34, 100, United Nations Conference on Trade and Development (UNCTAD), TD/B/863/Rev.1, October 1981.

2/ pp.37-38, UNCTAD, op.cit.

3/ See p.47, Table 16, UNCTAD, op.cit. The grant element is a technical measurement of the concessionality or softness of a loan: the lower the grant element, the harder the terms of the loan.

4/ See D. Avramović "The developing countries after Cancun: the financial problem and related issues", Journal of World Trade Law, January 1982. These debt values exceed those of the World Bank debt tables which exclude several nations.

5/ Avramović, op.cit., p.36, The Economist, 12 June 1982.

6/ Amex Bank Review, April 1982: note that the Amex Bank data includes the debt servicing costs of both long-term and short-term debt. Short-term debt (i.e. maturities of less than one year) is usually ignored by other agencies which publish data on developing country debt.

7/ See pp.92-93, Survey on International Banking, The Economist, 20 March 1982, for "Good Debt Guides", a comparative review of data on debt collected and published by the World Bank's debtor reporting system, the OECD/DAC, the Bank for International Settlements, and the IMF. OECD and World Bank data sometimes differ by one fifth for some countries. For a number of technical reasons there are major discrepancies between data from these sources, in particular the way in which short-term debt is treated (or not treated). Since short-term debt may amount to about one quarter of developing country debt (according to the IMF), its omission is serious. The coverage on private non-government guaranteed debt is also patchy, and for some countries may amount to about 20% of total debt.

PART III. INNOVATIONS IN FINANCE

The financing gap

16. The financing gap has two dimensions: quantitative and qualitative.[8/] This paper is meant to provide a summary background of the more important principles underlying a number of innovative proposals for change in international finance which have been made in recent years and go beyond improving existing instruments.[9/] Some of these proposals relate to new financial instruments, others relate to new financial institutions and mechanisms. All these proposals contain some elements which relate to the dimensions of the financing gap for developing country industrialization.

17. A theme common to these proposals, which has received an increasingly growing recognition in recent years, has been that of an increased capital flow to the developing countries serve the mutuality of interest in the world economy, despite the fact that industrialization in developing countries leads to a new international division of labour, with structural transformation taking place in the economies of both developed and developing countries. The degree of mutual interest between one country and another, or one country and a group of other countries, may be uneven, but that the sum total of the benefits accruing from financial co-operation has to be positive is in no doubt. Unfortunately none of these proposals nor of the concepts on which these proposals are based have been implemented by the international community for lack of will rather than lack of wisdom. All of these proposals are made by a number of prominent individuals or groups of individuals or countries which recognize the need for reforms in the current state of international financing.

18. For example, the mutuality of interest theme is contained in the proposal outlined by the Chancellor of Austria, Dr. Bruno Kreisky. The idea was aiding growth in developing countries which in turn would stimulate the economies of developed countries: use of excess industrial capacity in participating industrialized countries was explicit.[10/] Moreover, the idea of using developing countries as the engine of growth to the developed countries was recognized as far superior to that of increasing the domestic aggregate demand through macro-economic policies because not only is the multiplier effect stronger, but it would assist in resolving international structural adjustment problems.

19. Indeed, in a study prepared for the Commission of the EEC, there was a recognition that during the recession which occurred in the mid-1970s the world economy had been sustained to a considerable extent by the import demand of developing countries. It was estimated that unemployment within the Community would have increased by about 3 million at least if capital deficit developing countries had not continued to borrow in order to purchase exports from the Community.[11/] Another study suggests that in the construction of a steel plant in a developing country, over a ten-year period about four jobs would be created in the developed country for every job lost, as a result of a reduction in export demand for steel products.[12/] Similar considerations were at core of a report prepared by an Expert Group which was approved by Commonwealth Governments in January 1979.[13/]

20. A consideration of some of the principles on which these proposals are based will allow the Consultation to address aspects of two of the questions identified at the Global Preparatory Meeting, namely "How can the terms of external financing for industrial projects be liberalized?" and "What is the present and the future role of private external capital and of the multilateral and bilateral institutions?"

21. Some of the more important elements in these proposals will be examined through a consideration of external financing flows in the following areas:

(a) the private financial system;

(b) the multilateral and bilateral official institutions;

(c) official development assistance.

