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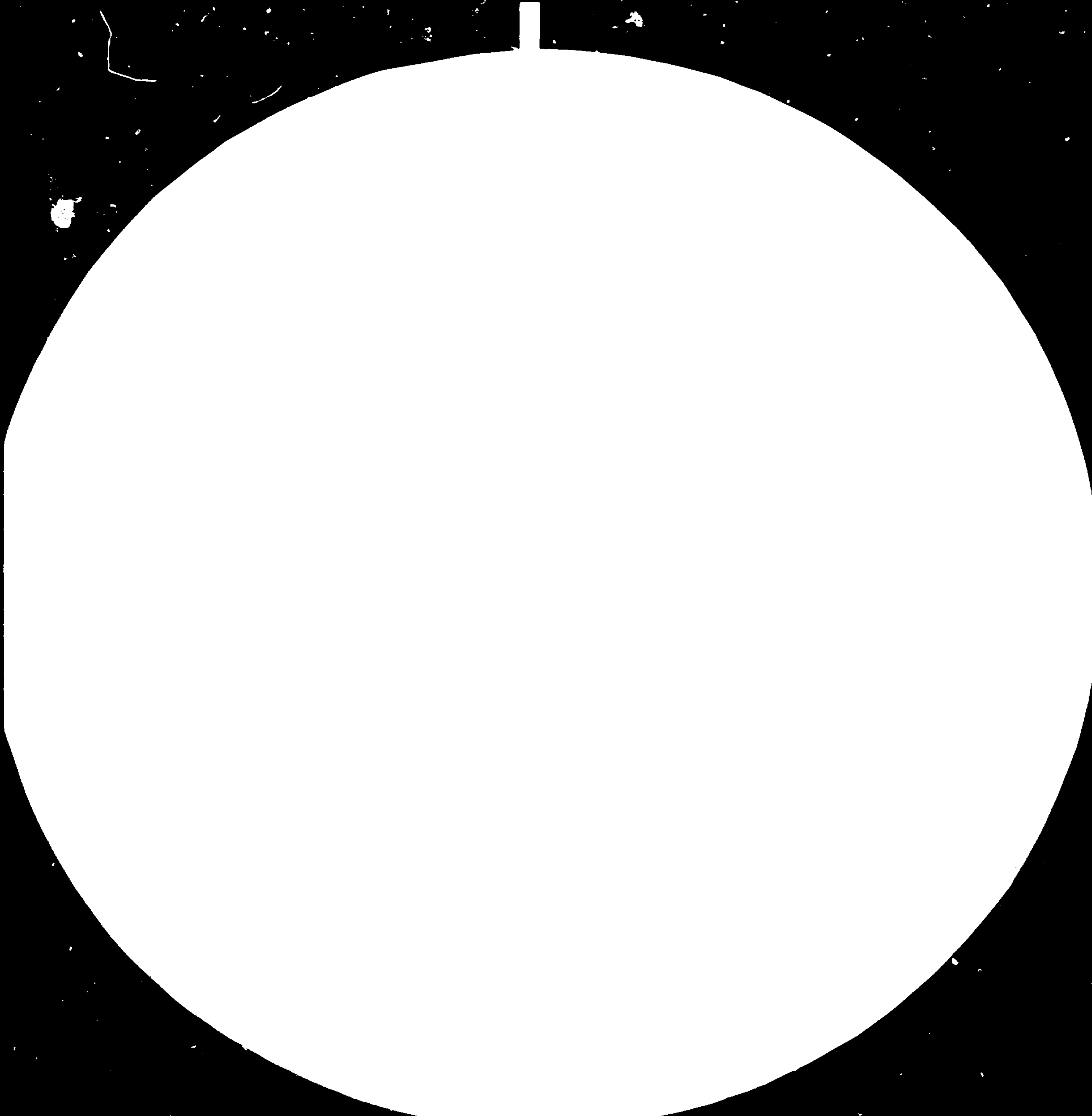

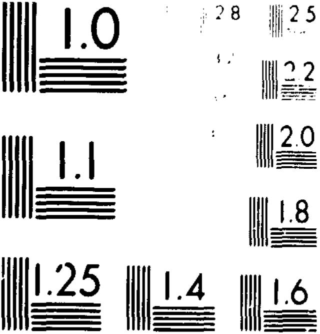
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ISSUE NO. 3: CAN THE POSSIBLE INDUSTRIAL FINANCING GAP BE OVERCOME BY THE ELABORATION OF INNOVATIVE CONCEPTS LEADING TO THE ACCEPTANCE OF NEW MECHANISMS AND/ OR INSTITUTIONS?*

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

INTRODUCTION

1. Issue no.1 identified a quantitative and qualitative gap in external financial flows arising from the dynamic nature of interdependence in growth, trade, industrialization and capital flows. Issue no.2 went on to examine 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. This present Issue no.3 comments on the principles behind proposals from many quarters, including the UNIDO secretariat, and on the uses of industrial finance. At base, all of these proposals respond to the perceived inadequacy of capital flows to developing countries and to the need to fill their uncovered external financial requirements.

