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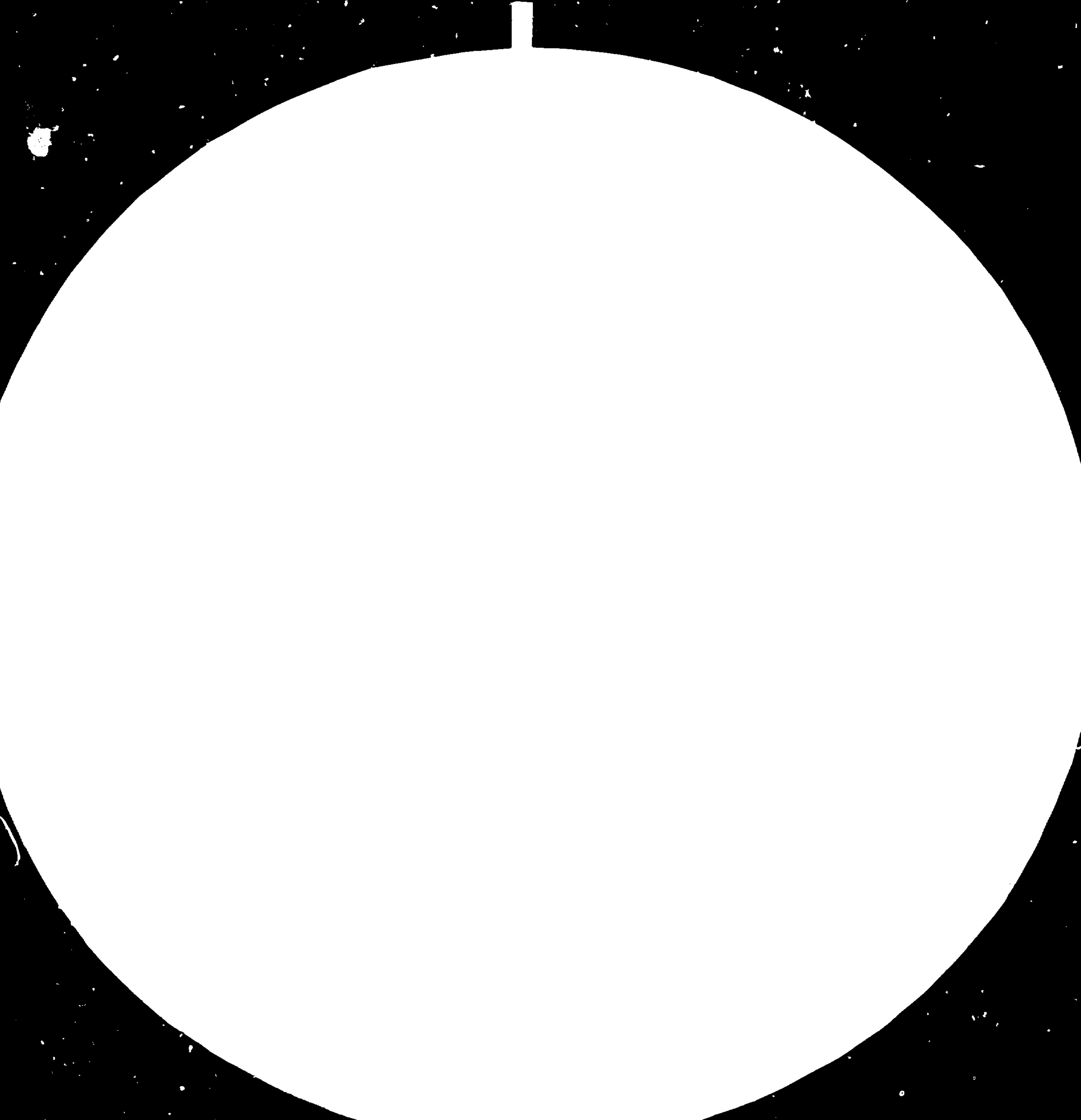