The private financial system

22. There is a common recognition of the important role played by the private financial system in recycling credit between surplus and deficit countries, developed and developing.[14/] At the same time, it is recognized that many developing countries have not borrowed from the private financial markets, either because these countries did not wish to borrow or were not allowed to borrow.[15/] Considerations of prudence on the part of prospective borrowers and of perceptions of creditworthiness on the part of prospective lenders were of relevance. In this connection, there was a recognition that low income developing countries, dependent on the foreign exchange export earnings of one or two commodities, might face difficulty in repaying private finance, since foreign exchange earnings of these countries as well as the quality terms of loans offered to them were subject to sharp fluctuations.[16/]

23. Increasing attention has been directed toward the capacity of the private financing system to continue to provide, at the minimum, amounts of finance to enable borrowing countries to roll over loans deriving from the use of relatively short-term money for long-term development, including industrial development-related investment.[17] The uneasiness arising from this has been compounded by yet another massive swing in the exchange rates of European currencies against the dollar between 1979 and 1982 and by the persistently high real interest rates during the past two years.[18] On the other hand, in the current international economic environment, the export prospects of developing country borrowers as well as several developed country borrowers have tended to diminish, causing nervousness in the private financing system.[19]

24. At the same time, the private financing system is not only subjected to the impact of external economic environment through their exposure to domestic borrowers. Banks are beginning to reappraise the risks inherent in large external lending.[20] The regulatory authorities of banks in the two leading lending countries have expressed concern over their banks' foreign lending. In recognizing the consequences of possible default and of giving special attention to the capacity of their commercial finance institutions to withstand such consequences, increased attention is being given to banks' total exposure in individual or in regional grouping of developing countries, with this exposure linked to balance sheet totals of equity and reserves.[21]

25. In order to alleviate the loan risks to developing countries and thus to provide a degree of stability to the flow of bank lending to developing co and to extend the sectors as well as range of countries seeking access t private banks, there was in 1977 the proposal to set up an International Loan Insurance Fund.[22] A proposal with certain similarities was advocated in May 1978 at the meeting of the Interim Committee in Mexico.[23] While the first proposal envisaged insurance cover for commercial bank loans, the second proposal envisaged guarantees on the issue of bonds which would be denominated in SDRs to minimize the risk associated with exchange rate fluctuation. Both proposals, however, assumed that guarantees would be provided by the developed countries and developed countries alone, in order to maintain such financial flows which would assist in overcoming the long-term structural transformation necessary in both developed and developing countries.

26. Another element in these two proposals was that additional finance so raised would go to development projects in general, while in a recent proposal with similar guarantee features, finance would be directed toward industry.[24]

27. In another proposal, there was reliance instead on an extension of guarantee arrangements on various co-financing operations between the World Bank, the regional development banks and commercial banks.[25/] It is noted that these four proposals could directly or indirectly facilitate the financing of industrial projects in a wider number of developing countries than is currently the case.

28. In a different proposal the Brandt Commission expanded the target for the use of funds raised on the international financial markets from project financing to programme lending in various sectors.[26/] Here there was an explicit recognition that one of the unfilled gaps in the industrial sector was for programme finance, i.e. an industrial finance gap for the purchase of spare parts, intermediate goods, and raw material inputs etc., as well as for the restructuring of debt contracted at unsuitable maturities for basic industry which went beyond the earlier proposals. In this explicit recognition, the international financial markets played a very significant role. Similarly, in the Arusha programme,[27/] there was also a recognition of the need for the programme lending technique. In this connection, industrial programme lending with its characteristic of quick disbursement would have the dual result of increasing industrial production in developing countries as well as having a quick impact on the development-derived deficit component of overall balance of payment deficits. There was the recognition that programme lending shares some of the extremely useful characteristics of syndicated credits, i.e. quick disbursement and flexibility in use, without the disadvantage of relatively short maturing debt. It is to be noted, however, that for a number of developing countries, the volumes of funds required under industrial programme lending would have to be commensurate with the need to restructure very significant amounts of this short maturing debt: industrial development-derived deficits.[28/]

The multilateral and bilateral official institutions

29. The discussion above involving the critical principle of extensions of guarantee powers and co-financing arrangements covers the relationship between the multilateral and bilateral institutions and the international financial markets: this principle governs an increased flow of finance from the international financial markets to developing countries via the multilateral finance institutions. The qualitative aspects of the financing gap in Third World industry are dealt with in a narrow aspect, i.e. concessionality with regard to interest rates and maturities, in the section below under Official Development Assistance. The remaining elements of the industrial financing gap relate to procurement and disbursement rules and to conditionality with respect to developing country policy,[29/] all of which are related to the management and decision-making structures in the multilateral and bilateral finance institutions. Moreover, to the extent that these institutions supply finance for non-industrial purposes, decisions have to be made by their managements between lending for industry and for these other purposes.