RECOGNITION OF THE INADEQUACY OF PRESENT FINANCIAL ARRANGEMENTS

2. The principles behind some of the proposals referred to above are summarized in Annex I attached. Two of these proposals if implemented would provide finance directly to industry, i.e. barter-related investment arrangements and the International Bank for Industrial Development. Seven of the proposals relate to general development finance including industrial development finance: the World Development Fund, the Avramović proposal, commodity-linked bonds, the Mexican proposal, the Commonwealth initiative, the International Loan Insurance proposal, and the Arusha programme. The other proposals shown in Annex I are for the financing of other sectors, such as infrastructure and agriculture, which would assist in the overall economic development, and given the close inter-relationship between industry and other economic and social activities, would be supportive of developing country industrialization.

*/ 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.

3. It should be noted that these are but a sample of some of the proposals and that only the bare essentials are shown in Annex I: space does not allow an analysis and full description of these very important ideas. However, the thrust of all these ideas indicates a recognition that all is not well in the international economic and financial environment; this is not a discovery unique to the UNIDO secretariat.

THE QUALITY OF FINANCE

4. It should be further noted that most proposals incorporate the concepts of an increase in government guarantee arrangements and in varying degrees an increase in the quality of finance, e.g. interest rates, exchange rates, loan maturities, risk capital, allocation arrangements, and conditions for the commitment and disbursement of finance etc. Annex II describes in summary some aspects of the dimensions of the quality of external finance.

5. The volume of finance envisaged by various proposals varies from the large sum of $1 billion up to a massive scale of transfer of resources.

USES OF FINANCE IN INDUSTRY

(a) Capital equipment and machinery

Developing countries require long-term finance for the purchase of capital machinery and equipment just as enterprises in developed countries do. However, the time required for construction, start-up and operation at full capacity is typically much longer than similar activities in developed countries; this is in the nature of under-development. The traditional solution to this need for long-term finance is that it be met by the provision of equity financing (plus long-term financing). Traditionally, finance in these forms has been provided through foreign direct investment. In recent years, foreign direct investment has played a more limited role because of reservations on the side of both developing countries and foreign investors. Instead, credits from the official export credit agencies as well as the private banking system have provided the main source of funding. Relatively few developing countries have access to finance from the commercial banking system, and the quality of funds provided from the system has been low, involving short maturities and violently fluctuating interest rates. The official export credit agencies have overcome the problem of fluctuations in the interest rate, but here too maturities tend to be unsuitable for projects in the basic industrial sectors, i.e. iron and steel, fertilizers, heavy equipment etc. Additionally, capital goods exporting countries have adopted measures (i.e. the so-called gentleman's agreement, a finance cartel) so as to increase interest rates which decrease the quality of export credits.

Points for discussion

- Will the overall effect of current export credit terms and conditions decrease opportunities for the sale of capital goods and equipment in developing countries?

Additionally, it is noted that loan maturities and interest rates have been set at different levels for categories of developing countries as defined in the gentleman's agreement cartel.

Points for discussion

- How should developing countries as a group respond to these measures which discriminate against individual countries?
- Since the need for long-term loan financing can be reduced by earnings obtained from the export of developing country commodities and manufactures, is it in the interests of developed country manufacturers of capital goods that the foreign purchasers of their products face conditions which permit them to pay for equipment from a stable stream of export earnings?

(b) Infrastructure related to industry

Long-term finance is also required for infrastructure on which many industrial enterprises critically depend. At the Second Consultation on the Fertilizer Industry, there was an agreed conclusion on the importance that finance to provide infrastructure for this industry (i.e. roads, power and water etc.) should be of the appropriate quality. Reference is made here to recent statements of the President of the

World Bank of the need to increase financing in all economic sectors and the importance of ensuring that this finance is of the appropriate quality. Furthermore, the UNIDO secretariat has noted that recent World Bank bond issues have carried interest rates of more than 15 per cent in dollars, for relatively short-term money. Money so obtained is re-lent to developing countries at higher interest, although at longer maturities. In developed countries, infrastructure related to industry is often already in place or will be financed from other sources; this marks one of the differences between finance conditions facing industry in a developed or a developing country.