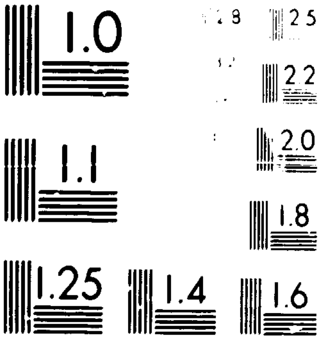
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ISSUE NO. 2: HOW AND TO WHAT EXTENT CAN EXISTING MECHANISMS AND INSTITUTIONS PROVIDE ADDITIONAL INDUSTRIAL FINANCING TO DEVELOPING COUNTRIES?*

prepared by

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

INTRODUCTION

1. Issue no. 1 concerns itself with assessments of the requirement and supply of external funds to meet industrialization needs in the developing countries. Estimates made by the UNIDO Secretariat indicate that the need for funds will not be met by a long way, not only quantitatively but also qualitatively, bearing in mind the specific profile of industrial financing. The projection of this uncovered financing requirement is based on an extrapolation of the historical trend in the supply of funds, ignoring any possible adoption of new measures or innovative changes in the modalities of financing.

2. Issue no. 2 considers ways of narrowing the uncovered requirement of external financing through changes and improvements in financial instruments which are currently used within the existing institutional framework. How much of additionality in external industrial financing can be achieved by such adaptation of existing instruments, will be determined not only by the parameters relating to each case, but also importantly by the global economic situation that might prevail in this decade and the next.

3. At this year's annual meeting of the Bank for International Settlements (BIS) held on 7 June 1982, the near- and medium-term prospects of the world economy were painted in dark overtones. Although substantial gains have been made in the fight against inflation, the BIS Annual Report emphasized that underlying inflationary expectations are still strong, leaving the Western industrial countries in a vulnerable position, with numerous forces steering the world towards a depression. The Report describes rising unemployment in the industrial countries and the "alarming worsening of the position of the developing countries" as contributing to a state of fundamentally unstable equilibrium in the world economy. While opening the annual meeting, the President of the BIS added his weight to the increasingly prevalent view among central bankers that commercial banks are becoming over-cautious in their attitude towards international lending. Despite the underlying inflationary expectations fuelled by high budget deficits, fiscal policies have not, by and large, supported the counter-inflationary actions of monetary authorities. This has caused high real interest rates in the industrial countries, pushing towards a decline in world liquidity.

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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.

Table 1: Nominal and real interest rates, 1977-81 (in per cent)

	1977	1978	1979	1980	1981
United States					
Three-month Eurodollar deposit rate	6.0	8.7	12.0	14.4	16.5
GNP deflator	5.8	7.3	8.5	9.0	9.2
Real interest rate */	0.2	1.3	3.2	5.0	6.7
Germany					
Three-month money market rate	4.4	3.7	6.7	9.5	12.4 ***/
GNP deflator	3.8	3.9	3.9	5.0	3.5
Real interest rate */	0.6	-0.2	2.7	4.3	8.6
Japan					
Three-month gensaki rate **/	5.6	5.1	5.9	10.7	7.4 ***/
GNP deflator	5.5	4.0	2.0	1.9	1.6
Real interest rate */	0.1	1.1	3.8	8.6	5.7

Sources: IMF, International Financial Statistics; Bundesbank, Monthly Report; Bank of Japan, Economic Statistics Monthly.

*/ If i represents the nominal interest rate, $\dot{p}$ the growth of the GNP deflator and r the *ex post* real interest rate, $1 + r = (1 + i)/(1 + \dot{p})$.

**/ Bond repurchase agreements.

***/ For Germany and Japan data refer to the first three quarters of 1981.

4. In order to prevent the international financial system from drying up the BIS suggests new forms of "active international co-operation" and calls for a strengthening of the role of official financing especially through selective intervention by the IMF which could create additional international liquidity through an increase in its quotas. There are, however, a number of specific questions to be addressed here: the proper size and distribution of IMF quotas; the need for a reinforcement of the World Bank's resources to deal with deep-seated problems of development in the Third World; the proper relationship between commercial banks and both these multilateral institutions; the World Bank's idea of an insurance fund for certain types of international bank loans; and the proper role of the central banks and the BIS in overseeing and underpinning the international banking system. These are basic questions which would determine the future global outlook for funds, against the context of which the possibilities of achieving additionality through innovations in instruments for industrial financing must eventually be viewed.

