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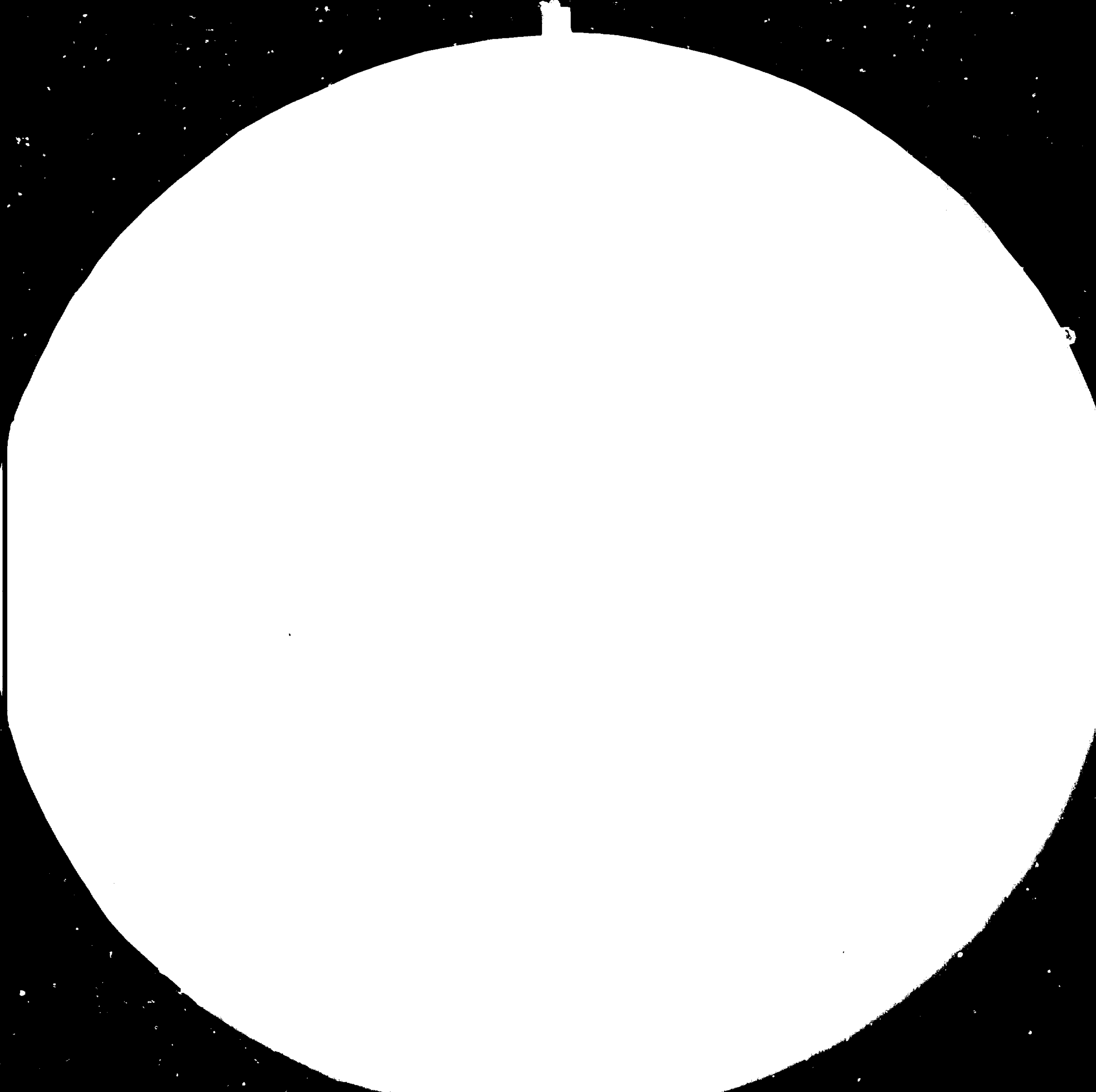

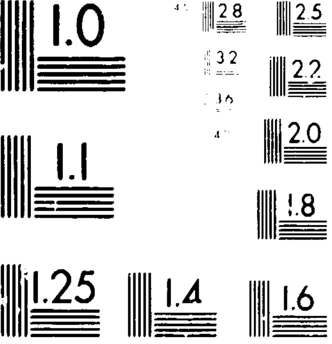

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INTERNATIONAL CO-OPERATION, RELEVANT NATIONAL ACTIONS INCLUDING INDUSTRIAL POLICIES, AND UNIDO'S CONTRIBUTION IN CRITICAL AREAS OF INDUSTRIAL DEVELOPMENT 1985-2000:

Mobilizing of financial resources for industrial development

Background paper prepared by the UNIDO secretariat

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CONTENTS

		Paragraphs	Page
Introduction		1 - 10	4
Chapter			
I.	CURRENT INTERNATIONAL SETTING AND ITS CONSEQUENCES FOR INDUSTRY	11 - 19	5
II.	PROGRESS, CONSTRAINTS AND PROSPECTS FOR FINANCING INDUSTRY IN DEVELOPING COUNTRIES . .	20 - 69	8
	A. External financing for industrial development	20 - 53	8
	B. Experience of national financing institutions in industrial financing . . .	54 - 57	16
	C. The "macro" view	58 - 68	17
	D. Conclusions	69	20
III.	THE ROLE OF DOMESTIC FINANCING FOR INDUSTRIAL DEVELOPMENT	70 - 106	20
	A. Problems and prospects	70 - 85	20
	B. Surveys by UNIDO of the domestic financing of industry in developing countries . . .	86 - 98	24
	C. The role of the State as financial intermediary	99 - 104	26
	D. Finance for small-scale industry	105 - 106	28
IV.	IMPLICATIONS FOR INDUSTRIAL FINANCING OF RECENT PROPOSALS FOR REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM	107 - 163	28
	A. Proposals to improve the financing of developing countries' deficit or investment programmes	116 - 137	29
	B. Proposals to enhance liquidity of the international economy	138 - 140	34
	C. Proposals to broaden compensatory finance	141 - 147	35
	D. Proposals to relieve conditionality . . .	148 - 152	36
	E. Proposals emphasizing the low-income developing countries	153 - 160	37
	F. Conclusions	161 - 163	39

Chapter		Paragraphs	Page
V.	CO-OPERATION BETWEEN DEVELOPING COUNTRIES IN INDUSTRIAL FINANCING	164 - 200	40
	A. Existing multilateral finance institutions in developing countries	167 - 176	41
	B. New forms of co-operation among developing countries' banks in the field of industrialization	177 - 193	43
	C. Implications of South-South co-operation, particularly for industrial financing	194 - 199	46
	D. Conclusions	200	48
VI.	SUMMARY AND EMERGING ISSUES	201 - 215	48
VII.	INTERNATIONAL CO-OPERATION AND THE ROLE OF UNIDO	216 - 221	52

3. The UNIDO secretariat submitted to the Industrial Development Board at its fifteenth session a proposal to establish an international bank for industrial development. While the Board has continued to request reports on relevant developments, further action on this proposal has been deferred.

4. At the First Consultation on Industrial Financing, held at Madrid in 1982, it was established that there was a serious problem of external financing for industrialization in developing countries, which would be aggravated if existing conditions prevailed. UNIDO was recommened to continue to analyse the problems of financing industry in developing countries, and notably the basic reasons for these problems and existing mechanisms and practices that made it difficult to obtain financing.

5. The identification and preparation of projects in developing countries is being pursued through the joint World Bank/UNIDO programme and the Investment Co-operative Programme of UNIDO. The Programme seeks to mobilize external financing for investment projects through a wide variety of contacts with investors and financing institutions. The Investment Promotion Service maintains offices in seven countries. A directory of financial resources for developing countries is issued regularly.

6. The present paper reviews the most important issues in the field of industrial financing at present and for the coming decades, for consideration at the Fourth General Conference. It should also serve as the necessary background for defining the future role of UNIDO in this field.

7. Industrial financing covers the area of interaction between industry and finance. The delimitation of the subject is therefore not a straightforward matter. It has, however, certain characteristics that distinguish it from other forms of financing. Underlying them all is the fact that a long time elapses before industrial investments, particularly in new capacity, enter a payback phase. The most appropriate financing for industry is that which meets the requirements (in terms of maturities, stability of interest rates, degree of insulation from exchange rate fluctuations, transaction costs, and so on) of a long-term payback.

$US 117 and $US 166 billion in 2000, against $US 20 billion for 1980. Estimates for total manufacturing investment and foreign flows over the two decades 1980-2000 are shown below:

Period	Manufacturing investment	Foreign flows to manufacturing
	(billions of dollars, 1975 prices)	
1981-1990	916	351
1981-2000 (average figures)	3 266	1 291

Thus, annual investment in manufacturing would have to be about 5.7 per cent (average figures) of GDP in constant 1975 dollars and perhaps up to 6.7 per cent (high figures) of GDP in the year 2000. This means a considerable increase over the ratio in 1980 (4.7 per cent). These estimates start from growth rates derived by the Lima Development Objective (LIDO) model of UNIDO, complemented by data in the UNIDO data base. * Other estimates of manufacturing investment required to progress towards the Lima target are even higher. 17/ With investment requirements of this magnitude, the question arises whether sufficient funds can be expected to be available at appropriate terms and conditions.

60. It should be noted that in the figures quoted above, about 60 per cent of funds are assumed to be provided by domestic financing. The availability of domestic funds will depend on whether Governments succeed in striking the necessary balance between consumption and savings - through internal economic policy - and whether domestic financing systems are capable of transforming these savings into investment in manufacturing industry. The latter problem is dealt with in chapter III below.

61. Many different future scenarios in these and other areas are indeed possible. Most projections and judgements indicate, however, that the total amount of funds available in money and capital markets, at least for the

development. It is important, in these more general flows, to make adequate allocations for measures that would contribute to industrialization.

10. The present paper addresses itself further to the obstacles imposed by the current and prospective shortfall of financing and the actions required to remove them. Reference is made to the current international setting, experience with existing sources of international finance and constraints and problems that have been encountered in developing countries. Recognizing that most investment is financed from internal sources, the paper also deals with issues of domestic financing, including the role of the State as a financial intermediary. It continues with an analysis of the international financial system, reviews current proposals for reform and analyses their specific implications for industrial financing. Finally, it examines the role of the multilateral financing institutions of the South and possible co-operation between banks in developing countries in accelerating the industrialization of developing countries in coming decades.

I. CURRENT INTERNATIONAL SETTING AND ITS CONSEQUENCES FOR INDUSTRY 2/

11. Growth in world production came to a standstill in 1982 and world trade fell significantly in volume and value for the first time since the Second World War (the decline was 6 per cent in real value in 1982). While all groups of countries have been affected, the developing countries have proved to be most vulnerable to the effects of international economic crises. 1982 was the third consecutive year in which real per capita income had fallen in developing countries. Budgetary cuts, shortages and a deterioration of living conditions are prevalent throughout the developing world. The contraction imposed upon developing countries, including the oil exporters, threatens the gains made in economic development. They have been unable to protect their productive sectors from fluctuations in interest and exchange rates. Unemployment rates have risen more rapidly and to much higher levels than in developed countries. Moreover, this has occurred for the most part without the safety net of the social security systems common in the industrialized

63. The contrast is even more apparent when considering non-official flows of capital. For this category of flows, which accounted for some 85 per cent of total capital flows in the period discussed, the industrialized countries accounted for between 50 and 60 per cent of total borrowings, whereas the non-oil-exporting developing countries accounted for between 23 and 24 per cent. At the same time, ODA increased only slightly, from $US 22 billion in 1977 to $US 37 billion in 1981. 16/ Direct foreign investment constituted a minor portion of net capital flows to developing countries in 1970. Subsequently, it has grown less rapidly than other forms of international capital flows.

64. In any case, if previous trends continue over the period 1981-2000, only about 50 per cent of the required external flows to manufacturing required to meet the Lima target will be met, with a shortfall of about $US 650 billion. According to UNIDO estimates, there will be a progressive deterioration in the situation if past trends continue. Annual foreign flows for manufacturing investment in developing countries will be about $US 50 billion at the end of the century meeting only one third of the Lima requirement. 18/

65. The fact that, while there are sufficient funds in the international capital market, there is a less than adequate flow of finance for industry in developing countries is largely due to shortcomings in the international financial system. Two aspects are of special importance.

66. First, existing multilateral financial institutions in fact channel rather small amounts of funds from the international market directly to industry in the developing countries (cumulative lending to industry by the World Bank and IDA stood at $US 7.1 billion in June 1982, to which must be added funds that reach industry indirectly through lending to development finance corporations). Normally their activities are based on grants received from donor countries or from borrowing on national or international capital markets, highly restricted by their existing capital structure. Currently only about 18 per cent of World Bank/IDA funds go to industry.

world. Thus unemployment in the South magnifies rather than reflects that found in the North and its effects are distorted. In many developing countries, this distortion has manifested itself in terms of further social imbalance and unrest.

12. This crisis of development in the South has to be seen against the background of the progress and structural transformation that occurred in the two decades ending around 1978. Over these two decades, economic growth and industrialization proceeded at a rapid pace and were financed for the most part from domestic savings. Investment as a proportion of domestic product had increased from around 11 per cent in the 1950s to about 18 per cent in the 1960s and reached about 24 per cent in the 1970s. This increase in investment accounted for the shift in the structure of these economies. The share of developing countries in world manufacturing value added had risen from 8.1 per cent in 1963 to 11 per cent in 1982 at constant (1975) prices. 3/ The fruits of this progress, as well as the progress itself, are now threatened; efforts have to be directed at preventing a move backwards.

13. The consequences of bankruptcy and industrial dislocation in developing countries are different from those in developed countries. Two specific phenomena have occurred whose incidence is accelerating in many developing countries. First, in some countries, fixed assets, that is, plant and equipment, face physical deterioration due to a lack of foreign exchange for spare parts and replacements. Secondly, skills embodied in workers and management may be lost through disuse, emigration or employment in different occupations of the domestic economy.