30. Loan finance for industry can be perceived to differ from finance for infrastructure, mining and agriculture in that resulting industrial output can compete, in the short term or the long term, with the main output of industrialized countries. Whereas infrastructure output is not traded, unprocessed output from mining and agriculture typically forms a major part of exports of developing countries:[30/] the transformation of these raw materials is done through industrial processes. Since finance for industry leads to a new international division of labour it is typically the most politically sensitive part of development finance: it is this which distinguishes it from development finance generally.

31. Dissatisfaction with decision-making arrangements in the multilateral institutions has been explicit or implicit in most of the proposals examined. The trend of these dissatisfactions relate to the limited role of developing countries in decision-making, including decisions on allocation, commitments, disbursements, conditionality, etc.[31/] Thus, some proposals incorporate suggestions for major changes within the decision-making structures, i.e. management and voting arrangements, within new or existing multilateral agencies,[32/] so as to allow a degree of equality between creditor and debtor countries. In the bilateral finance institutions, developing countries have no formal decision-making role.

32. Decision-making arrangements also govern the criteria used by operational staff in fulfilling their responsibilities.[33/] It is noted that multilateral institutions, new and existing, are by definition intergovernmental organizations so that government policies of developed and developing countries provide the background against which management decisions are made: these management decisions are then interpreted and implemented at the operational staff level. Thus, government policies are of direct relevance in allocations between finance used for industrial purposes and finance used for other development-related purposes. To the extent that the economies of both developed and developing countries are undergoing a structural transformation which is accomplished at differing speeds and with a greater or lesser degree of social and other difficulties, resulting government policies have an impact through the decision-making and management structures of the multilateral institutions on allocation not only for industry as against other economic sectors, but also between various branches of industry, e.g. light manufacturing as against heavy manufacturing, manufacturing for domestic markets as against manufacturing for export markets etc.

Official Development Assistance

33. All of the above concepts and proposals so far cited have at their base an increase in direct or indirect form of official development assistance. Thus, increases in guarantee arrangements, a concept common to many proposals, may be regarded by some governments as a contingent liability which may need to appear, depending on their administrative and legal systems, under their ODA budget allocation. Nevertheless, extensions of guarantee arrangements discussed earlier, as well as the necessary allocations to the industrial sector and to the least developed countries, could be covered relatively easily if developed countries as a group are successful in reaching the agreed United Nations target for ODA of 0.7 per cent of GNP of developed countries. It is be noted that one among the more recent proposals for providing development assistance has been that all countries, regardless of their income level (from Chad to Sweden, from the USSR to the Vatican), should participate in the aid process pledging a graduated share of their GNP, from 0.05 per cent from low income countries to 0.7 per cent from high income countries; other suggestions which do not fall on existing government budgets derive instead from the important concept of a "global commons". Thus, considerations have been directed toward

a possible levy (of a fraction of 1 per cent) on international trade, on resources regarded as belonging to all mankind (for example, the resources of the sea-bed) and yet another suggestion envisaged a tax on those activities regarded as detrimental to the global environment, including the production of armaments and of directly polluting activities.[34/]

34. Alternatively, recent proposals for major reform have identified the desirability of forging a link between the creation of SDRs and development finance needs which would involve the IMF.[35/] In this connection, the decision-making body governing the IMF could decide on a further creation of SDRs to the required amount and could allocate these SDRs under an appropriate formula to developing countries to be used for industrial and other development purposes as identified above. The most recent proposal[36/] envisages an appropriate international financial institution creating and issuing a new international currency, with all governments and their central banking authorities making the commitment to accept this international currency as a means of payment in settlement of debt obligations. This new currency would be loaned to developing country governments for periods of up to 25 years with low income borrowers paying a low rate of interest, and with other developing country borrowers paying a small positive real interest rate (i.e. slightly above the inflation rate in developed countries).

35. The immediate linkage between this concept and the industrial financing needs of developing countries is that firstly, it would allow a financial reconstruction of short maturity debt which has been used by many developing countries for their industrial investment needs over the past 10 years. Secondly, there would be a positive impact, if such lending takes the form of an industrial programme loan, on the industrial output of many developing countries, since this output has been seriously constrained in many countries by a shortage of intermediate outputs, spare parts, raw material, etc., the import of which has had to be compressed as these countries have struggled to cover development-derived balance of payments deficits: including their industrial development-derived deficits. More generally, the implication of this innovation could provide an instrument for the conversion of short-term funds arising from capital surplus countries, both developed and developing, into longer-term assets bearing a positive real rate of interest; the extensive use of such a new currency instrument would also provide a means of dampening some of the fluctuation in exchange and interest rates between major currencies: this dampening would in itself lead to an increase in industrial investment.