5. Following from the above, it is clear that the current recession severely threatens to affect the flow of funds from all sources, but particularly those which originate as grants in national budgets, i.e., Official Development Assistance (ODA). Total ODA which was granted in 1981 by countries belonging to the Development Assistance Committee (DAC) has been estimated by the OECD to have declined by 4% in real terms from 1980. Most of ODA which may be forthcoming would most likely be bilaterally tied to national exports through the granting of export credits, and be targetted mainly towards infrastructure and other social needs. Developing countries, particularly those which are least developed, will find it extremely difficult to earn profits in industrial enterprises which would be large enough to service present high real interest rates or offer higher returns on the risk capital investment. These countries would therefore continue to look upon ODA as a substantial contributor towards development needs, and attempt to achieve larger allocations to industry and its infrastructure.

6. In addition to ODA, both multilateral and bilateral, an examination of the prospects of filling the projected uncovered external financing requirement would therefore leave one to assess future prospects which might relate to funds from three major sources, namely, multilateral financing institutions, transnational corporations (TNCs), and the commercial banking system in the industrialized countries. A rough idea of the relative weights of these three sources of financing for industry in the developing countries is obtained from the following table.

Table 2 Estimates of the flows of external financing to manufacturing industry in the developing countries in 1980

(US $ billion)

	To Industry	Total Lending
The World Bank and regional development banks */	2.4	16.1
Direct foreign investment by TNCs	4.0	14.0
Capital market/commercial banks	7.2	25.0
	13.6	55.1

It should be noted that this table does not purport to indicate total flows from all sources to industry in developing countries.

*/ Including some ODA.

I. MULTILATERAL FINANCING INSTITUTIONS

7. Most developing countries would give a high preference to multilateral financing institutions including the regional development banks, in filling their gaps in external financing. These mainly comprise the World Bank, Asian Development Bank, African Development Bank and the Inter-American Development Bank. In the past this preference stemmed from the possibility of obtaining international development association (IDA) credits from the World Bank even for industrial investment, since these carry only a 3/4% service charge, bear no interest and are repayable over 50 years. Two recent developments however have overtaken this situation. First, the US administration has decided to stretch its commitment to IDA over a longer period, raising the risk of other contributors also making similar adjustments. At the recent Helsinki conference the President of the World Bank admitted that a short-fall of over $1.0 billion still remains in the year 1982. Second, because of the decline, the World Bank is beginning to target its IDA resources to the least developed countries and away from industry.

8. Nevertheless, the World Bank's direct lending still remains extremely attractive for developing countries wishing to borrow for industrial investment, despite the raising of the interest rate to around 12% and the imposition of a front-end fee of 1.5%. It has been hoped for some time that the total volume of World Bank lending would be doubled following upon a doubling of its capital base and/or relaxation of its present capital/borrowing ratio of 1:1. Unfortunately, after years of processing, the capital increase issue still remains in doubt, while a recent announcement by the President of the World Bank rejects the possibility of an improvement in its gearing ratio. At the same time, lack of progress on the setting up of an energy affiliate of the World Bank requires the institution to make substantial allocations to projects for energy development, leaving less for allocation to industry.

9. Problems which concern the future operations of the World Bank have also already begun to have their impact on the regional development banks. At a recent fund-raising session with major donors in Paris, the Asian Development Bank had to accept a reduction of about $1 billion in its lending capability. Multilateral institutions taken together are therefore faced with the certainty of reduced lending to industry.

10. One technique for increasing the leverage of its own lending is now being explored by the World Bank, namely, extensive co-financing with commercial banks, which are being offered the option of joining at the front-end, with the World Bank queuing up at the rear.

11. Co-financing is by no means a new idea; it has prevailed in some measure or form for a long while. Since the World Bank does not as a matter of policy finance any more than 40 to 50% of the foreign exchange cost of an industrial project, the need for building up a financing package has prevailed all along. Most often, however, parallel financing rather than co-financing has been the answer because it allows disparate procurement procedures and contractual arrangements to be pursued. The global preparatory meeting held in 1981 for the forthcoming consultation had recommended the examination of co-financing arrangements between national export credit agencies and multilateral institutions, particularly the World Bank. Since national export credit agencies would wish to tie their assistance to national exports, the potential clash with the World Bank system of international competitive bidding might be hard to avoid.