14. In some developing countries, enforced industrial dislocation and a move away from domestic and public-oriented ownership and control towards foreign and perhaps more monopolistic ownership may hamper the Government's attempts to implement fundamental changes in industrialization policy. Activities such as increased South-South co-operation, implementing new arrangements and instruments to facilitate joint production, trade, technology transfer and training, or other forms of co-operation among developing countries, could also be made more difficult. Thus, the economic crisis of 1981 and 1982 has not merely halted the industrial progress attained in the 1960s and 1970s but may well lead backwards to a loss of industrial capacity, manpower capability and the measure of domestic control and autonomy obtained with such great difficulty and sacrifice in the 1960s and 1970s.

15. The most severe impact of the crisis on the developing countries is in the financial sphere. Between 1980 and 1982, world commodity prices dropped under the impact of the world recession: 4/ 50 per cent for oil seeds and oils, 40 per cent for tropical beverages and 30 per cent for agricultural raw materials and minerals. New protectionist measures, coupled with weakened demand, hindered the South's exports to the North and the volume of exports from developing countries dropped, after having grown at an average annual rate of 3.4 per cent from 1973 to 1980. This meant a drop over two years of some $US 40 billion. Debt-service payments rose by approximately the same amount. Instead of contributing to the accumulation of resources for future growth and development, export earnings of developing countries go to servicing their foreign debt. Within the last five years, 1978-1983, the balance of payments on current accounts of developing countries as a whole have deteriorated sharply from a deficit of $US 28.8 billion in 1979 to a deficit of $US 42.3 billion in 1980 and $US 85.7 billion in 1982. Official

development assistance (ODA) has also declined in real terms. The share of developing countries in world manufacturing value added, which had grown from 9.3 per cent in 1973 to 11 per cent in 1980, has since, at best, stagnated. Industrial production in developing countries increased between 1973 and 1980 by about 45 per cent, whereas it has been constant since then. Gross capital formation as a percentage of gross domestic product (GDP) also remained at about 25 per cent from 1975 to 1980, after having risen from 21 per cent in 1973.

16. The developing countries' outstanding total debt, which in 1976 stood at $US 250 billion, had soared by mid-1983 to over $US 800 billion. 5/ Repayments of medium-term bank debts by developing countries, which were $US 21 billion in 1977, rose to over $US 44 billion by 1982. The spectacular growth of short-term debts in 1979 and 1980 meant that the developing countries had to roll over or repay over $US 140 billion, or three times the repayment of their medium-term debts, in 1982 alone. Interest payments of $US 60 billion, of which $US 48 billion were on medium-term debts, should be added to this figure, bringing total payments by developing countries to service their debts to about $US 244 billion in 1982. The ordinary debt-service ratio, i.e. service on medium-term and long-term debts as a percentage of exports, rose from 6 per cent in 1977 to about 24 per cent in 1982, while the total debt-service ratio, which includes servicing and roll-over of short-term debts, moved from 32 per cent to about 60 per cent in 1982. Taking into account the roll-over of short-term debt the debt-service ratio averaged 70 per cent for the 20 largest debtors, and for some countries was about 100 per cent. Debt service as a proportion of ongoing borrowing for all the least developed countries now stands at about 150 per cent.

17. These developments have brought into question the ability of the developing countries to service their debts and their ability to raise non-concessional finance has been hampered. It is by now conventional wisdom that this situation poses a threat to the world financial system and hence to the world economy as a whole. There is no doubt that the present international financial crisis cannot be overcome without a major recovery in the developed countries. It is still uncertain when and to what extent such a recovery will take place. 6/ Even though there are signs of recovery in the developed market economies, the overall outlook is still highly uncertain and government policies continue to be basically contractionary. Combating inflation remains the top priority in most developed market economies. There is also considerable uncertainty whether a recovery will spread to developing countries and have the necessary effect on their ability to export, to improve capacity utilization in industry, to raise foreign exchange, to service their foreign debt and to raise the international finances required for industrialization and development.

18. Even in a favourable short-run scenario for the world economy, there are still longer-term structural problems that require long-term structural reform in order to get the process of development on track again and to prevent crises similar to the recent one from recurring. While world recovery can help to counteract the reverses suffered by developing countries, it will not of itself bring an acceleration compatible with their needs and aspirations. To achieve a long-term improvement in the financial situation of the developing countries, structural changes in import and export flows will be needed, which in turn will require structural changes in output; these will call for basic changes and development in capital stock, which can be achieved only through industrialization.

19. While it is recognized that the measures necessary to achieve general economic recovery in the world and short-term measures to remove the current debt crisis are a prerequisite for every long-term growth process, including the industrialization process, and that the present crisis has severely changed the long-term industrialization objectives, such measures fall within the scope of general economic and financial policy rather than in the specific area of industrial financing. They will therefore not be dealt with in this paper which will concentrate on the long-term structural reforms in industrial financing, which are essential factors in achieving the goals for the industrialization of developing countries expressed in the Lima Declaration and Plan of Action, as well as in the New Delhi Declaration, once general growth is under way.

II. PROGRESS, CONSTRAINTS AND PROSPECTS FOR FINANCING INDUSTRY IN DEVELOPING COUNTRIES

A. External financing for industrial development 7/

1. Foreign equity 8/

20. Traditionally, foreign finance for manufacturing industry in developing countries was in the form of equity, ownership and control being in the hands of foreign shareholders. In many countries, this has become politically unacceptable, either because of a belief that foreign ownership of domestic assets is incompatible with economic and political independence, or on the more pragmatic grounds that foreign ownership and control enable the owner to capture a quite disproportionate share of the profits generated by the enterprise.

21. Some aspects of equity are well suited to the conditions of manufacturing firms in developing countries, in a way that other forms of international finance are not. Loan finance almost invariably carries fixed debt-service commitments, which have to be met regardless of the availability of profits to make the payments. All projects are liable to variations in their profits. Manufacturing projects in developing countries are more vulnerable than most because of strong variations in demand due to such problems as fluctuations in international prices for exported commodities and the risk of natural disasters, which affect domestic purchasing power and the availability of essential imported inputs. Theoretically, at least, providers of equity share these risks to an extent that providers of loans do not. There is some flexibility in the service obligations of equity finance, whereas there is none in the case of almost all loans, and equity service is, by definition, well matched to companies' earnings and capacity to pay.

22. Foreign equity is not, however, always ideally suited to the capacity of countries to pay. It is possible for a company to make profits at a time when the host country is facing balance-of-payment difficulties and is unable to supply foreign exchange for dividend payment.

23. Equity investment today is often more costly to the host country than would otherwise be the case, because investors perceive a higher level of risk. For the same reasons, there is probably a bias towards investments with exceptionally quick returns, and against investments with profits spread over long periods, to the detriment of a balanced type of industrial development.

24. Not surprisingly, equity represents a declining proportion of foreign financial flows to developing countries. It fell from only 19 per cent of the total in 1970 to 14 per cent in 1981. 9/ For many countries it has dried up altogether.

2. Eurocredits

25. Syndicated Eurocredits were the fastest growing form of foreign finance in the 1970s. Several features make them particularly attractive to developing countries. In contrast to multilateral loans such as those from the World Bank, or official bilateral loans or export credits, Eurocredits can be arranged and disbursed very quickly. This could be extremely important when the activity financed is part of a large integrated project and when any delay could involve extreme cost. Furthermore, they are not tied to purchases from any one country, as are export credits and a high proportion of bilateral aid. The borrower has more flexibility in the end-use of these funds. The total flow of Eurocredits can increase very quickly in certain circumstances. This is in contrast to the bureaucratic constraints on rapid changes in the flow of bilateral aid, for example, and may be tremendously important to a country faced with a sudden and serious worsening of its foreign exchange availability. One further advantage of Eurocredits is that they are available in a wide range of currencies and, since 1981, in special drawing rights (SDRs), thus permitting borrowers to diversify the currency composition of their debt portfolio in a planned way (although, so far, borrowers from developing countries have taken very little advantage of this facility and have borrowed overwhelmingly in United States dollars).

26. There are, however, a number of disadvantages in using Eurocredits for industrial financing. The financial charges carried by Eurocredits can be very much higher than those on other forms of international finance. They carry fully commercial interest rates; and a number of other charges (signing fees, management fees, commitment fees, drawdown fees etc.). There may be a spread of four or five percentage points over LIBOR (London interbank offered rate - the basic interest rate for Eurodollars); such a spread would involve a substantial element of country risk for most developing countries. Moreover, the rates, tied to LIBOR, are variable; this makes it difficult to determine the full costs to the borrower at the time the loan is negotiated. Worse, it ties such costs to a measure of international inflation, which may have little or no relation to the activities for which the credit is used. Costs are higher than official credits or export credits, and maturities are considerably shorter. Relatively short maturities reduce the time available for inflation to decrease the real value of debt repayment. The maturity is also often too short for the loan to generate the increased output from which repayments can be made.

27. The element of flexibility also has its disadvantages, since the terms of Eurocredits need have no relationship to the economic rate of return or the pay-back periods of the activities the borrower may actually use the funds to

finance (unless they are made to finance specific projects). Another disadvantage is that, just as the amount of finance available from Eurocredits can increase rapidly, it can dry up even more quickly if the international banks decide for whatever reason to reduce their exposure in a particular country - as indicated even in the 1970s. Indeed, the industrial enterprise may remain fully creditworthy and yet be unable to obtain new loans, or roll over existing ones, if the host country loses its credit rating in the market. Moreover, since Eurocredit syndicates now include a very large number of banks from many different countries, renegotiation of credits can be an extremely complicated and time-consuming process, made all the more delicate by cross-default clauses under which a small, relatively inexperienced bank, by putting a lien on the assets of a country or other borrower, could cause all loans to become due and payable. In summary, the high charges, variable interest rates, short maturities, unpredictability and complexity of syndicated Eurocredits limit their suitability for industrial financing in developing countries.

28. For these reasons, Eurocredit financing must be considered as less suitable than other means of financing industry in developing countries. The introduction of new mechanisms for maturity transformation and spreading currency and country risks would greatly improve the possibilities of tapping this source of financing.

29. It might be desirable for the Government of a developing country to take on the risk of interest-rate fluctuations. The Government will normally have, through the central bank, some assets invested in the same Euromarkets from which domestic companies are borrowing. In some countries, the foreign exchange reserves, mostly invested in short-term assets carrying variable interest rates, are in fact quite a lot larger than the amount of variable interest rate debt taken on by domestic borrowers. In such a case, where the Government has more to gain from a rise in, say, the rate of interest on United States dollars than borrowers have to lose, there is obviously a very strong case for the Government to carry the risk on behalf of the borrower. Even in countries where the foreign exchange reserves are smaller than the amount of variable interest rate debt, the Government would probably be well advised to consider carrying this risk, partly on the grounds that the risk is too large and unpredictable for most companies, partly on the grounds that the growth of manufacturing industry is a national priority (if such is the case), and partly on the grounds that the Government is often better placed to get short-term credit or use its reserves at a time of high interest rates in international markets.

30. In the absence of a Government or a domestic financial institution willing to carry the risks inherent in foreign exchange interest rates, any company borrowing abroad in commercial markets is taking a large and unknown risk. The cost of repaying Deutsch mark and Swiss franc, for example, more than doubled in the 1970s, and although both currencies weakened in the early 1980s, this would have been of no comfort to a company that had had to repay some or all of its foreign borrowing before that weakening occured. LIBOR has varied between 5 per cent and 20 per cent in the last 10 years. The need for an international mechanism to carry the larger part of these risks is therefore obvious.

3. Export credits

31. The flow of official export credits to developing countries is much smaller in total than the flow of Eurocredits ($US 2.8 billion in 1981 compared with $US 25.0 billion of bank lending). Official export credits have, however, many of the same characteristics as private export credits, which are much larger in total volume ($US 10.6 billion in 1981). Official export credits have the considerable advantage of fixed interest rates, currently about 10 per cent with quite minor variations according to whether the borrowing country is classified as very poor or not. Interest rates and maturities of official export credits are agreed among the major industrial countries from time to time, in order to avoid "excessive competition". This has some curious effects, since the interest rates, until recently, took no account (and still take very little account) of the different interest rates prevailing in the market for the various currencies, or of their probable variations in value against each other. It has at times, therefore, been possible to borrow more cheaply in commercial markets than by using official export credits.

32. All such credits are, of course, tied to the country offering the credit, and most private credits are also tied to the particular firm supplying the goods. If goods are bought because of the offer of a credit, then the borrower is highly likely to be paying prices very much higher than the cheapest available alternative. There are many examples of borrowers in developing countries buying expensive and inappropriate equipment because of the offer of export credits.

33. If, on the other hand, the manufacturer first identifies the cheapest equipment appropriate to his needs, then export credits are often a useful and reasonably priced source of credit, well suited to the purchase of many types of equipment.

4. Multilateral loans

34. Multilateral financing institutions such as the World Bank and regional development banks (the Asian, Inter-American, African and Carribbean Development Banks) play an important role in providing financing for industry with maturities very much longer than those available from commercial lenders. These institutions have, however, devoted only a small share of their resources to industry (ranging from 4.3 per cent for the Inter-American Development Bank to about 30 per cent for the African Development Bank, which recently decided to allocate $US 1 billion specifically for industrial projects during the 1980s). The World Bank and the International Development Association (IDA) directed only about 7 per cent of their lending to industry in the fiscal years 1981 and 1982. Even with the inclusion of lending to development finance corporations - since such corporations, for the most part, specialize in financing industry - the total allocation comes to no more than about 16 per cent. Manufacturing, which in the past accounted for about two thirds of the number of projects financed by the International Finance Corporation, accounted for less than 38 per cent of new approvals in 1983. 10/

35. Multilateral lending is dominated by the World Bank, which has accounted for about two thirds of the total in recent years. Furthermore, other multilateral lenders, such as the regional development banks, tend to follow World Bank practice in a number of important ways. While the World Bank has in the past few years initiated a number of measures that should have beneficial effects on the flow of financing to industry in the developing countries, such as increased lending for energy, programme lending for structural adjustment and co-financing arrangements to extend maturities of commercial loans and attract new funds, there have also been some developments with adverse effects, such as the introduction of variable interest rates and the shortening of maturities. Until recently, one of the main attractions of multilateral loans was that they carried an interest rate that was fixed for the life of the loan. The World Bank has recently changed its practice: its loans now carry variable interest rates, although only on a relatively small proportion of each loan. In itself, this does not add greatly to the risk of using World Bank finance; but the Bank has started requiring repayment of equal annual amounts of capital, with interest on the outstanding balance. This means, of course, that the total debt service is highest in the first year of capital repayment and declines thereafter, greatly to the disadvantage of the borrower.