Conclusion

36. A residual gap for industrial financing will exist in most developing countries in quantitative and qualitative terms. Past efforts to reduce this gap have resulted in insufficient increases in volume of flows, and have in turn widened the gap in qualitative terms. The danger of leaving the residual gap for industrial financing unfilled would lead not only to slow rates of industrial growth in developing countries, but the result of this almost certainly would be increased political and social instability, and this in turn would lead to ever increasing international tensions. Unfortunately, in a cause-effect relationship, increases in international tension lead to the diversion of already scarce resources in the production and purchase of armaments. Thus, the implications of this financing gap have impacts on both developed and developing countries. There is a growing mutuality of interest between developed and developing countries as can be seen in the fact that while the net flows of external resources to developing countries have fallen from an estimated 22 per cent of gross flows in 1980 to estimates of near zero per cent of gross flows in 1982,[37/] growth rates in OECD countries which stood at 1.2 per cent per annum in 1980 (foreign demand accounting for two thirds) fell to 1.1 per cent per annum in 1981 (foreign demand accounting for four fifths) and are estimated to fall further in 1982 to 0.3 per cent per annum, with foreign demand accounting for about one third of this minute increase in growth.[38/]

37. Financial flows to industry can be increased through increased flows from the private financial system, the multilateral institutions and official development assistance. As indicated above, possible changes involving flows from these three channels to industry can increase in quantitative and qualitative terms if innovations in the modalities, instruments and institutions in the international financial system are accepted. That consensus which would allow innovative concepts to be developed and implemented has not been reached. Perhaps reforms of the international monetary and financial systems will one day be firmly placed on the international agenda and as a result some of the innovations identified would lead to a closing of the industrial financing gap in quantitative and qualitative terms. That there is a degree of mutuality of economic interest has been demonstrated above, but this mutuality has not yet been strong enough to overcome resistance to reform on a broad front. Consensus might be possible, however, on more limited arrangements.

FOOTNOTES:

8/ See Annex attached for a brief description of the quality of loan finance.

9/ The sources of these proposals are indicated in the footnotes to this paper.

10/ See also the proposal for a global infrastructure fund by Mr. Masaki Nakajima, President of the Mitsubishi Research Institute, in 1978; see also the proposal for a World Development Fund in North-South: a programme for survival (Report of the Independent Commission on International Development Issues, under the Chairmanship of Mr. Willy Brandt), Pan Books, 1980; the Development Assistance Committee (DAC) of the OECD has released a draft report in May 1978 on 'Elements of a Programme of Stepped-up Investment in the Third World in the Context of Interdependence"; "the Arusha programme for collective self-reliance and framework for negotiation", as adopted by the Group of 77 in Tanzania, 1979; and the proposal for an International Bank for Industrial Development, UNIDO, ID/B/261/Add 7. Currently the Industrial Development Board of UNIDO is considering whether an intergovernmental meeting should be convened to examine the proposal.

11/ See A study of interdependence, Europe and the Third World, Commission of the European Community, Brussels, 1978.

12/ See 1990 scenarios for the iron and steel industry, Part I. "The Dossiers", UNIDO/IS.213/Rev.2.

13/ See report of Commonwealth Group of Experts in A description and preliminary evaluation of proposals for global stimulation, paper prepared by R.E.Müller and D.H.Moore, UNIDO/IOD.324.

14/ See for example the proposal made by Prof. X. Zolotas, former Governor of the Bank of Greece, at the 1977 IMF/IBRD meetings for an International Loan Insurance Fund; see also North-South, op.cit.

15/ See North-South, op.cit.; Amit Bhaduri "An anatomy of the 'country risk' concept in the context of external debt of developing countries", information paper; "The influence of the variability of exchange and interest rates on industrial development", by J.M. Parly, E. Cohen and M. Poix, ID/WG.334/2, information paper.

16/ See Arusha programme, op.cit.; Parly et.al., ibid.; Bhaduri, ibid.

17/ This relatively short-term money gives rise to a deficit in the balance of payments on current account which is development related, hence "development-derived-deficit"; see p.41. Trade and Development 1981, TD/B/863/Rev.1, UNCTAD, 1981. See also R. Green, "The international financial system: limits and perspectives", information paper.