12. Prospects for increasing the resources flowing through multilateral institutions seem, under the present circumstances, to revolve around the possibilities of implementing extensive co-financing arrangements between the World Bank and the commercial banks as well as export credit agencies. To the extent that co-financing with the World Bank may overcome the concerns of country risk on the part of the commercial banks, there could be reasonable grounds for expecting that some additionality might result in financing for industry. This possibility, however, could be limited by the nature of the contractual arrangements and security obtained by the commercial banks, as well as by the possibility that a mere diversion of funding by the commercial banks may take place, leaving these banks at the present limits of their capital asset ratios. Any judgement as to whether such co-financing would result in additionality must therefore take the overall factors into account, and it is possible that the final outcome may at best be a marginal increase in the volume of total lending to industry in the developing countries, since these, as borrowers, may not welcome commercial bank loans being available in future only in tandem with the slow World Bank project cycle, and on the strength of its feasibility criteria. What would seem to promise better results would be wider co-financing between the multilateral institutions and the Arab funds including the Islamic Development Bank, which are not concerned with tying their financing to exports of goods and services. Appreciable additionality in industrial financing could result from these Arab funds if sufficient well-prepared industrial project proposals are forthcoming. In any event they could, particularly the Islamic Banks, provide a useful service by taking up equity and financing associated infrastructure.

Points for discussion

13. Participants are invited to discuss:

(a) whether the size, structure and difficulties in changing their statutes and regulations would constrain the multilateral institutions from increasing their lending to industry in the developing countries;

(b) whether effective co-financing arrangements can be designed between commercial banks and some or more of the multilateral institutions on the one hand and between the latter and the national export credit agencies on the other, taking into account the differences in procurement objectives and the interests and priorities of the borrowing developing countries;

(c) whether effective co-financing arrangements between the multilateral institutions on the one hand and the commercial banks, national export credit agencies, and the Arab Funds and Islamic Banks could lead to substantial additionality (what order of magnitude?) in the financing of industry in the developing countries and an increase in the range of borrowing developing countries.

II. DIRECT FOREIGN INVESTMENT BY TRANSNATIONAL CORPORATIONS

14. Recent developments show a growing policy thrust in certain industrialized countries, towards emphasizing the role of private enterprise in fulfilling the investment needs of the developing countries. Indeed the impending decline in IDA as well as the reluctance to increase the capital base of the World Bank or allow it to set up an energy affiliate are reflections of the present emphasis on the efficiency of the market place and of private enterprise as opposed to public undertakings. Given appropriate terms which fit the priorities of developing countries, the TNCs do provide a useful package of inputs comprising technology, capital goods, marketing, brand names, management expertise and sometimes financing. Concern is sometimes caused by the propensity of TNCs to exploit the extractive industries rather than other sectors in the developing countries, especially those dependent on a few mineral resources for generating a large part of their national income. It is felt that the sharing of benefits from mineral extraction under most arrangements with TNCs may not be entirely equitable from the point of view of the host countries. This aspect touches upon a whole range of questions pertaining not only to the TNC objective of

maximising global profits, but also to the capability of most developing countries to negotiate appropriate terms and conditions. Closer to the concern of the present consultation meeting however is the question as to whether the financing component in the package is provided from the TNCs' own generation of funds or whether it is usually "arranged" to be procured from the capital markets or the commercial banking system. If the latter is usually the case, one would fall back on the same pool of funds and crowd out other options of tapping this pool, so that there would be no additionality in total financing of industry in the developing countries. Even if funds are additional, i.e. self-generated by the TNCs, the benefits may be neutralized by higher prices for goods and services which may be charged by the TNCs. However, these are open questions, and well deserve fuller examination.

Points for discussion

15. Participants are invited to discuss:

(a) to what extent TNCs might offer a viable alternative option for industrializing the developing countries, taking into account the development priorities and investment climate prevailing in the developing countries;

(b) whether the financing component offered by the TNCs is provided from their own generation of funds and if not from where;

(c) how much additionality in terms of orders of magnitude could be provided in industrial financing available to the developing countries through the involvement of TNCs.

III. INDUSTRIAL FINANCING PROVIDED BY THE COMMERCIAL BANKING SYSTEM

16. Two distinct features marked commercial bank lending in the 1970s. First, it was the commercial banking system which undertook the bulk of the recycling of oil surpluses leading to an explosive growth in the volume of deposits taken and loans granted. Second, commercial lending took over as the largest single source of funds for developing countries seeking either balance of payments support or development financing. This lending however went almost exclusively to middle- and higher-income developing countries and was in fact concentrated on a very small group of about ten borrowers who improved their performance, while others, mostly low-income countries benefitted less. These latter countries could neither obtain nor afford commercial money.