36. The main advantage of multilateral loans is that their maturities have been much longer than those obtainable commercially. Some lenders still have very long maturities, especially from their soft-loan windows. Some borrowers have found, however, that the World Bank has been shortening its loan maturities from more than 20 years to around 15 years. This is still attractive, especially for manufacturing projects, which tend to have much shorter payback periods than infrastructure projects. But this shortening of maturities would have quite a significant effect on the prices charged by, say, a hydroelectric scheme, which would in turn increase manufacturing costs. In combination with the change from a system of equalizing annual debt-service payments, the effect could be very serious. It would, however, be very simple to devise a schedule of capital repayments that roughly equalizes total debt service, even when the rate of interest over the life of the loan is not known in advance.

37. Another disadvantage of present multilateral lending activities is the delay involved in reaching agreement on the terms of the loan; this is a result of the use of project, rather than programme, lending. Loans for specific projects often require lengthy and complicated negotiations, which may result in a costly delay in the project itself. Moreover, unlike commercial lending, multilateral lending may be contingent upon agreement on policy questions relating to the plans and priorities of the Government of the developing country concerned and may thus be seen as unwarranted interference.

5. Bilateral aid

38. The major advantage of bilateral aid is the softness of the financial terms. These make bilateral aid extremely attractive to borrowing countries, especially at times of severe balance-of-payments and foreign-debt crises, as at present. The very softness of the terms of most bilateral aid, however, gives to the lending agency an exceptionally strong bargaining position when negotiating the conditions under which a loan must be used, because of the

great need of borrowing countries for such soft finance. Bilateral aid is not often available for the manufacturing industry, but such lending has a major effect on manufacturing costs because it is frequently used to finance such things as electricity and transport.

39. Bilateral aid is also, however, part of the foreign policy - both political and economic - of the lending country. About 50 per cent of it is tied in the formal sense that it may only be spent on the exports of the lending country; an unknown additional amount is informally tied in that the lending country uses various ways of bringing pressure on the borrowing country, to use the aid in ways that benefit the lending country's industry. Other costs include the fact that all bilateral aid loans are denominated in the currency of the lending country, and delays in negotiation can be long. Bilateral aid may not always be as cheap as it appears on paper, but it may still be less costly than the cheapest available alternative.

6. International bonds

40. An international bond can be defined as an issue made by a borrower in a capital market outside the borrower's country. A Eurobond issue is denominated in a currency other than that of the host market, underwritten by an international syndicate and sold in two or more capital markets. These bonds were an important source of external financing for a few selected non-oil-exporting developing countries, predominantly in the high- and middle-income group, which accounted for about 98 per cent of the total capital raised through bonds by developing countries. However, total borrowings by developing countries in the bond market declined in 1979 and 1980, reducing the developing countries' share of the total to 10.6 per cent in 1979 and to only 7.7 per cent in the first half of 1980. 11/

41. One of the major difficulties encountered by non-oil-exporting developing countries entering the international bond market is that the terms on which they are able to borrow are much tougher than they are for sovereign and corporate borrowers of developed countries. Maturities, too, are shorter. Given the current credit problems of many non-oil-exporting developing countries and the poor chances of an immediate improvement, the possibility of raising more substantial sums in the international bond market at acceptable rates and for sufficiently long periods appears to be rather remote.

7. Conclusions to be drawn from past experiences with existing sources of financing

(a) The common search for new forms of lending

42. There is an obvious mismatch between fixed debt service on loans and the variable capacity of developing countries to pay. In international finance, however, lenders do not have the option of declaring a defaulting sovereign borrower bankrupt and selling the borrower's assets for what they will fetch; they can only continue to support the borrower in the hope of recovering both old and new money at some future date. Corporate borrowers in

developing countries could, in some cases, be forced into bankruptcy by their international creditors, but that would still leave the problem of converting the proceeds of the sale into foreign currency.

43. The almost universal pattern, then, is for negotiations to take place on the rescheduling or refinancing of debt. In this sense, the mismatch between the terms of repayment and capacity to meet those terms could be said not to matter: the rigidity of repayment terms is only de jure. De facto, rescheduling and refinancing provide the necessary flexibility.

44. If countries can default on their debts, and then negotiate at their leisure with creditors, it could be argued that there is no point in devising new forms of lending to reduce the likelihood of default. But borrowers do suffer in such a situation. It becomes extremely hard, while in default, to arrange new credit, even the routine trade credit on which nearly all international trade is based; and countries that run into difficulty with debt service are, almost by definition, badly in need of additional international loans. It would seem, therefore, that borrowers would prefer more flexible forms of finance de jure, because reduced debt-service payments in a bad year, legal under the original loan agreements, would probably mean that it would be easier to continue to borrow in a financial crisis. At present, once a borrower is in default, it is difficult, if not impossible, to obtain any financial assistance beyond that provided by delayed payment of debt service on the existing debt.

45. Lenders also have an incentive to devise new forms of lending. Renegotiation uses up management time, damages the lender's reputation, and may lead to reductions in declared profits through greater provision for doubtful debts. Although international banks receive fees for renegotiated loans, the flow of new lending is reduced to nil, or at most to the level imposed on the banks by the International Monetary Fund (IMF). If new forms of lending instruments could in fact be devised, based on the borrower's capacity to pay, lenders would have to be compensated for the prospect of lower debt service in bad years by an agreement to pay higher debt service in good years. Meanwhile, because a reduction in debt service was legal under the original agreement, bank auditors would not be required to insist on increased bad-debt provision out of profits. It should be mentioned that certain lenders, such as the Compensatory Financing Facility of IMF, and the STABEX export stabilization scheme of the Lomé Convention, have automatic mechanisms for deciding when the sovereign borrower can afford to repay.

(b) Programme financing for improved use of capacity and structural adjustment support

46. Rationalization, maintenance and improved capital utilization are extremely important for the industrialization of developing countries. Although data are scattered, there is overwhelming evidence of poor capacity utilization in the industrial sectors in developing countries. 12/

47. While the importance of adequate working capital is recognized, any improvement in capacity utilization will depend largely on a general improvement in the overall economic situation, brought about by increased demand and improved terms of trade. Direct financing for the increased utilization of industrial capacity has largely been confined to direct

subsidies and to export financing schemes, the impact of which has in both cases been hampered by a lack of domestic and external demand. The financing possibilities are, however, poor. Structural adjustment support is one means of improving capacity utilization in the longer term. The building up of infrastructures, a diversification of economic activity, a greater compatibility between various sectors, and the removal of bottlenecks in the economy will contribute to the achievement of this objective; programme lending can be one of the main modalities of structural adjustment support.

48. Programme financing, i.e. financial support for a whole range of related projects and investment activities, not tied to any one specific project, can provide flexibility and speed of disbursement, improve the prospects of building the required structures for industrialization and help developing countries to avoid the larger-scale projects historically preferred by these countries and by many international project financing mechanisms. Such programme financing schemes can involve elements of both industrial financing and more general development financing, without any clear demarcation between them.

49. The need for programme financing has been particularly stressed by the Brandt Commission, 13/ but also earlier by the Pearson Commission 14/ and by a number of countries in the joint World Bank/IMF Development Committee. Programme lending, supporting the process of capital formation and capacity utilization, has a greater expansive effect than project lending. Programme loans can also reduce the waste of resources from incompleted projects. They are particularly suitable for countries in which certain sectors have been "overdeveloped" through project financing. It should be noted that post-war experience in Europe made it clear that reliance on specific project provisions was incompatible with the need for a speedy and efficient transfer of resources. Most of the Marshall Plan funds were therefore disbursed on a programme basis, as were the loans granted to European countries by the World Bank during this early period.

50. Whereas there are strong arguments in favour of increased programme financing for developing countries, the arguments against it are also well-known. It is feared that programme financing may encourage waste, that funds may be used for consumption or military expenditure rather than for investment and so on. In fact many of these arguments are identical to those being voiced against loans by commercial banks. Additionally, investors have traditionally had a preference for project financing because they feel that it allows them to retain identifiable control over the end-use of their funds, as well as to enforce the necessary conditions.

51. As matters currently stand, however, the need for programme financing is widely recognized. The discussions and proposals of the Brandt Commission 13/ as well as the interest of the World Bank in structural adjustment loans, bear witness to this.

(c) Adequacy of available forms of financing for industry

52. Of the sources mentioned above, Eurocredits are not well suited to industry and can be expected to decline in availability. The drawbacks and declining popularity of equity have already been referred to. Multilateral loans and export credit, while useful, are of limited and insufficient

magnitude. Bilateral aid is very limited. The need, therefore, for new forms of financing to reduce the mismatch between the requirements of potential suppliers and recipients of funds is acutely felt.

53. It is worth noting that some multilateral institutions already offer equity finance, notably the International Finance Corporation (IFC) and the Commonwealth Development Corporation (CDC) and certain Islamic and Arab institutions (such as the Islamic Development Bank and the Kuwait Fund). While this financing is a partial solution to the problem being discussed, it is conventional equity, in which the standard rights of ownership and participation in management of all shareholders are held by IFC and CDC. What is needed is a form of finance with the flexibility of equity in the payment of debt service, and the arms-length relationship between lender and borrower of commercial bank lending.

B. Experience of national financing institutions in industrial financing

54. The difficulty of generating bankable industrial projects is often pointed out by financing institutions. The activities of the UNIDO Investment Promotion Service, as well as those connected with feasibility studies, are to a large extent devoted to generating suitable projects that would be accepted for financing by international institutions. The need for this type of activity was also strongly voiced at the First Consultation on Industrial Financing, notably by the industrialized market economy countries.

55. The two views whereby on the one hand the flow of funds to industry is insufficient and on the other hand the number of bankable projects is too small are not incompatible. The apparent discrepancy can be explained by the following facts:

(a) Global long-term industrialization objectives, such as the Lima target, do not appear within the conceptual framework of financing institutions. By definition, these objectives will not be met through a "continuation of present trends" or within the present financial framework, based on flows from, or through, the North to the South on conditions and in forms such as those reviewed above;

(b) Good projects are, by definition, those that can meet current requirements given prevailing interest rates, maturities and other conditions. If these terms or conditions are unsuitable for the industrialization requirements in developing countries, as is often the case, the number of good projects will indeed be very low;

(c) Potentially good projects may exist but, because of a lack of proper identification and promotion, they will never reach the financing stage.

56. A limited survey of the views of a small number of bankers from developing countries was carried out by UNIDO at the Third Conference of Banks from Developing Countries, held at Ljubljana from 6 to 8 July 1983. Results indicate that bankers in developing countries often see financing as a major

problem for industrialization in their countries. * The lack of adequate resources, lack of loan security and lack of absorptive capacity seem to be especially prominent obstacles to effective industrial financing. There are, of course, many other barriers as well, one being absence of good projects. A good project is often defined by bankers as one that meets certain financial criteria. This obviously raises doubts about the adequacy of such criteria, given the differences known to exist between public and private costs and benefits. 15/ A thorough examination of the criteria for determining a good project is therefore urgently needed and will go a long way towards shedding light on the relation between availability of good projects and industrial financing. Perceived country risk can be expected to have an important effect on this relation.

57. Of the two problems stressed by national financing institutions, the lack of funds will be dealt with below. With respect to the second problem, the lack of suitable projects, it should be noted here that a strengthening of project generation and promotion facilities would yield immediate benefits. The importance of a systematic approach to these problems, structured to follow national development and industrialization strategies, cannot be overemphasized.

C. The "macro" view

58. International long-term objectives for the industrialization of the developing countries are set out in the Lima Declaration and Plan of Action on Industrial Development and Co-operation and the New Delhi Declaration and Plan of Action on Industrialization of Developing Countries and International Co-operation for their Industrial Development, which called for efforts to increase the flow of external financing to industry in developing countries.

59. If the Lima target is to be met, the present trends in the growth rates of GDP, industrial production and investment in developing countries must be considerably accelerated. UNIDO has elsewhere estimated that manufacturing investment must grow from an annual level of $US 56 billion in 1980 to about $US 130 billion in 1990 and to between $US 293 billion and $US 415 billion in 2000 (at 1975 prices). 16/ External financial flows to meet these requirements would have to amount to $US 52 billion in 1990 and between

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* Responses were obtained from bankers in China, Ethiopia, Jamaica, Mali, Malta, Nigeria, Sierra Leone and Yugoslavia. All but one said that financing posed a real problem and was a hindrance to industrialization. A lack of adequate resources was cited as the main barrier to effective industrial financing, followed by lack of loan security and lack of absorptive capacity. Three respondents mentioned the absence of good projects as the main cause of insufficient project generation. It is interesting to note that a lack of projects in general, without regard to the quality of the project, was not mentioned by anyone. Asked to define a good project, six of the respondents mentioned projects that met financial criteria. Other criteria included projects that would result in exports, projects that conformed to the country's development plan, that met the basic needs of the population, that generated employment, and whose promoters had acceptable expertise.

100 per cent of current-account receipts when roll-over of short-term loans is considered), banks are becoming more and more reluctant to increase their exposure in developing countries.

D. Conclusions

69. The above review indicates clearly that:

(a) There are currently few possibilities for financing an improvement of the capacity utilization in industry and new schemes are urgently needed to finance structural adjustment programmes;

(b) There is a clear need for improved and strengthened project identification, preparation and promotion service;

(c) Both a "micro" and a "macro" view show that the availability of finance at terms and conditions suitable for industry is insufficient in the short run and completely inadequate in the long run if developing countries are to approach their industrialization objectives.

III. THE ROLE OF DOMESTIC FINANCING FOR INDUSTRIAL DEVELOPMENT

A. Problems and prospects

70. Although international external finance plays a pivotal role in industrialization, filling the gap between gross domestic saving and gross domestic capital formation, and is a prerequisite for obtaining much of the needed machinery, know-how and intermediate goods and raw material, and although its importance is much greater than its share in total industrial finance would imply, * the fact remains that the largest part of finance for industry must be, and is, domestically mobilized, transformed and allocated, and that significant amounts of labour and material input, especially of a non-specialized nature, are often locally available and obtainable through local currencies.