18/ Much higher for developing countries as their commodity prices have fallen drastically and protectionism increased: effective interest for some developing countries is currently above 30 per cent per annum; the economic position of developing countries has been described as alarming in the latest B.I.S. annual report.

19/ See The Economist, 20 March 1982, supplement of international banking; see also the Brandt Commission Papers, Independent Bureau for International Development Issues, Geneva-The Hague, 1981; Parly et.al., op.cit.

20/ See The Economist, ibid; the 1982 Annual Report of the Bank for International Settlements describes the world economy as suffering from fundamental economic instability; see Financial Times, 15 June 1982.

21/ See The Economist, 20 March 1982, op.cit.; see also D. Avramović "The developing countries after Cancun: the financial problem and related issues", Journal of World Trade Law, January 1982; see also remarks attributed to the President of the B.I.S. as reported in the Financial Times, 15 June 1982.

22/ Zolotas, op.cit.

23/ May/June 1978, Meeting of the Interim Committee in Mexico, proposal by the Mexican representative.

24/ ID/B/261/Add.7, op.cit.

25/ See Elements of a Programme, op.cit.

26/ See Brandt Commission, op.cit.; North-South, op.cit.

27/ See Arusha programme, op.cit.

28/ See Avramović, op.cit.

29/ See Annex for summary description of the quality of finance.

30/ Indeed, this is the main link between developed and developing countries: developed countries, traditionally, buy developing country commodities, while developing countries buy developed country manufactures. The problem is that generally developing countries do not increase their export earnings by increasing the volume of commodity exports. See The slowing down of the engine of growth, by W.A. Lewis, Nobel Memorial Lecture 1979, The Nobel Foundation.

31/ Brandt Commission op.cit.; elements of a programme, op.cit.; Nakajima proposal, op.cit.; North-South, op.cit.; Arusha programme,op.cit.

32/ See Arusha programme, op.cit.; UNIDO, ID/B/261/Add.7; for the suggestions that discretionary, orderly, untied and equitable arrangements would increase the quality of resource transfers, see Brandt Commission, op.cit.

33/ See Amit Bhaduri "How scientific is cost-benefit analysis?", ID/WG.358/5, information paper.

34/ See North-South, op.cit.; Brandt Commission, op.cit.; see also Economic implications of sea-bed mineral development in the international area, United Nations, A/CONF.62/25, 1974.

35/ See Arusha proposal, op.cit.; North-South, op.cit.; see also R. Green "The international financial system: limits and perspectives", information paper, for a report on discussions of this issue in various developing country forums.

36/ See Avramović, op.cit.

37/ Avramović, op.cit.; Green, op.cit.

38/ See The Economist, 29 May 1982, op.cit.

ANNEX

The parameters of the quality of loan finance

The quality of finance

The quality of loan finance is defined by the following elements:

(i) The interest rate: the lower the interest rate, the softer the loan: the converse is also correct. Floating interest rates can begin soft (or less hard) and in time can become hard; an additional penalty may have to be paid by the rational borrower in that the uncertainty in floating interest rates may deter the borrower and hence deter investment, including industrial investment.

(ii) The loan maturity: generally, the longer the time period contracted for repayment of interest and capital, the softer the loan (other things being the same, i.e. interest and exchange rates and procurement conditions).

(iii) The exchange rate: borrowers face uncertainty if the currency which they borrow is different from the currency they earn as a result of investment; if the currency they earn falls in value against the currency they borrow, the net result is a higher repayment of interest and capital. The converse is also correct. Uncertainty in exchange rates also deters investment.

(iv) Procurement conditions: a loan may be tied: to purchase of a particular product, or for a particular purpose, or in a particular market, or in a large number of markets. If the suppliers' market is competitive, the price paid for goods tends to be lower, but searching in a large market of potential suppliers also involves purchase costs. Procurement conditions also include various other constraints on how funds should be used and formal procedures and rules that borrowers contract to follow; to overcome both constraints and procedures involves costs and these costs tend to increase if the borrower is unfamiliar with the constraints and procedures. Disbursement conditions, i.e. the manner and timing of the receipt of the loan can be considered to be part of procurement conditions.

(v) Conditionality: a loan may be tied also to the condition that a borrower (private or government) changes certain of its economic, social and political policies; the consequences of conditionality can therefore be far reaching. In general, the greater the conditionality, the greater the "hardness" of the loan as perceived by the borrower. Loan disbursement is sometimes directly linked with conditionality.