17. A large proportion of commercial lending is of relatively short maturity which is really unsuitable for manufacturing investment with its longer pay-off periods. These short-term loans involve roll-over problems which can be severe when bunching occurs. While in normal circumstances roll-over may present no problem, it can provide an occasion for a crisis of confidence in a particular country. Industrial financing would require medium- to long-term credits which are affected by the current trend of high real rates of interest.

18. The extent to which the key sectors of the economies of developing countries were financed by commercial banks between 1973 and 1978 can be seen from table 3. Many of the loans financed programmes and projects vital to economic and industrial development. However, the actual percentage of commercial bank lending which went directly into industry was only 14% over the period 1973-1978. Considering that the bulk of the credits went to very few of the developing countries it seems clear that commercial bank lending supported industrial development in the Third World only to a limited extent during this period.

Table 3: Commercial bank lending to developing countries by sectors, 1973-1978

	1973	1974	1975	1976	1977	1978	1973-78	
	$ billions							%
Industry	0.3	1.3	0.6	2.8	3.6	5.2	13.8	14.0
Public utilities	0.5	0.9	0.9	2.5	2.5	5.5	12.9	13.1
Transport	0.5	1.2	1.1	0.8	1.2	2.7	7.4	7.5
Natural resources	0.4	0.3	0.3	0.6	0.2	0.9	2.7	2.8
Petroleum and natural gas */	0.4	0.4	1.1	1.4	1.7	4.6	9.7	9.8
Bank and finance */	1.4	3.9	4.0	4.5	4.2	9.1	27.2	27.6
General purpose	1.1	0.8	1.1	5.2	6.5	8.8	23.5	23.8
Public and community services	-	0.1	0.1	0.3	0.2	0.8	1.4	1.4
Total	4.6	8.9	9.2	18.1	20.1	37.6	98.6	100.0

*/ Some of these loans may have been for industry.

Source: World Bank, Borrowing in International Capital Markets.

19. Despite the fact that around 50% of the developing countries' current external debt is owed to the commercial banking system in the North, two considerations seriously limit the capacity of the commercial banks to undertake much greater lending. First, they find themselves at the limit of their capital/asset ratios making it highly unwise for them to extend themselves further, unless they raise new capital or widen the margins between loan and deposit rates to rebuild their reserves - a process which would take a long time. Lending capacity of the commercial banks may also be increased by a reduction of this ratio, but this would increase the fragility of the banking system and the vulnerability to defaults. Second, the extremely high debt service burdens already being shouldered by the developing countries inhibit the commercial banks from pushing up their country risk exposures much further.

20. These two constraints should prevent the commercial banking system from continuing to expand indefinitely. In the opinion of the World Bank ..." the extraordinary expansion of private commercial lending to developing countries that took place in the 1970s is unlikely to be repeated during the current adjustment".[1/]

21. On the other hand some take the optimistic view that if the commercial banking system has proved itself capable of adapting to major market upheavals in the past, it should be able to continue to do so in the future. Towards this end there are a few proposals for innovating with modalities and instruments in order to broaden the base and increase the volume of commercial bank lending in the future.

Co-financing arrangements

22. One possibility which could perhaps be most effective is that of co-financing between the commercial banks and the multilateral institutions already discussed above. A similar proposal relates to co-financing between multilateral institutions and commercial export credit agencies and other bilateral sources as well as Arab Funds and Islamic Banks.

1/ World Development Report, 1980, Washington, D.C., THE WORLD BANK, 1980, pp. 10-11.

Better use of industrialized countries' intermediation potential

23. This proposal starts from the observation that industrialized countries already do intermediate in the financial markets in favour of the developing countries. Part of the loans taken up by big industrialized countries is used to cover outflow of capital in the form of development aid and financing of export credits for developing countries.

24. Industrialized countries could use their intermediation potential more consistently and more efficiently than at present. They could borrow funds on the capital markets at more favourable terms and at greater volumes than developing countries. These funds could then be re-lent to developing countries on favourable conditions, e.g. by lending to developing countries which have difficulties in gaining access to private bank financing. Industrialized countries could also use part of their development aid budgets to assume exchange and interest rate risks, for instance through the setting up of an insurance fund. Even if such measure would imply a reduction in direct aid to developing countries, it could have the effect of increasing considerably the total volume of external financing on satisfactory terms to developing countries.