71. It is on the market for industrial credit that the issues of industrial financing proper become explicit. The market, which consists of the demand for investible funds on the part of manufacturing enterprises and the supply of such funds by lenders, functions basically within the domestic scene of developing countries. With the exception, perhaps, of transnational enterprises and a few public enterprises, manufacturing enterprises of

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* In the 1960s and early 1970s, external finance accounted for 10 to 20 per cent of the total investment in developing countries and this ratio has risen somewhat since then. Obviously, these are average figures and much higher ratios for individual projects are not uncommon.

developing countries must borrow from domestic lenders. Even transnational enterprises borrow extensively on the domestic market. Thus, the functioning of the domestic financial system is of central importance to the financing of manufacturing industries.

72. There is a wide network of financial institutions in developing countries that are engaged as intermediaries and promoters of industrialization. Virtually no developing country is without a development finance institution. 19/ There are 495 development finance institutions in developing countries: of these, 150 are in Africa and the Middle East, 180 are in Latin America and the Caribbean, and 85 are in Asia and the Pacific, the rest being international, regional, Islamic or Arab institutions. Most of the latter two types are in Africa and the Middle East. Many of them are new; some have 20-30 years' of experience. The institutions vary widely in size, scope of activity, orientation and resource mobilization capabilities. They take many forms: governmental institutions and agencies; development banks of mixed ownership; State investment corporations; private investment houses; parastatal corporations; and semi-commercial companies. While these institutions play a central role in the financing of industrialization in developing countries, there are certainly areas where their effectiveness could be increased, not only by adopting measures to improve their functioning and efficiency but also by disseminating information on their objectives and the conditions for providing funds and bringing them in contact with potential recipients and promoters of projects.

73. In the field of domestic financing, the main issues are, first, sectoral priorities in the allocation of the pool of investible resources. Manufacturing industries must compete with other users for the available funds. As developing countries attach priority to industry in their development plans, manufacturing enterprises should be favoured in the allocation of funds. Considerations of efficiency should, however, be respected.

74. Secondly, borrowing should be as cheap as possible. The crucial variable here is the transaction costs: administrative costs and default risks. The probability of default gives rise to institutions that specialize in acquiring information about default risk. In mediating between lenders and borrowers, these institutions have financial costs (the interest rate) and transaction costs. Transaction costs arise from the fact that each financial transaction is determined by the characteristics of the lender. Thus, each product is tailor made: margin requirements, repayment terms, security and compensating balances vary according to the profile of the borrower. As the transaction relates to a relationship over a period of time, the product must have attributes that take uncertainty into account. Generating these specific attributes also entails a cost.

75. Whereas little can be done about the interest rate (linked, perhaps, to the profit rate and to capital scarcity), financial innovations can reduce transaction costs (ranging between 6 and 20 per cent in developing countries).

76. Traditionally, the cheap funding of manufacturing enterprises has been taken on by specialized institutions lending at subsidized interest rates. These institutions, however, lack the motivation to reduce transaction costs. Permanent subsidy cannot be a viable solution; thus, ways and means must be sought to bring transaction costs in developing countries into line with costs in developed countries.

77. This issue is particularly important in the present context of balance-of-payment troubles. Developing countries urgently need to export manufactures. This need implies trade liberalization policies. Such policies expose the enterprises, both domestic and foreign-oriented, to more competition. The profit margin being squeezed, it becomes less easy to mobilize resources without the help of the financial system, i.e. through a ploughing back of profits and generous depreciation. Self-finance or, more precisely, self-saving has traditionally been the largest source of funds for manufacturing enterprises. Since they will now depend more on the financial system, it becomes more urgent than ever to improve it.

78. The domestic financing of industrialization can be enhanced not only by increasing the quantity of real resources saved domestically for investment but also by improving the effectiveness of the financial system whereby some of these resources are channelled into investment.

79. It is much harder to generalize about domestic sources of industrial finance than about foreign sources, because of their much greater variety. The main sources of foreign finance are common to all developing countries, whereas financial institutions and lending practices in different countries vary enormously. Nevertheless some problems are common to many countries, and are worth discussing, bearing in mind the fact that a few developing countries have a well-developed financial sector with few, if any, of the drawbacks described below.

80. A major source of industrial finance is commercial bank lending. Very often this is only available, at least nominally, in the short term. Some overdraft finance is available de facto in the longer term, since it is constantly rolled over, but it is not always satisfactory, being vulnerable to changes in monetary policy. Short-term finance is suitable and necessary for many purposes, but industries need longer-term money as well, especially for fixed investment.

81. Commercial banking was established in many developing countries for the finance of foreign trade, which is short-term, and has never lost that characteristic. Furthermore, many commercial bankers argue that, because their liabilities are mainly short-term deposits, it would be imprudent for them to make long-term loans. This attitude is reinforced, where the commercial banks are foreign-owned and foreign-managed, by the rules laid down at head office by the owners. Generally, banks are limited in the transformation of short-term deposits to long-term lending by legislation or central banking regulations. However, this argument should not be over-extended. There are many examples of financial institutions being able to borrow very short and lend very long, e.g. building societies in the United Kingdom, which provide housing loans for 20 years and longer, on a base of short-term deposits.

82. Many Governments in developing countries have set up development banks to provide long-term finance. Development banks have a very useful and important role to play, but there is a gap in the finance available to industry if long-term loans have to be obtained from a public sector institution. Such banks often have obligations to lend to particular sectors or types of borrower, thus tending to exclude the unfavoured sectors and types of borrower, unless the development bank has enough funds and administrative capacity to satisfy all potential borrowers. Most countries are unable to

fund their development banks as generously as this would require, and the few countries with very large financial resources tend to be those with limited management capacity. Furthermore, development banks are frequently required to lend at unprofitable rates of interest, to some or all borrowers. This makes it impossible for the bank to generate new funds internally; as a result, the bank then becomes dependent on the Government for new funds for increased lending, and sooner or later the Government is unable to provide them. Meanwhile, the bank is unable to attract funds from the general public or from the money markets if it cannot charge a profitable margin on its loans.

83. On the other hand, some institutions have funds to invest for long periods and lack long-term financial instruments to buy. Most notably, insurance companies and pension funds are often restricted to urban property development and government stock for the funds they can afford to invest for a long term, while the industrial sector has to finance itself, or exists precariously by rolling over overdraft finance and trade credits. It is often assumed that it is necessary to have a fully-fledged stock market in order to be able to sell long-term debt and equity to institutions, or indeed to individuals. Certainly a market for second-hand financial paper makes it easier to attract investors in the first place, but such paper can sometimes be placed, if not as easily or in such large quantitites, even in the absence of an active stock market. Moreover, the existence of new forms of financial obligation, such as "loans" with interest and capital repayment terms dependent on the borrower's success in making profits, with a (possibly limited) upward and downward potential yield, might make it easier to bring together the industrial concerns needing finance and potential lenders and investors. Certainly it should not be assumed that it is necessary to create a stock market before it is possible to raise long-term finance from institutions and the general public. In some cases, a stock market may follow, or the holding of equity and long-term loans may be confined to a few institutions (including pension funds). The important thing is to generate a flow of long-term and flexible finance to industry.

84. Another gap in the range of financial services available in many developing countries is the sort of financial entrepreneur who can put together a package of finance from both domestic and foreign sources, or who can bring together lenders and borrowers in the ways suggested in the previous paragraph. One way of selling equity and long-term loans is to advertise them or to introduce them on a stock exchange, but where this is not possible for some reason, as for example in some small economies, there is still a possibility of placing such paper privately, and yet this is not always attempted.

85. There is a delicate balance between encouraging the development of financial intermediation and pushing it in undesirable directions. For example, requiring large companies (usually foreign-owned ones) to sell shares to local investors can be a formula for reinforcing the wealth and power of the already rich and powerful. Those with assets or political influence seek loans from the commercial banks to buy shares, a process that has very little, if anything, to do with the better allocation of resources, which efficient financial intermediation should achieve. The placing of long-term loans and shares (and other hybrid forms of finance) with insurance companies and similar institutions, and perhaps the sale of shares in the Government's development corporation to the general public, is arguably as far as many countries should go at their present stage of development in the creation of new types of private financial markets.

B. Surveys by UNIDO of the domestic financing of industry in developing countries

86. UNIDO has undertaken surveys of the domestic financing of industry in developing countries of Latin America, Africa and in India, and one encompassing Bangladesh, Indonesia, Malaysia, Sri Lanka and Thailand (IS/252, IS/256, IS/266, IS/276). The surveys were designed to discover whether the financial system contributes as much as it is capable of doing; if so, what should be done to keep the system in good condition as developing countries undergo the profound structural changes that lie ahead and if not, how it can be brought into working order. The following account draws on the results of the surveys.

1. The structure of the domestic financial system

87. The main intermediary financial institutions are the banks and the development finance corporations (DFCs). A cross-section of the surveys of Africa and States members of the Association of South-East Asian Nations (ASEAN) reveals that the financial structure follows a typical pattern of change in the course of economic development. In very poor countries, the most important aspect of financial intermediation is the policy of the central bank in providing credit to productive enterprises. Time and savings deposits require not only full convertibility of the means of payment but also a real return that is attractive enough to compensate for the time restriction of liquidity. Provided these conditions are fulfilled, a relative diminution of the amount of coins and currency occurs and the commercial banking sector, broadly defined to include interest-bearing deposits of all kinds, tends to gain importance in the organized capital markets. If banks are to take their right place in the financing of industry, it is recommended that facilities should be made available throughout each country to acquire claims on banks.

88. As development proceeds, the rise of demand and time deposits in commercial banks is supplemented by the emergence of pension funds, insurance companies etc. The banking system is usually the main source of financing for industry in developing countries, but its credit is almost entirely short-term because the banks lack the incentives, the means and the skills to deal with long-term credits or because they are prevented from doing so by law or custom. The purpose of the DFCs is to fill the gap in medium-term and long-term credit and investment.

89. The Latin American survey describes the importance of internally generated funds - reinvested profits plus capital utilization allowances - and funds provided by outside savers - debt and equity. This pattern is then compared with existing patterns in more developed countries and found to be similar as far as the proportion of financing by banks is concerned. It is observed that Latin America tends to have a disproportionate share of short-term financing, probably as a result of high and fluctuating inflation rates. Several suggestions for the improvement of financial instruments are offered in the surveys. Sophisticated variants of term loans convertible into equity are proposed for consideration, particularly in the Indian survey.

2. The functions of the domestic financial system

90. According to the surveys, there is room in virtually all the countries concerned to mobilize more financial savings than are actually being realized. Often savings tend to be in a form that is not freely transferable to long-term investment uses. Compared with developed economies, only a modest proportion of total savings is held in financial assets: for instance, 29 per cent in Bangladesh, 45 per cent in Malaysia and 33 per cent in Thailand. Furthermore, financial assets held in the countries surveyed are generally not suitable for subsequent long-term lending. These assets tend to be in the form of currency or sight deposits, in post office deposits or in funds entrusted to insurance companies. Time deposits, which in industrialized countries are the main contribution by households to the pool of investible resources, are negligible in most developing countries. In any case, in these countries their maturity is not much longer than that of sight deposits.

91. A number of measures could be taken to attract more funds into forms of finance suitable for lending to industry. Some measures are indirect, including all actions taken to increase the monetization of the economy. It is a well-established fact that, as the ratio of money to income rises, the ratio of all financial savings to income tends to rise more rapidly. In African countries, the community's assets in the form of money and quasi-money are a remarkably low proportion of gross national product (GNP) compared with industrialized countries (typical ratios would be 0.25 for African countries against 0.60 for industrialized countries). Thus, accelerating monetization in Africa would have the side effect of increasing the source of funds suitable for financing industry. Another set of indirect measures are designed to maintain monetary stability. Money-denominated assets are eroded when the general level of prices is rising. Once serious inflation emerges, savings tend to be diverted into land, building and other durable assets that are not readily convertible to money.

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

93. Improved funding of the DFCs is another way to increase the supply of long-term funds. In order to promote investment, official regulations usually confine the DFCs to the lower end of the spectrum of lending rates prevailing in the country. The DFCs are consequently unable to raise significant resources on commercial terms.

94. In most of the countries surveyed, the shortage of long-term capital is greater than that of short-term capital. There is thus a case for encouraging maturity transformation. Central banks can influence maturity transformation in countries where they are net lenders to commercial banks, for example, long-term finance can be encouraged by specific central bank rediscounting

policies. A more passive but perhaps more effective means of stimulating maturity transformation would simply be to relax restrictive requirements for refinancing by central banks and to widen the banks' regulatory requirements.

95. Commercial banking legislation over-emphasizing liquidity requirements has been found to inhibit long-term assets. A re-examination of this legislation and the introduction of concepts more oriented towards venture capital would be useful here. Similarly, insurance institutions could commit a larger share of their resources to long-term investment if they were released from "liquidity requirements".

96. Even if legislation is not a hindrance, financial institutions will tend to restrict long-term loans when they are funded on short-term deposits because interest rate and liquidity risks are implied in the imbalance between the spans of deposits and loans. Long-term loans could be indexed to the cost of short-term money in order to overcome this problem. A second problem, which arises when a bank makes long-term loans with short-term resources, is the risk that deposits will contract if the demand for money falls as a result of a contraction of the monetary base. One possible solution is that adopted by the Central Bank of the Republic of Argentina, which established a four-year rediscounting system intended to lower the liquidity risk.

97. The allocational role of financial institutions is decisive in explaining why Japan devotes about 50 to 70 per cent of its financial savings to long-term industrial credit while in the United Kingdom the proportion is only about 20 per cent. The surveys clearly show the potential for increasing industrial finance in developing countries by assigning new roles to the financial institutions.

98. For reforms to be really fruitful, however, a considerable array of measures would be needed, some of them directed at forces outside the financial system itself. First, there is the challenge of creating a stable money-and-price environment, which would be the prerequisite for attracting savings in time deposits of, say, over one year. Furthermore, the pattern of interest rates offered should be shaped so that time deposits would be inflation-proof and more rewarding in real terms than short-time deposits. Laws and customs biased against long-term loans should be removed. Finally, the financial institutions, particularly the banks, should be encouraged to provide industry with the finance.