Points for discussion

- How can industry in developing countries obtain finance for industrial infrastructure on the appropriate terms and conditions so that they can maintain and perhaps accelerate their industrial development?

(c) Financing of industry in the least developed countries

As recognized at the United Nations Conference on the Least Developed Countries held in Paris in 1981, it is essential that the quality of finance should be as good as possible to overcome the very many disadvantages which the least developed countries face, i.e. interest rates should be low, maturities long, conditions flexible. It is noted that particular industries such as food-processing and the manufacture of agricultural tools and implements are essential to the very survival of these low income countries.

Points for discussion

- In the current phase of the world-wide economic recession, what are the measures which should be taken to ease the urgent industrial development problems of the least developed countries?
- Additionally, what can developed and developing countries individually or collectively do to provide finance in the volume and quality required for those manufacturing activities which are critical to survival in the least developed countries?

(d) Industrialization programmes

Most developing countries are small and most of their projects tend to be small. Economies of scale, infrastructure etc. indicate that their industrialization might best take place around one or two leading industrial sectors based on whatever raw materials and comparative advantages specific developing countries face. The UNIDO secretariat recognizes the importance of the linkages of a variety of small industrial enterprises with one or two leading industrial sectors as well as with agriculture, and the necessity for the planning and financing of industrialization programmes based on linkages with the leading sectors.

Points for discussion

- How do external financing agencies adapt their rules on the commitment, disbursement and conditions of lending to take account of the financing of industrialization programmes?
- Can the rules and regulations imposed by lending agencies be adapted and used flexibly in financing the many small projects which comprise an industrialization programme?

(e) Training programmes

In the context of preparatory activities undertaken for the First Consultation on the Training of Industrial Manpower (Stuttgart, December 1982), the requirement was identified of finance for training programmes, particularly for those basic industrial branches such as iron and steel, fertilizers etc. which are meant to play the role of "poles of industrial development". Moreover, such training should be programmed rather than piecemeal. The UNIDO secretariat recognizes that in many developing countries the stock of skilled industrial manpower is often small and that there is a necessity for improved means on a programmed contractual basis for the acquisition of these skills by developing countries; moreover, case studies have shown that finance required in manpower training programmes can amount to over 5 per cent of capital costs on heavy industrial plants.

Points for discussion

- Which of the finance agencies are willing to provide long-term low interest funding for the acquisition of programmed industrial skills linked to the purchase of heavy capital equipment?
- Additionally, how can existing contractual arrangements for the sale and purchase of equipment be extended to cover arrangements for manpower training on a programmed basis?
- In this connection, would it serve the interests of the manufacturers of heavy equipment to make special arrangements of a financial and organizational nature for the provision of necessary programmed manpower training?

(f) Industrial development services

A major barrier standing in the way of developing country industrialization is a shortage of the skills and services required for industrial development: industrial development services. Thus, in many countries industrial planning skills and services are scarce: the skills required for the identification, preparation, evaluation and implementation of industrial development project and programmes. The scarcity of these skills can often hamper rational industrial development, and for this reason purchases have to be made by developing country governments and/or enterprises, or by developed country governments providing soft finance acting through bilateral or multilateral channels, for the supply and improvement of such skills. The preparation of proper industrial plans, programmes and projects is an essential and inseparable part of industrialization: good projects and programmes require good preparation and should not be separated from the purchase of plant and equipment. However, budgetary constraints in both developed and developing countries may well lead to a decrease in resources going to these key areas; the effect of this may be considerable and long lasting, akin to the loss of seed corn.

Points for discussion

- Is it likely that budget cuts by all countries in the preparation and planning of industrial projects and programmes will have adverse effects on the industrialization prospects of developing countries, as well as on developed country capital goods suppliers?

- What can be done to meet these needs?

(g) Imports for industry

A problem increasingly common to industrial enterprises in both developed and developing countries has been the impact of the adverse external economic environment on their net cash flow. As a result, spending is cut on essential spare parts, services and maintenance. As serious as these problems are in developed countries, in many developing countries these problems are far worse. Enterprises in developing countries face not even the painful merger or take-over by stronger competitors, since in few developing countries do these options exist. Instead, industrial firms are faced with rapid physical deterioration of non-obsolete plant and equipment through firms' inability to obtain foreign exchange for imported critical spare parts, intermediate inputs and vital raw materials. Thus, in addition to capital investment, measures need to be undertaken to provide external finance for imports required for operating industrial capacity in developing countries.