Promotion of risk capital financial instruments

25. In order to facilitate financial risk transfer other than through direct foreign investment, non-voting or non-controlling equity type financial instruments could be developed and promoted especially for the expansion of intra-Third World investment. These instruments may be attractive to both investors and users of funds in high-risk industrial activities, such as in countries largely dependent on the processing of raw materials and products which face significant market price fluctuations. They could offer an advantage over straight debt financing, because interest or dividend payments could be designed to fluctuate with profits or output.

26. Risk transfer can be achieved through the use of index-linked bonds and trade-indexed bonds, which could be sold internationally and intraregionally through orthodox channels. With index-linked bonds, the interest payable can be linked to an index or indices to allow for fluctuations with inflation. Similarly, trade-linked bonds can carry a return based on the trading performance of the issuing country; in this way both investors and users of funds can share in trading profits/losses.

Promotion of buy-back related long-term investment

27. Buy-back related investment may be contemplated as a means of transferring industrial capacity from industrialized to developing countries. The arrangements could be placed in the class of financing associated with risk transferral and with orthodox debt. Such arrangements would provide an effective method of increasing the volume of investment for industrial projects, of broadening the choice of sources for external investment and of gaining access to new markets while serving as a viable alternative to direct foreign investment. However, the benefits of such agreements would depend crucially on the knowledge of opportunities and the negotiating capabilities of developing countries. Co-operative efforts could be undertaken to:

- provide technical assistance to developing countries in order to help them determine their objectives, plans and negotiating strategies, as well as in the formulation of barter laws, and especially transfer prices;
- promote means through which financial institutions can facilitate barter and buy-back related investment arrangements;
- create a Multilateral Buy-Back Bank (MBB).

Other proposals

28. Several other proposals have been made in the attempt to increase the flow of industrial financing, by innovating with instruments which are not new. There are the possibilities, for example, of issuing long-term bonds with innovative features. The World Bank has recently announced its intention, subject to the Board's agreement, to borrow on international capital markets at variable interest rates. Currently in favour with the Bank's staff is the retractable issue, a fixed rate bond where the coupon changes periodically, say every three years. Private financing institutions may consider wider use of "venture financing" or plant-leasing which has already had a fair amount of testing. In order to provide a degree of stability to private bank lending to developing countries and to extend the sectors as well as range of countries having access to the private banks, a proposal was made in 1977 to set up an International Loan Insurance Fund.2/ A proposal with certain similarities was also advocated in May 1978 at the meeting of the Interim Committee in Mexico.3/

2/ Made by Prof. X. Zolotas, former Governor of the Bank of Greece at the 1977 IMF/IBRD meeting.

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

While the first proposal envisages insurance cover for commercial bank loans, the second proposal envisaged guarantees on the issue of SDR denominated bonds. A critical principle in both proposals, however, was that guarantees would be provided by the developed countries and that the maintenance of such financial flows would assist in overcoming the long-term structural transformation necessary in both developed and developing countries. These proposals could directly or indirectly increase the financing of industrial projects and widen the number of developing countries which would have access to commercial funds.

Points for discussion

29. Participants are invited to discuss:

(a) whether the commercial banking system is at the limit of its expansion as presently constituted;

(b) whether and how industrialized countries could in practice and effectively intermediate to increase the lending of the commercial banks to developing countries;

(c) whether index-linked and trade-indexed bonds would be a feasible proposition for raising industrial finance;

(d) whether the buy-back arrangements would provide an equitable basis for industrial investment in developing countries;

(e) how much additionality in industrial financing may be yielded by some of the other proposals referred to in paragraph 28.

IV. OVERALL EVALUATION

30. This issue paper reviews the prospects of increasing the volume of industrial financing through the present institutional framework by adopting certain innovations which promise to be potentially viable.

31. The participants are finally requested carefully to evaluate whether the uncovered foreign exchange financing requirement for industry in developing countries amounting to around US $50 billion in the year 1990 and US $100 billion in the year 2000 as identified under Issue No. 1, can be bridged by the above innovations within the existing framework of international financing.