C. The role of the State as financial intermediary

99. The question is sometimes raised whether the Government, through its central bank or some other financial parastatal organization, should act to create a "market" in equity and long-term loans. One argument for so doing would be that such funds would be easier to raise if there were some chance of their being marketable, and that some sort of buyer of last resort would greatly increase marketability in the absence of a private market. A second argument would be that government intervention would create a more stable market, and so avoid the disadvantages of instability and excessive speculation.

100. On the question whether to adopt some form of centralization of foreign borrowing, for industry or for other use, at least two main reasons are given for doing so. First, it is argued, all foreign borrowing should at least be monitored by the Government, whether the borrowing is for the public or the private sector. The nation will have to make the foreign exchange available for the payment of debt service, whoever does the borrowing, so the Government of a developing country should have a complete record of all foreign borrowing (in developed countries with floating exchange rates and the ability to adjust to varying demands for foreign exchange, this is less necessary). Secondly, there is a strong case for getting the Government to take some of the risks inherent in foreign borrowing, because it is in a much better position to spread those risks and to manage them through access to reserves and short-term credit. Moreover, it is likely that many borrowers will have relatively little experience of foreign financial markets, and could make good use of the accumulated experience in a central institution such as the central bank.

101. Most individual industrial firms are unlikely to be borrowing on a large enough scale to diversify their foreign debt by currency of denomination. There are no forward exchange markets offering cover far enough into the future for any but short-term debt. The only way, therefore, to cover local firms against the risk of appreciation of foreign currencies borrowed, is to centralize that risk in a larger institution, or in the Government itself. The same procedure is appropriate for the management of interest rate risk.

102. There is another reason for suggesting that Governments act as financial intermediaries between foreign lenders and domestic borrowers. The predominance of foreign loans in foreign finance is, as has already been argued, ill-adapted to the needs of most borrowers in developing countries. In the absence of new and more flexible forms of finance, it is nevertheless possible for a Government or other financial intermediary to borrow abroad on the prevailing loan terms, and to on-lend to domestic borrowers on different terms. Such on-lending could be in the form of equity, or the debt could take some new form in which repayment terms would depend on the borrower's agreed ability to pay from year to year. The risk of lower or zero debt service in bad years could be compensated for by the possibility of higher payments in good years. Furthermore, a centralized intermediary would have a good chance of spreading the risk, because there is some chance of the income from different projects fluctuating in opposite directions in any one year.

103. Governments do already act as financial intermediaries on a large scale. In nearly all developing countries, not just those committed to various forms of centrally planned development, Governments already lend to a wide range of domestic institutions: development banks, local authorities, urban housing authorities, parastatal businesses, private businesses, co-operatives etc. Governments often provide loans at well below market rates of interest or lend money to corporations that are not able to make a profit, as a way of encouraging or subsidizing a favoured activity. While the role of government in bridging the gaps that arise from differences between social and private costs and benefits is widely accepted, every effort should be made to improve efficiency and to allocate resources properly.

104. Many parastatals regard equity as simply a form of free finance, since it is rare that any servicing in the form of dividends is required. This can lead both to a misallocation of the finance in the first place and to

inadequate return on capital on a continuing basis. For example, the non-payment of dividends on government equity can conceal, via low returns on capital invested, the poor performance of public sector enterprises, or their failure to charge the right prices. Legal requirements and administrative procedures could be set up to improve the use of government funds or at least to provide a greater transparency.

D. Finance for small-scale industry

105. It is well known that small-scale industry can play an important role in industrialization of developing countries. The argument for subsidized finance for small-scale industries is that they do not have access to private-sector financial institutions, or that they cannot afford the rates of interest charged in the private sector. More generally, the argument is that the net social benefit of the development of small-scale industry is greater than the net private benefit, thus justifying a public subsidy.

106. If a private sector financial institution cannot lend profitably to small-scale industry, it is quite likely that this would also apply to a public sector institution. There is, however, some scope for the creation of specialized credit institutions for lending to small-scale industry. Especially in countries with very underdeveloped financial sectors, such institutions can play a valuable role in assisting important categories of business. There is also an "infant borrower" argument, namely that some businesses may not at first be profitable customers of a development bank but may later become so, as a result among other things of the financial help provided.

IV. IMPLICATIONS FOR INDUSTRIAL FINANCING OF RECENT PROPOSALS FOR REFORM OF THE INTERNATIONAL FINANCIAL SYSTEM

107. Many proposals have been put forward in recent years to improve or reform the international monetary and financial system. As a rule, they are addressed to the economy as a whole or to the financial system at large and pay no specific attention to the industrial sector. Given the crucial role of industrial development, this presents a striking anomaly. It is therefore necessary to analyse the most important reform proposals to see how their implementation would influence industrial financing. This will give a basis for setting priorities between different measures from the point of view of industrialization and will also help to identify the remaining gaps in the proposals.

108. In considering the impact of proposed reforms in the international monetary system on industrial finance, various general considerations need to be borne in mind.

109. First, any change that permits a higher growth in output of developing countries will improve the prospects for their industrial sector. This is because of the high income elasticity of demand for industrial products within developing countries, which, combined with the development strategy adopted by

most developing countries, means that a substantial proportion of additional income is spent on industrial products and a substantial proportion of extra investment goes to the industrial sector.

110. Secondly, much finance is fungible, i.e. increased availability of finance for projects in one sector releases funds for other uses and hence indirectly increases the supply of funds to other sectors. The precise sectoral composition of new finance may not therefore be an indication of the actual net effects.

111. Thirdly, new schemes involving fresh sources of finance may not provide additional funds but may substitute for existing sources. Hence, the net effect of the new schemes will depend on how much additional finance is involved when the source in part displaces existing flows.

112. Fourthly, the sectoral distribution of additional finance is likely to depend in part on country distribution. It is likely that additional finance will be more industrially-oriented among middle-income than among low-income countries.

113. Fifthly, the availability of industrial finance is only one condition for industrialization. It is also necessary to identify and develop projects for obtaining the required managerial and technical resources, to develop the required infrastructure and to secure markets for the output (see also chapter II, section B, above).

114. It should also be borne in mind that measures to increase the stability and growth of the world economy as a whole will result in increased output and debt-service ability in developing countries. A systematic attempt follows to specify the possible impact on industrial financing of the various proposals. It must be recognized, however, that in several cases the fungibility effect makes it impossible to distinguish any specific impact on industry.

115. In this chapter various proposals are grouped according to their common characteristics. For each group a short review of the proposals is followed by an analysis of their probable impact on industrial financing. 21/

A. Proposals to improve the financing of developing countries' deficit or investment programmes

116. As is known, the oil price adjustments during the latter part of the 1970s triggered off many proposals for new mechanisms to recycle funds from surplus to deficit countries. None of these proposals (with the exception of the Oil Facility of IMF) was implemented and the recycling was carried out by the international private banking system of the industrialized countries. In later years doubts have again been expressed about the banks' willingness and ability to continue financing developing countries' deficits and such flows have indeed declined significantly after their peak value of 1978.

117. One group of proposals for financing developing countries' deficits is directed towards sustaining private flows. One of the first proposals of this type was the Mexican one to establish a fund, financed by bond issues, for long-term loans to be used for the purchase of capital goods. More recently,

a proposal has been made in UNCTAD for the establishment of an international export credit guarantee facility, which would guarantee export credits of developing countries, for improving the marketability of export credit papers. A broader proposal has also been put forward for an international loan insurance fund with IMF, the World Bank and Governments of developed countries and States members of the Organization of Petrol Exporting Countries (OPEC) as guarantors. Other proposals of this type include guarantees of bond issues by some supranational agency and issues of long-term indexed bonds by an agency such as IMF or the World Bank acting on behalf of a collective of developing countries. One far-reaching proposal suggests an explicit international lender of last resort, backed by the central banks of the industrialized countries, with far stricter supervision of commercial banks by those central banks.

118. Another group of proposals for improving the financing of deficits and the investment programmes of developing countries aims at increasing the role of existing public institutions, in the first place IMF, the World Bank and regional development banks. Some of these proposals would provide more financing of these public institutions by enlarging their capital base, whereas others rely more on increased borrowing on the private capital markets. Yet other proposals, emanating mainly from the Group of 77 and the UNCTAD secretariat, advocate the establishment of a new low conditional facility to extend medium-term-payment financing, the establishment of a new trust fund financed from additional sales of IMF gold stock and an expansion of the lending programme of the World Bank, for instance by increasing the subscribed capital base or the gearing ratio. The outcome of the recent general review of IMF quotas sets these proposals in a clear perspective.

119. The World Bank itself has recently stressed the increased contribution it can make to the finance of developing countries by expanding its co-financing activities with the commercial banks. Experimental initiatives were started in January 1983. In addition to making direct loans for a project, the World Bank will also participate in finding commercial finance through:

(a) Direct financial participation in the later maturities;

(b) Contingent participation in the later maturities of a commercial loan: if the interest rate rises above the initial rate and the amortization period is lengthened, the World Bank would then make a contingent commitment to cover the longer repayment period;

(c) Guarantees of the later maturities.

120. The proposals for the regional banks are somewhat similar to those made for the World Bank: enlargement of their capital base; possible increase of their gearing ratios; borrowing on private capital markets.

121. Yet a third category of proposals for improving the finance of investment programmes of developing countries entails the creation of new public international financial institutions.

122. An international bank for industrial development was proposed by the UNIDO secretariat in 1981. It would constitute a financial intermediary in the market. The capital base would consist of subscription by member States, only a small proportion of which would be called up. Major features of operations would be:

(a) Maturity transformation of the funds borrowed on the markets to make lending appropriate for industrial projects;

(b) Interest subsidization at differential rates funded through a scheme linked to export orders;

(c) Offer of refinancing facilities for export credit;

(d) Provision of a package of such services as project generation and promotion of joint ventures, as well as finance.

123. Among the many proposals for reform, this, and to an extent the Multinational Trust Fund discussed below, are the only elaborated proposals that explicitly give priority to industrial financing.

124. A multinational trust fund for industrial development was proposed by the Inter-American Bank in 1979, to be based on contributions made by member States and borrowing in financial and capital markets. The aim was to provide support for small and medium-scale industrial enterprises in the Latin American and Caribbean States members of the Inter-American Development Bank.

125. Proposals have also been made for new global institutions, which would finance general development programmes or projects in developing countries. Among the most important were a world development fund, proposed by the Brandt Commission in its report, 13/ and a third world development agency, proposed by Algeria and Venezuela at the OPEC meeting of ministers held in December 1979.

126. The world development fund proposed by the Brandt Commission was conceived as an institution that would provide a bridge between long-term financing available from institutions such as the World Bank and the short-term adjustment finance available from IMF by providing mainly long-term programme finance. It would obtain the great bulk of its resources from government contributions.

127. The proposal for a third world development agency was based on an expansion of the OPEC Fund, thus being founded on contributions from States members of OPEC. It was envisaged that bonds would be issued in international capital markets.

1. Impact of proposals on industrial financing

(a) Additionality

128. Proposals for sustaining and improving flows of finance of the private sector generally involve some official guarantee (partial or total) for private flows. It has often been argued that the funds used to provide any

guarantee facility could alternatively be used for lending directly to developing countries. A guarantee facility could, however, offer a higher gearing ratio than the World Bank or the regional development banks, so that the finance diverted to such a guarantee fund would increase total lending if the facility were not administered by these bodies or, if their charters were modified to treat guarantees more flexibly. The creation of guarantees, including those of the proposed international lender of last resort, could help restore confidence and generate significantly larger private flows than the size of the actual guarantees. It could be combined with the introduction of more appropriate financial mechanisms, stronger supervision and a more desirable distribution among developing countries.

129. At the moment, when commercial lending is low because of lack of confidence, it seems likely that extra public-sector borrowing and lending could considerably increase international lending to developing countries without eating into private sector lending, which is constrained for reasons other than availability of finance. Indeed substantial extra public lending might actually increase the flows of private finance by adding to the banks' confidence. But public lending, on hard terms, adds to developing countries total indebtedness. So, in normal times, it can be expected that a greater role for public institutions will involve a smaller role for private ones. Moreover, there may also be a certain crowding out within the public sector. A new World Development Fund, for example, could be expected to reduce the prospects for expansion of the World Bank. Because, however, of the present great shortage of institutions willing and able to lend to developing countries on a scale commensurate with their needs, it seems likely that much extra finance would indeed be additional. All else being equal, this would also mean increased funds for industrial financing.

(b) Sectoral composition

130. Different financial mechanisms are associated with a different sectoral composition of finance. For example, while the official sector (e.g. the World Bank) has a greater agricultural and infrastructural element in its lending, some forms of lending (e.g. IMF balance-of-payment support) have no specific sectoral composition. Because of the fungibility of finance, the actual or nominal sectoral composition of financial flows is not necessarily a guide to the effects on availability of finance to different sectors. It is very unlikely, however, that fungibility is ever total.

131. The proposals to sustain commercial lending are likely to have a significant industrial sector component. This is especially true of the schemes intended to finance industrial exports (i.e. the Mexican scheme and the export credit guarantee schemes). Fund finance is general, not sectoral, but will, by releasing foreign exchange, indirectly improve the financial position of the industrial sector in recipient countries. Of the proposed new institutions, the international bank for industrial development would be totally devoted to industrial finance, acting on a global scale, as would be the multinational trust fund for industrial development, acting on a regional scale. The sectoral composition of the proposed new global institutions would depend on the details of their operation: for the most part it seems that they are intended to provide general medium-term balance-of-payment support providing indirect, rather than direct, assistance to the industrial sector.

(c) Country distribution

132. Developing countries tend to increase the proportion of output accounted for by the industrial sector, so that the country composition of flows may not make a great deal of difference to their sectoral composition. The creation of guarantee facilities might be expected to broaden the distribution of commercial flows between developing countries. As a result of the problems encountered in rescheduling the debts of the largest borrowers, private bankers have begun to diversify their portfolios by lending relatively more to countries to which they had given less credit in the past. This is reflected in the fact that the terms (of maturities and spreads) on which private bankers are lending to lower-income countries are not only improving rapidly but are significantly more favourable than the terms in which the banks are lending to upper-middle-income developing countries. It is therefore no longer clear that the creation of guarantee mechanisms would in fact lead to a greater spread among developing countries. In fact, guarantees might even turn the banks more towards lending to old clients who are illiquid in the short term but solvent in the long term, i.e. the middle-income and relatively more industrialized countries.