6. IN THE CONTEXT OF ISSUES 1 AND 2 AND THE PROBLEMS ENCOUNTERED UNDER THIS THIRD ISSUE WITH RESPECT TO THE UNCOVERED EXTERNAL FINANCING REQUIREMENTS FOR INDUSTRY IN DEVELOPING COUNTRIES, what are the institutional changes required to meet these problems?

ANNEX I

SUMMARY: ANALYSIS OF FINANCIAL PROPOSALS
ALL PROPOSALS STRESS MUTUALITY OF INTERESTS
ALL PROPOSALS REQUIRE INTERGOVERNMENTAL GUARANTEES

Name of proposal, sponsor and year launched	Scope of financing	Size (US$)	Decision-making structure	Sources and methods of funding	Terms and modes of lending
1. An International Bank for Industrial Development, proposed by the UNIDO secretariat, April 1981	Industry	15 to 30 billion per annum	More equitable decision-making	Bonds and bank borrowing; arrangements for sale to capital surplus governments	Interest subsidy element as appropriate long-term
2. Barter-related buy-back instruments (UNIDO, 1980)	Industry	No limit	Not applicable Government to Government negotiation	Official or private finance institution as intermediary	Long-term project and programme; interest subsidy not specified
3. World Development Fund, proposed in the Brandt Commission report: <u>North-South: A Programme for Survival</u>, 1980	General	Massive scale	Independent global fund with universal membership and decision-making evenly shared between lenders and borrowers	Resources as may be raised on a universal and automatic basis, for instance through levies and global taxes	a) Long-term programme loans; b) Support for trade between developing countries; interest subsidiy possible

ANNEX I
(continued)

SUMMARY: ANALYSIS OF FINANCIAL PROPOSALS (continued)

Name of proposal, sponsor and year launched	Scope of financing	Size (US$)	Decision-making structure	Sources and methods of funding	Terms and modes of lending
4. Avramović proposal (1982)	General	Massive scale	Reform in decision-making	Long-term borrowing from governments with capital surpluses	Long-term project and programme lending
5. Commodity-linked bonds (UNDIO, 1980)	General	No limit	Not applicable	(No developed country government guarantees) Financial markets	Long-term project and programme; no interest subsidy
6. The Mexican proposal, presented at a meeting of World Bank/IMF Development Committee in 1978	General	15 billion	A separate fund to be administered by the World Bank	Bonds, with 15 year-maturity, issued on international capital markets	Long-term loans to projects, sector programmes and/or private firms
7. An initiative, presented by the Commonwealth Secretariat in the report The World Economic Crisis, 1979	General	At final stage: 44 billion with 12 billion paid-in	Negotiated guarantee arrangements between governments would enable bond issues for further fund raising. Reform in institutional decision-making	Raising funds on capital markets	a) Longer-term programme loans b) Interest subsidy element
8. The Arusha proposal, presented by the Group of 77, 1979	General	An initial additional transfer of 35 to 50 billion	More equitable decision-making	International capital markets; levies on the global commons	Long-term project and programme lending; an interest subsidy element as appropriate

ANNEX I
(continued)

SUMMARY: ANALYSIS OF FINANCIAL PROPOSALS (continued)

Name of proposal, sponsor and year launched	Scope of financing	Size (US$)	Decision-making structure	Sources and methods of funding	Terms and modes of lending
9. International Loan Insurance Fund (Zolotas proposal), 1977	General	Not specified	Not specified (independent agency)	Financial markets	Long-term project and programme lending; interest subsidy not specified
10. Kreisky proposal (1976/80)	Infrastructure	Initially one billion	Not specified	Not specified	Long-term project financing; interest subsidy element not specified
11. OECD/DAC Draft Report (1978)	Commodities, energy, infrastructure, food	30 to 50 billion	Collaborative approach	Borrowing from capital surplus governments, private financial systems, and export credit agencies	Project lending; long-term interest subsidy not specified
12. The Venezuelan proposal, presented at a meeting of OPEC ministers in 1977	Energy, minerals, food production and related inputs, infrastructure	16 to 20 billion	To operate as a special trust fund of the World Bank and/or of regional development banks; shared decision-making on a more equitable basis	Bonds on international capital markets; surplus government purchase of a proportion of bonds issued	Long-term project lending through multilateral finance institutions; interest subsidy element as appropriate
13. Nakajima proposal (1978)	Infrastructure	500 billion over 20 years	Reform in decision-making	Government budgets	Project lending; long-term interest subsidy not specified

ANNEX II

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 and commitment 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 and commitment conditions also include various other constraints (on allocation for example) 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