133. Schemes involving official institutions are likely to be proportionately more geared to low-income countries. For example, in 1980, while low-income countries received only 2.5 per cent of commercial loans to all developing countries, they received over 40 per cent of ODA. Low-income countries also receive more non-concessional loans from official agencies than loans from the commercial sector.

134. As far as IMF is concerned, expanded facilities for general balance-of-payment support to countries in serious financial difficulties are likely to provide most finance to the now crisis-ridden middle-income countries that borrowed so heavily in the 1970s. An expansion of facilities to support those suffering most from commodity price fluctuations, on the other hand, would be more likely to involve funds for low-income countries. The country composition of lending by the proposed new institutions will depend on the nature of these institutions.

(d) Terms and conditions

135. Several of the proposals are designed to increase the length of maturities and some involve fixed interest finance. These changes would make such lending more appropriate to development needs, and particularly to investment with long gestation periods (for example in new industrial sectors, infrastructure etc.). Such a trend would be favourable to all economic sectors but could be particularly valuable to the industrial sector, where a longer time horizon for the finance available could allow more long-term planning and investment with a longer gestation period.

136. IMF currently provides short-term finance, much of it subject to stringent conditions. The World Bank has recently been increasing the proportion of non-project finance it provides in the form of structural adjustment loans. These loans, however, are accompanied by some quite strict conditions, not unlike those of IMF, and often require that the country obtain

prior agreement from IMF. One frequent requirement is import liberalization, which, in the short run, can have adverse effects on a country's industrial sector. The proposed international bank for industrial development would have the greatest direct impact on industrial finance but the other schemes (e.g. the world development fund) would indirectly improve the terms on which industry acquires finances.

137. Schemes which use existing institutions to expand financial flows to developing countries tend to be technically easier to implement and are more likely to be backed by Governments of developed countries. Against that, the probability is greater that such enhanced flows would be granted according to criteria that have evolved in past practice and are often now inappropriate.

B. Proposals to enhance liquidity of the international economy

138. The IMF Group of 24, the Group of 77, the UNCTAD secretariat and the Brandt Commission, 13/ as well as many observers, have stressed the urgent need for a sizeable new allocation of special drawing rights (SDRs). It is argued that the new issue of SDRs must be large to compensate for the declines in total international liquidity that occured in the early 1980s (one particularly serious decline was noted at the beginning of 1982, when the reserve levels of some 30 developing countries had been reduced to the equivalent of one month's imports or less). The SDRs must also be large enough to help finance deficits if the world economic recovery is to be rekindled, trade increased, capacity utilization improved, and industrial development put back on the right path. An SDR allocation would help to restore to earlier levels the deteriorating ratio of SDR to non-gold reserves. The Brandt Commission has estimated that an allocation of about SDR 10-12 billion would be needed for the next three years just to restore this ratio to its 1972 level, when the first period of allocation ended. SDR allocations do not create repayment obligations, a particularly crucial consideration at a time when countries' debt-service ratios are already so high that many are unable to service their debts. Finally, there is a problem of timing. There is an urgent need for expanded liquidity, particularly for the developing countries, and an issue of SDRs is one of the quickest ways of achieving this. Several of the proposals for a new issue of SDRs convincingly argue the case for allotting a greater proportion of this issue to developing countries than has beem done in the past.

139. The creation of "Southern" SDRs, or trade currencies that can be supplied without hard-currency backing and can provide for counter-cyclical global changes in liquidity, would also give the South more freedom to manage its economic affairs. If countries in the South want to expand trade and output among themselves while the North does not (owing, say, to contractionary policies), the South can continue to increase liquidity for South-South co-operation through "Southern" SDRs or other trade currencies strictly from countries in the South. In a recession, this would cost the North little in terms of opportunity and would greatly benefit the South, since greater liquidity would allow increased trade, which in turn would help to activate idle industrial capacities in the South. Such rekindled industrialization and trade would also have beneficial spillover effects for the North, too, chiefly from the increased amounts imported by the South from the North.

1. Impact on industrial financing

140. A new issue of global or "Southern" SDRs, is needed not only to rekindle growth in developing countries but also to help prevent further production cutbacks in many of them. A new issue would benefit both the poorest countries, with very limited foreign exchange reserves, and the heavily indebted middle-income developing countries. Although not directly geared to the financing of industrialization, such a measure would undoubtedly have a beneficial effect on industrial output, especially as a result of improved capacity utilization in the initial stages.

C. Proposals to broaden compensatory finance

141. This section examines financial measures and proposals for stabilizing the import capacity of developing countries as their export earnings fluctuate. The equally important measures and proposals for stabilizing export earnings directly, through such mechanisms as the Common Fund or international commodity agreements, will not be dealt with here, as they are not purely financial measures.

142. The first change in the rules of the international monetary system that the developing countries succeeded in securing was the introduction of the IMF Compensatory Financing Facility (CFF) in 1963. It has since become accepted by the international community as a necessary mechanism to mitigate the adverse impact of fluctuations in export earnings of developing countries on their development process.

143. The CFF became in the 1970s a major facility for providing payments assistance by the Fund to member countries, especially developing ones. Borrowing under the facility remained modest, however, by comparison with the terms-of-trade deterioration experienced by developing countries. The main problems with the existing modus operandi of the CFF are the quota limits on maximum drawings, the calculation of export shortfalls in nominal terms, and a formula for repayments which is not linked to the recovery of export earnings.

144. Therefore the Group of 77, the UNCTAD secretariat and the 1980 20/ and 1983 13/ reports of the Brandt Commission have all proposed a liberalization of the CFF so as to provide full coverage of shortfalls. There is also widespread support for the proposal that the shortfall formula should be reviewed and expressed in real terms (so as to take account of real import capacity rather than nominal one) and that repayments should be more closely linked to a country's recovery of export earnings. It has also been reported that even Governments of developed countries may be open to proposals for liberalizing the CFF. It therefore seems quite likely that such proposals may be approved.

145. A more ambitious proposal has been put forward for an additional facility that would complement the improvement in the CFF. The proposed complementary facility would offer assistance in financing additional foreign exchange costs that would be incurred through domestic stabilization of commodity sectors (there are important similarities between this proposal and

STABEX which is currently operated by the EEC). The Secretary General of UNCTAD has recently been requested to convene a preparatory meeting for a negotiating conference on the proposed complementary facility.

146. Expanded compensatory finance, whether it operates by providing general balance-of-payment assistance or assistance to particular sectors, mainly implies that real import capacity will be sustained when export earnings are in decline owing to circumstances outside the countries' control. Such measures have proved particularly necessary in view of the recent dramatic declines in the terms of trade and the resulting curtailment of growth experienced by so many developing countries. Expanded compensatory finance therefore seems essential for avoiding a curtailment of crucial imports which would disrupt growth and industrialization. As pointed out above, it would have a very desirable counter-cyclical impact on both developing countries and the world economy, thus helping to break the recent vicious circles of recession and financial distress. By providing substantial flows in times of balance-of-payment difficulties, it would also indirectly help to alleviate the negative impact of the "debt overhang" and moderate the risk of financial crisis.

1. Impact on industrial finances

147. The proposals for expanding compensatory finance would clearly have a desirable impact on the growth and industrialization prospects of developing countries, not so much in generating new projects but in the equally essential task of rekindling and then sustaining growth and industrialization (by advancing already initiated projects and improving capacity utilization) whenever the international environment in which a developing country operates becomes unfavourable. While these measures may not have a direct effect on accelerated industrialization, their indirect impact may be critical especially for some countries.

D. Proposals to relieve conditionality

148. Both IMF and the World Bank impose certain conditions before agreeing to substantial loans. Both have been subject to criticism and proposals have been made for reform. Since the World Bank's structural adjustment loans form only a small part (8.2 per cent in 1982) of its total lending and since the Bank generally requires that the Fund's conditions also be met, this discussion is confined to Fund conditionality. It is generally agreed that some conditionality for countries with acute difficulties in their balance of payments is required so as to secure improvement in the external payments position. Several elements of Fund conditionality have, however, been criticized. The objectives of the conditionality are improved short-run balance-of-payment performance and control of inflation, but several countries, while sharing these objectives, would put relatively more emphasis on employment and output objectives. The Fund treats each country individually, whereas the programmes for one country also affect others. Consequently, cutting imports in one country makes it more difficult for others to meet their export targets. Furthermore, the choice of instruments tends to impart a deflationary bias. Lastly, performance criteria are felt to be excessively strict.

149. Apart from changes in the content of the programmes, it has been proposed that the method of negotiation should be changed. Instead of the Fund presenting Governments with a programme, the programmes should be devised with the active participation of the country concerned, other interested parties and independent observers. The main gist of proposals for reform is that conditionality should be concerned with structural aspects as well as demand. Formally, supply is now included in Fund programmes, but in practice this has not made a great difference, since the main emphasis has continued to be on control of demand, while supply conditions have been interpreted as being largely a matter of price incentives and not a question of building up investment in potential export and import substituting industries. For many countries, the main cause of balance-of-payment problems is not excessive domestic expenditure but changes in the nature of the world economy (including deteriorating terms of trade and reduced world demand), for which an appropriate response would be to improve their productive structure rather than to reduce demand.

150. Emphasis on structural changes to secure improvements in the balance of payments involves a longer-term perspective than emphasis on demand reduction. There is widespread agreement that Fund finance should be medium- term rather than short-term and should also be larger. Indeed, without these changes, the alternative approach to conditionality would not be very feasible.

1. Impact on industrial financing

151. Fund finance provides short-term balance-of-payment support and does not explicitly discriminate between sectors. The proposed changes would, however, tend indirectly to increase industrial finance and also to raise demand for industrial products.

152. Whether a structural approach to adjustment would favour the industrial sector will depend on the nature of each economy. Any improvement in the balance of trade requires an increase in the production of tradable products in relation to their consumption. With a demand approach, this is achieved by reducing the consumption of tradables, which often leads to a reduction in production as well. With a structural approach, the emphasis is on an increase in the supply of tradables.

E. Proposals emphasizing the low-income developing countries *

153. There are three reasons why special schemes for low-income developing countries are required: first, these countries are the ones most in need of development assistance; secondly, changes in the international monetary system in the 1970s have reduced the relative share of low-income countries in

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* These proposals are, of course, not explicitly directed towards the least developed countries. By definition, however, they would have a special significance for them.

external finance; and thirdly, the structural characteristics of low-income developing countries make them particularly vulnerable to external shocks, and rather inflexible in adapting themselves to such shocks.

154. Some of the schemes to provide special assistance to low-income countries some are of a short-run nature. The proposed changes for the most part consist in increasing the quantity of IMF finance and making access to it easier. This could be achieved by:

(a) Increasing IMF quotas;

(b) Untying CFF from quota limitations and relating it to shortfall of export earnings;

(c) Relaxing the quota limits of the Extended Fund Facility;

(d) Setting up a special window as an emergency facility for access to low-income countries;

(e) Increasing subsidy accounts;

(f) Making a substantial new issue of SDRs linked to development finance;

(g) Changing conditionality to take account of the special problems of low-income countries.

155. Other proposals for improving long-term finance include:

(a) Raising the proportion of aid that goes to low-income countries;

(b) Increasing aid-leverage by providing interest subsidies from public funds for private loans to low-income countries, by arranging co-financing between the aid and private funds, and by providing guarantees for commercial flows;

(c) Increasing the total flow of aid from aid donors while directing most (or all) of the additional aid to low-income countries. 22/

1. Impact on industrial financing

156. None of the proposals - short-term or long-term - are directly geared to industrial finance. Both in the short and long term, however, industrialization in low-income countries depends largely on their overall economic strategy and the general financial situation. The greater the availability of finance, the greater the rate of industrial expansion, while a severe financial problem, leading to a cut-back in investment and output, affects industrial projects particularly acutely. Among low-income countries other than China and India, growth in GDP fell from 4.4 per cent a year in the period 1960-1970 to 3.5 per cent a year in the period 1970-1980, but the fall in the growth of industrial output was much greater, from 7.0 per cent a year in the decade 1960-1970, to less than half that rate (3.2 per cent) in the following decade.

157. These short-term crisis proposals would lessen the need for low-income countries to cut back on investment and output while making the required adjustments. The proposals also combine this general relaxation with the restructuring of low-income economies so as to improve the external financial position in the medium term. In general, this restructuring involves an expansion of the supply of exportables and of import substitutes.

158. The industrial sector enters into the picture as a processer of primary products and a provider of essential inputs for the agricultural sector (e.g. fertilizers, tools, and also consumer goods for rural producers). For countries in which manufactures are only a small element of potential exports, a restructuring programme will be concerned with redirecting and increasing manufacturing output in order to generate increases in the exports of the primary sector and in the production of food (so as to reduce food imports). Other low-income countries export a significant amount of manufactures. For such countries, restructuring to improve the external financial position will focus more on the manufacturing sector as a major source of additional exports.

159. The longer-term proposals summarized above all involve increasing the medium-term access to external finance of low-income countries, thus permitting a greater rate of investment. While it is generally concluded that the agricultural sector requires a greater proportion of new investment than it has received in recent years, a higher rate of investment will certainly involve a higher rate of industrial investment as well.

160. From 1961 to 1982, total flows of IDA loans (the soft loans of the World Bank) were $US 26,738 million of which $US 2,906 million were for industrial projects and $US 910 million for development finance companies that lend mainly for industrial projects. Thus, of the total commitments, only 14 per cent were directly related to industrialization. It might be expected that the proportion of extra aid going to the industrial sector would be at least the same as this (14 per cent); the other schemes to increase aid-leverage involving, for example, co-finance or interest subsidies to private loans, would be certain to involve a higher element of industrial finance because the private sector tends to be more heavily involved in the industrial sector. The fungibility of finance, discussed earlier, must modify this conclusion somewhat, but it may tentatively be concluded that the proposals to assist low-income countries may not make adequate provision for industrial finance.

F. Conclusions

161. A comprehensive review 21/ shows that while most of the schemes considered would have some positive effects on the industrial sector of developing countries, the nature and magnitude of these effects differs from one scheme to another. For some, the main effects are derived from increased markets for industrial products rather than from the creation of new forms of finance. There is also a distinction between direct and indirect effects for both markets and finance: some schemes will directly increase the flow of finance to industry; others may increase commodity finance in the first instance but may also indirectly contribute to industrialization by releasing finance for industry and extending the markets for industrial products; others would improve the transformation process; yet others would be addressed to the

allocation issue. It does not follow, because the effects of some schemes are indirect rather than direct, that they are necessarily smaller than schemes whose main effects are direct. Moreover, as far as the rate of industrialization is concerned, the effects on markets may be as significant as the effects on finance. The fact remains, however, that proposals explicitly concerned with industrial financing are extremely rare.

162. Only a few proposals would have both a substantial impact on industrialization and good prospects for implementation in the current world political and economic situation, and these need to be vigorously pursued and promoted. They include: improvements in domestic financing systems, guarantees for private sector loans and export credits; increased effectiveness and enlargement of financial institutions, especially institutions of the South including multilateral institutions (see chapter V below for a detailed discussion of such institutions); and improved commodity finance.

163. Furthermore, the special requirements and characteristics of industrial financing make it unlikely that underlying problems will be solved unless solutions specifically directed towards the needs of industry are developed.

V. CO-OPERATION BETWEEN DEVELOPING COUNTRIES IN INDUSTRIAL FINANCING

164. There has been an increasing call for greater South-South co-operation in trade and finance in recent years. This is partly a response to the widespread view within the South that little progress has been made in North-South negotiations. The concept of self-reliance is an important element in the new international economic order and South-South ties provide a logical development of this concept. Many financial institutions based in the South have developed as a result of these tendencies. They are described and analysed below, together with the proposals for further South-South co-operation in financing.

165. The question is whether countries that are themselves in need of finance can assist others in a similar position. Much depends on the nature of the proposed schemes: some require little or no "hard" currency. For others - especially those involving support for balance-of-payment financing - the possibility of mutual assistance among countries of the South depends on the extent to which their problems occur simultaneously.

166. The South may collectively be in a stronger position to borrow on international capital markets than individual developing countries. Consequently a collective effort may enable the South to borrow from the North for balance-of-payment and other types of support.

A. Existing multilateral finance institutions in developing countries

167. A relatively recent development that might facilitate industrial finance in developing countries is the establishment by developing countries of multilateral finance institutions. 23/ At present these fall into four basic categories: *

(a) Regional development banks, generally established in the 1960s;

(b) OPEC/Arab development funds established in the 1970s;

(c) International Arab commercial banks established or operational in developing countries since the mid-1970s;

(d) Islamic financial institutions established and operational since the late 1970s, or early 1980s.

168. The mandates and operational policies of these institutions differ considerably but in none of them does industrial financing play a predominant role. At the same time, however, it should be noted that the share of industrial financing in their total operations is often significantly higher than that of other multilateral institutions, such as the World Bank. An analysis of the sectoral distribution of their project-lending showed that the aggregate maximum amount allocated to industry was about 20 per cent of the total. For development-oriented institutions, the minimum allocation was below 5 per cent. For example, the Asian Development Bank provided between 15 and 25 per cent of its total allocations to industry; the African Development Bank in fiscal 1981 allocated about 30 per cent and the Inter-American Development Bank only 4.3 per cent in the same period. The aggregate sectoral distribution of all OPEC aid agencies was 17 per cent for industry, of which the Saudi Fund provided 8.5 per cent and the Abu Dhabi Fund 33 per cent.

169. The various institutions have different reasons for their preference for other sectors:

(a) In the case of regional development banks, statutes stipulate regional integration as a priority, with the emphasis on infrastructure. A preference has also been shown in the past for agriculture and energy, depending on the priorities of the Governments of recipient countries;

(b) Among the OPEC/Arab development funds and banks, only the Abu Dhabi Fund and the Islamic Development Bank have committed substantial portions of their project-lending to industry. In the past, co-financing was their main project-lending activity, project-generation being the responsibility of the co-financing partners. Improved project identification and appraisal capability are needed, particularly for the industrial sector;

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* There are also some risk capital institutions, such as the ASEAN Finance Corporation, which have been of limited impact up to now but could be potentially important.

(c) Arab international commercial banks have a preference for liquidity and security. In the absence of alternatives, this has led them to place large portions of their funds in the Euromarket. They have so far only taken tentative steps towards longer-term commitments in the developing countries outside the Arab region and Islamic countries;

(d) Islamic financial institutions are a recent phenomenon except for the Islamic Development Bank, established in 1976, which occupies a special position within this group. Owing to their interest-free structure, they have had to develop special Islamic financial instruments. They have not yet achieved the capability or the experience for adequate project generation, identification or appraisal in the industrial sector. The support provided by the Islamic Development Bank for industry in the past (about 30 per cent) may help the commercial Islamic financial institutions to develop this capability in the near future.

170. The following paragraphs outline possible means of facilitating industrial financing in developing countries in the near future and the medium term.

171. Regional development banks. Regional development banks can only increase their level of lending if their ordinary capital resources as well as their concessionary resources are augmented; negotiations are on the way in all three regional banks. The following possibilities should also be investigated:

(a) The donor agency as a financial intermediary. (This is only feasible for institutions that are empowered by their statutes to borrow from t international capital market. Some institutions that are so empowered ha yet to take this step.) In the near future, financial intermediation is likely to become more prominent because direct and bilateral access to capital markets will become more expensive, if not more difficult, for developing countries;

(b) The donor agency as a co-lender with commercial sources. Compared to commercial banks, donor agencies are in the privileged position of having, inter alia, greater access to reliable information on potential borrowers, the capacity for project appraisal, and acceptability by recipient Governments. Donor agencies could use such advantages more systematically to attract greater volumes of non-concessional funds in the co-financing of industrial projects;

(c) The donor agency as catalyst in foreign direct investment. By providing equity participation, together with loans for projects appraised by it, the public donor agency can, directly or through the intermediary of national development finance institutions, play an important role in attracting additional risk capital from other sources;

(d) The donor agency as an advisor and source of technical assistance. The experience of donor agencies should be made available to interested developing countries by putting together financial packages that are attractive to foreign investors. These may include information on foreign sources of finance, assistance in tapping international markets, revising investment codes, improving the efficiency of local institutions, instruments and legislation etc.;

(e) The donor agency as a promoter of investment companies. Public development finance institutions could take the lead in sponsoring the establishment of investment banks.

172. OPEC/Arab development funds. OPEC/Arab development funds and banks did benefit from substantial capital increase in 1980 and 1981. Given the present level of annual oil revenues, these institutions cannot expect capital increases in the near future. Their developmental impact could, however, be further strengthened by extending their well-established co-ordination activities in the field of industry. Another possibility could be to strengthen and to co-operate more with national development finance institutions, catering especially to the industrial sector. Furthermore, all the possibilities available to the regional development banks in mobilizing non-concessional funds for industry could also be pursued by OPEC/Arab funds. International Arab commercial banks and investment companies could be natural partners.

173. International Arab commercial banks. International Arab commercial banks have only limited project-lending capabilities and thus limited project identification and appraisal capacities. They could, therefore, use to good advantage the "umbrella" function of both Arab and international aid agencies. Furthermore, they could use information on potential investment possibilities, particularly in growth areas outside the Arab and Islamic countries.

174. Islamic financial institutions. Islamic financial institutions concentrated in their formative years on mobilizing rather than on deploying funds. The identification of profitable investment opportunities, appraisal and follow-up of projects in great numbers will be the major challenge of these institutions in the future.

175. It is also important to point out that Islamic institutions and domestic banks now contribute heavily to the mobilization of additional funds and have attracted large amounts of savings that would otherwise have remained outside the monetary circuits. Within a few years they have acquired an impact, especially in some least developed countries, that conventional banks were only able to achieve after decades of operation.

176. The possibility of co-operating with other banking systems, for example to provide working capital and other short-term requirements in addition to long-term lending, poses opportunities but also problems that arise because of different policies and business styles.

B. New forms of co-operation among developing countries' banks in the field of industrialization 24/

1. Exchange of information

177. A better exchange of information on development projects would provide banks in developing countries with more of the information their executive boards need to prepare their policy of finance allocation. Such exchanges could be used as an instrument for furthering industrial financing and could,

at the same time, serve as an important channel of information to all kinds of companies in their countries on the possibilities for their participation in the industrialization of other developing countries. In this sense, the banks would play an important catalytic role in establishing contacts among non-banking economic entities in their countries, such as investors, construction companies, suppliers of equipment, consulting and engineering firms etc. This role is already being pursued to a great extent by banks in developed countries.

178. An information exchange programme among financing institutions in developing countries was operated by UNIDO between 1973 and 1978. The programme had as its object the promotion of a crossflow of information on industrial projects in developing countries among financing institutions and the transfer of information on the financing of industrial ventures in developing countries from one institution to another. Furthermore, an ongoing pilot operation also under the auspices of UNIDO, the Technological Information Exchange Network (TIEN) reviews current experience in evaluating the technological content of industrial projects dealt with by industrial development banks. It contains information required for the technological evaluation of projects submitted for financing, such as choice of technology, terms of and conditions for its acquisition and prices paid for equipment and services. Six industrial priority sectors have been selected for treatment.

179. Account must of course be taken of the fact that banks that would like to exchange information are potential rivals, if not directly, then indirectly as a result of competition between clients wanting to be included in the preparation and realization of individual industrial projects. This competition is one of the factors behind the present lack of co-operation. Banks in developing countries should endeavour to overcome these difficulties and improve their position in relations with competitors from industrially developed countries.

180. The importance of some organized pattern of co-operation among banks from developing countries in the field of information on industrial projects (which could in the future develop into a permanent system of co-operation) is confirmed also by the experiences of banks from developed countries. Existing systems of co-operation among industrially developed countries in the field of information cannot serve as absolute models for the establishment of systems for the exchange of information on industrial development projects in developing countries but they certainly should be taken into account.

181. Basic information on developing economies differs in many ways from information on specific development projects. These differences should be taken into account in setting up a system for the exchange of information among banks from developing countries.

182. The following basic information is pivotal:

(a) The overall magnitude of the ventures in terms of various indicators and the timetable for the ventures;

(b) The volume of financial resources expected to be available for the planned ventures; information on the expected participation of multilateral financial institutions is of special importance;

(c) Priorities of the development plan according to sectors or branches (a list of projects to be undertaken would be very useful);

(d) Targets of the global as well as sectoral development plan, intersectoral relations, linkages etc.

183. The existence of interbank agreements is a necessary condition for the establishment of this type of exchange system. To begin with, only a few development banks would need to reach such an agreement. In the course of time, the system could be expanded to include other development banks. The information system would begin its operations with an exchange of basic data on the kind, location, value and technical characteristics of projects for the preparation or implementation of which foreign partners are sought.

184. An effective information store on a certain development project should include a continuous rendering of data on all its relevant features. This means that countries should be informed of all phases of the so-called project cycle - from the identification, preparation, assessment of feasibility, contracting, execution and supervision of the project to its evaluation as a whole. In each phase, specific data and information are needed to enable the foreign partners to be effectively included in the project.

185. Potential partners are mostly interested in information relating to the initial phase of a project cycle, i.e. identification, preparation and evaluation. A full and up-to-date interbank information system in developing countries could become an extremely important source of information.

2. Further proposals for South-South co-operation

186. There have been a number of proposals for new institutions based on South-South co-operation: A "South-IMF" has been proposed to provide short-run balance-of-payment assistance to countries in acute difficulties. A less ambitious, but similar proposal is that the central banks of developing countries should explore the possibilities of increasing their deposits with each other. Some proposals involve the expansion of existing institutions or the creation of new ones in order to provide a direct flow of finance from surplus countries in the South and deficit countries without relying on the intermediation of institutions from the North.

187. Export credit refinancing and guarantee facilities for exports from the South have been proposed to enable exports from the South to enjoy the financial facilities now generally available in the North. Various means have been proposed to ease trade and payments among developing countries. These include clearing and payments unions, which would economize on the use of hard currency in trade between developing countries. A clearing union would provide a small element of short-term credit for the interval between the delivery of goods and the net foreign exchange payment. In payment unions, credit would be extended between members and only the net balance would be payable in convertible foreign exchange. One variant of this type of arrangement is the issue of "Southern money", which countries would use in part payment for trade with each other. All such monetary schemes would facilitate intra-South trade. Changes in tariffs, transport etc. may, however, be necessary in order to bring about an actual redirection of trade.

188. The proposal for a "South bank" was first mooted at the Meeting of Experts of the Group of 77 on ECDC Finance held in Jamaica in March 1982. After a follow-up meeting, UNCTAD was asked to provide technical documentation. The proposed bank would incorporate many of the functions the facilities proposed earlier were intended to perform. Its main functions, as currently envisaged, would be: the financing of development projects including joint ventures; the provision of export credit or export credit guarantees; balance-of-payment support; finance for commodity stabilization; support for regional payments and credit arrangements.

189. The provisional figures would indicate the use of about 44 per cent of the resources for balance-of-payment support, 20 per cent for joint ventures, 18 per cent for export credit, just over 10 per cent for commodity stabilization, 8 per cent for mining and processing investment, and less than 1 per cent for support for regional payment arrangements.

190. There are several questions that should be closely examined in relation to the South bank as currently envisaged, including the question of how to ensure its financial viability, particularly in view of the fact that the proposed ratio of lending to paid-in hard foreign exchange reserves is very high. It must also be made clear how many of the identified needs the bank could meet without over-extending itself.

191. In the wake of this proposal, another proposal has been put forward at the Third Conference of Banks from Developing Countries held at Ljubljana, in July 1983. This proposal is for the creation of a third world commercial bank, shares of which would be held by commercial banks from the developing countries. The bank would be active in supporting South-South trade, assisting in balance-of-payment difficulties, and aiding the recovery of developing countries from recessionary problems.

192. There is undoubtedly both a need and a desire for new institutions in the South and a potential for the South to exploit its collective strength. A "South bank", focusing initially, at least, on a narrower set of functions and with a lower ratio of lending to paid-in hard currency could provide useful finance and promote collective activities of the developing countries.

193. It is important to note that emphasis on South-South co-operation is by no means intended to detract from the importance of any possible improvements in North-South or East-West-South co-operation. Indeed, there is considerable historical evidence to indicate the potential complementary benefit of these types of co-operation, especially the complementarities of the financing capabilities of the West (through private credit and national credit subsidies), and the bilateral clearing agreements between the East and the South. The different modalities of co-operation (South-South, North-South, East-West-South) should all be seen as means of improving the options and degrees of freedom available to the South. 25/

C. Implications of South-South co-operation, particularly for industrial financing

194. Short-term balance of payments assistance provided from within the South. The precise implications will, of course, depend on the constitution and objectives of any new institution or arrangement. A general feature of

any such assistance should be a new type of conditionality. It is likely, that while conditionality of a "South-IMF" would have to be strict in order to make the institution viable in the medium term, there would be some major deviations from the current standard IMF-style conditionality. While it would have to aim at a turnround in the balance of payments just as much as the present IMF conditionality, it would emphasize a turnround that would increase supply rather than reduce demand. Reference is made to alternative conditionality in the proposal for balance-of-payment assistance contained in the documentation on the South bank, but the only specific element mentioned is the issue of adjustment through co-operation between developing countries. In so far as this is possible, it would be likely to involve a redirection of trade towards the South, probably largely in relation to industrial products.

195. Financial support for projects for development with an emphasis on joint ventures. A quite substantial proportion of the "South-bank" lending is intended to be for this purpose (a total of $US 7.6 billion according to provisional estimates). A very high proportion of such projects are likely to be in the industrial sector.

196. Export credit and export credit guarantee schemes. Schemes to ease the financing of exports (the credit refinancing facility) are likely to be directed to industrial products and not primary commodities, since it is among industrial products that the absence of credit facilities poses a major problem. Thus, while such facilities will not directly finance industrial exports, by extending credit facilities for the sale of industrial exports they will indirectly be providing industrial finance. It is estimated that traditional exports, i.e. manufactures, would require about $US 45 billion for finance or refinance and $US 11 billion for guarantees. The South-bank proposal involves a much more modest commitment of $US 6.7 billion.

197. Schemes intended to ease payments for trade within developing countries. The potential for expansion of trade between developing countries in response to schemes of this type is mostly for manufactured products, since trade in primary commodities in the South depends chiefly on aggregate rates of growth, while there is more discretion with manufactured products. If the payment situation were easier among developing countries, there would be an increase in their specialization and division of labour, thus raising productivity and exploiting economies of scale by relaxing trade restrictions between them.

198. Support for the stabilization of commodity prices. This is a major feature of the proposals. It could provide an important instrument for the establishment of a new international economic order and could make an indirect contribution to industrial financing.

199. The country distribution of South-South schemes will depend on the detailed specifications of the various schemes. It is likely that schemes for the promotion of exports will be concentrated on countries having the greatest capacity to export manufactures. Among low-income countries, manufactures accounted for 42 per cent of total exports in 1979 compared with 70 per cent for middle-income oil-importing developing countries. Within these exports, total manufactures excluding textile and clothing accounted for 23 per cent of exports among low-income countries and 63 per cent among middle-income oil-importers. It is likely that the schemes will serve mainly to extend markets for manufactures other than textile and clothing, thus further increasing the potential concentration on middle-income countries.

D. Conclusions

200. As in the case with proposals for monetary and financial reform at large, it must be concluded that the South-South proposals by themselves are not specifically directed towards supporting the industrialization of developing countries. Obviously, several of the proposals would have definite benefits for industry, particularly those aimed at export financing. Nevertheless, unless the specific requirements and needs of industry are explicitly taken into account, there is always a risk that they will be squeezed out by other requirements, investment in other sectors or consumption, be it private, public or military.

VI. SUMMARY AND EMERGING ISSUES

201. The international economic crisis has severely hurt the industrialization of developing countries. Growth in production has come to a standstill and the volume of trade has fallen. In the developing countries, real per capita income has shown a continuously declining trend since 1980. Budgetary cuts, shortages, unemployment and deteriorating living conditions are prevalent throughout the developing world. The degree of capacity utilization is dangerously low and prospects for building up new capacities that would make it possible to approach the Lima target are bleak in the absence of an international economic upswing.

202. There is no doubt that the present international financial crisis cannot be overcome without major recovery in the developed countries. It is still uncertain when and to what extent such a recovery will take place. Even though there are signs of recovery in the developed market economies, the overall outlook is still highly uncertain and government policies continue to be basically contractionary. There is also considerable uncertainty whether a recovery will spread to developing countries and have the necessary effects on their ability to export, improve capacity utilization in industry, raise foreign exchange, service their foreign debt, and raise the required international finances for industrialization and development.

203. Many of the fundamental actions required to overcome the current global crisis can be undertaken only by the industrialized countries. The developing countries have repeatedly and at various international forums called for such actions by the developed countries. 26/ These actions include initiation of a comprehensive recovery programme based on a concerted expansion of their economies. In view of the large currently underutilized capacity, high unemployment, reduced inflation rates and inflationary expectations, and the productivity increases that can be expected from increased output, this expansion will stimulate demand without rekindling runaway inflation. The reduction of real interest rates through an easing of monetary policy is called for here, along with appropriate fiscal policies. Countries with an external surplus should find ways of increasing their external demand. Protectionist trends must be reversed. It is vitally important that there should be immediate increased access to the markets of industrialized countries for manufactured goods from developing countries. Developing countries also need to be shielded from the havoc-wreaking effects of erratic

exchange rates. The industrialized countries have been requested in various forums to realize the insufficiency in the long run of emergency actions with regard to the international financial system. Innovative approaches should be tried, coupled with constructive solutions to the present debt problems, and increased direct assistance, especially for the purpose of stimulating the industrialization of developing countries. Industrialized countries should consider the impact of their domestic policies on the developing countries, not only in the short term, but in the medium and long term as well. Failure to do so could have grave consequences for the international economy and, in the final analysis, for the developed countries themselves. There is a strong mutual interest for both the developed and developing countries to enter into concrete negotiations on immediate measures for restoring growth in the developing countries.

204. The flows of finance and the financing instruments available are inadequate both for the urgently needed increase in industrial capacity utilization in the developing countries and for the creation of new capacity in the longer run.

205. In the short run, programme financing schemes for rationalization, improved capacity utilization, modernization and structural adjustment should be introduced. This type of financing can provide flexibility and speed of disbursement and improve the prospects for preparing the prerequisites for suitable industrial projects and the initiation of these projects.

206. Once the world economy has overcome the effects of the present recession, the underlying and persistent bottlenecks and obstacles to an accelerated industrialization of developing countries will again surface, because nothing was done to remove them during the previous growth period (and certainly not during the crisis). Among those obstacles, the lack of funds for financing new industrial capacity in developing countries, as well as the shortcomings of existing financial institutions, will be greatly felt. In the long run, measures therefore need to be taken in a large number of areas.

207. The identification, preparation and promotion of projects must be approached in a systematic way within the framework of a consistent industrialization strategy.

208. The role of the domestic financing system in the transformation of savings into lending and in the allocation of resources between sectors has not been given enough attention. In many cases, the domestic financing system does not fulfil its potential role in industrial financing. Technical assistance and an exchange of information between developing countries could improve matters.

209. The role of the State as financial intermediary should be considered closely, paricularly if the Government is willing to absorb some of the risks inherent in foreign borrowing. Furthermore, the creation of a focal point for industrial financing can mean greater transparency and improved efficiency.

210. The most important conclusions to be drawn concern the mobilization of external financial resources. There is a shortfall of finance for industry in developing countries, which will not disappear in the near future. There is room for improvement in both domestic and international industrial financing and there are institutional gaps and shortcomings that must be overcome in both areas.

211. The following table briefly evaluates the effects various reform proposals for the international financing system would have on industrialization in developing countries. Inevitably, there is some element of subjectivity in this evaluation. Nevertheless it seems that most of the schemes for financial reforms considered would have some positive effects on the industrial sectors of developing countries. Their effects differ, however: for some, the main effects are the result not of new forms of finance, but of increased markets for industrial products. There is also a distinction between direct and indirect effects for both markets and finance: some schemes will directly increase the flow of finance to industry; others may increase commoditv finance in the first instance but indirectly contribute towards industrialization by releasing finance for industry and extending markets for industrial products; others would improve the transformation process; yet others would be addressed to the allocation issue. It does not follow, because the effects of some schemes are indirect rather than direct, that they are necessarily smaller than some schemes whose main effects are direct. Moreover, as far as the rate of industrialization is concerned, the effects on markets may be of as much significance as effects on finance.

212. The few proposals that would have both a substantial impact on industrialization and good prospects for implementation in the current world political and economic situation need to be pursued and promoted vigorously. They include: the need for improvements in the domestic financing system; guarantees for private sector loans and export credits; increased effectiveness and enlargement of financial institutions, especially institutions in the South including multilateral institutions, and improved commodity finance.

213. All the analyses made in this background paper, as well as the review of current proposals for financial reform, point clearly towards the need for industry-specific measures and reforms. There is an obvious mismatch between fixed debt service on loans and the variable capacity of developing countries to pay. Depending on the industrial structure of individual developing countries and the special characteristics of specific industries, the extent or consequences of such a mismatch could vary. Lenders and borrowers have an equal interest in eliminating this mismatch so as to reduce the possibility of costly defaults or need for difficult negotiations. What is needed is a form of finance with a flexibility of equity in payment of service fees on the one hand and, on the other hand, the arm's-length relationship between lenders and borrowers in non-concessional and commercial lending, which does not allow excessive interference by the lender in the affairs of the borrower.

214. The special requirements and characteristics of industrial financing make it unlikely that the underlying problems will be solved unless solutions, specifically directed towards the needs of industry, are developed. Without industry-specific solutions, the effect of reforms will, at best, be indirect and vague, at worst, detrimental to the interest of this sector. This conclusion is valid for any proposal aimed at improving North-South co-operation and for proposals based on direct co-operation between developing countries, such as, for instance, the South bank that is at present under intensive discussion.

Effects of various financing reform proposals on industrialization in developing countries

Proposed reform	Increasing amount of finance		Increasing size of markets		Potential impact on Industrialization	Current prospects for Implementation
	Direct	Indirect	Direct	Indirect		
Improvements in domestic financing of guarantees for private sector	X	X	X	X	Substantial	Fair to good
For loans	X	X	-	-	Substantial	Fair to good
For export credit	X	-	X	-	Substantial	Good
Enlargement of existing public institutions	X	X	-	-	Moderate to substantial	Good for small enlargement; poor for substantial
Creation of new public institutions	-	X	-	-	Substantial	Fair to poor
Improvement of commodity finance	-	X	-	X	Substantial	Fair to good
Extra SDRs	-	X	-	X	Substantial	Poor
Reform of conditionality	-	X	-	X	Moderate	Poor to fair
Assistance to low-income countries	X	X	X		Moderate	Fair
Schemes to promote South-South co-operation:						
Multilateral institutions in the south	X	X	-	-	Moderate to substantial	Already existing
Payments union/credit	X	X	X	-	Moderate	Fair
South-South bank	X	X	-	-	Moderate to substantial	Fair
Third world commercial bank	X	X	-	-	Moderate	Fair to good
Co-operation between banks of countries of the South	-	X	-	X	Moderate	Fair
World recovery:						
International co-ordination for expansion	-	-	X	X	Very large	Poor in short run, better in medium
Reduction of exchange rate fluctuations	-	-	-	X	Not significant	Fair
World central bank	X	X	X	X	Very large	Poor
Reduction of debt "overhang"	-	X	-	-	Moderate	Fair

215. To achieve the necessary improvements, the following issues must be discussed and clarified:

(a) All the proposals that have any reasonable chance of implementation in the near future lack an explicit "industrial financing window". Given the pivotal role of industry in development, what proposals can be put forward so that industrial financing receives the explicit treatment it deserves? It is especially important to take into consideration the need for long-term investment in capital goods and plant construction. The international bank for industrial development (IBID) proposed by UNIDO is currently the most detailed proposal on this issue. The Industrial Development Board has, however, deferred action on the matter.

(b) There is also a vital need to direct attention to the improvement and rationalization of productive utilization of capacity as a means of better mobilizing and allocating resources for achieving the Lima target. Here the industrial financing needs are of a more short-term nature. South-South co-operation, especially in credit allocation and in increasing the liquidity of the South, would have a major impact on achievement of the improved capacity utilization. What financial measures are possible to improve and rationalize productive capacity utilization in developing countries?

(c) A clear understanding is needed of the relationship between adequate financing under appropriate conditions, the existence of good projects, and country risk. What constitutes a good project? Is the definition of a good project related to the perceived country risk? How does adequacy of industrial finance relate to the existence of good projects and country risk? What are the special problems of the least developed countries in this context?

(d) There is a complex interaction between domestic and international industrial finance. What is this relation? What conditions affect the importance of the international finance component of industrial projects? What measures can be taken to ensure that these two types of finance best complement each other?

(e) Many developing countries have made innovations in their domestic financial instruments, packaging and modalities that could be of significant use to other developing countries in streamlining and improving the working of their domestic financing system. Some experiences of developed countries could also be useful to developing countries in this regard. How effectively are these domestic financing innovations and practices diffused in developing countries? What can be done to improve the international transfer of financial technology and know-how, especially through South-South co-operation of various forms, such as inter-bank co-operation and multilateral Southern institutions?

VII. INTERNATIONAL CO-OPERATION AND THE ROLE OF UNIDO

216. By definition, most of the proposals for reform of the international monetary and financial system that were scrutinised in chapter IV above stem from a growing realization of the malfunctioning of international co-operation in this vital field. Several new forms of co-operation, either North-South or

between the countries of the South themselves have been proposed. The conclusions show that, whereas most of these reform proposals would have a beneficial effect on industry if they were implemented, very few have any explicit provision for this sector. In the context of industry as the primus motor of development, this appears to be an anomaly that can only partly be explained by the fungibility issue.

217. The discussions of international co-operation at the Fourth General Conference should therefore focus on how to ensure that the requirements of industrial financing are properly met. In the absence of a specialized international institution to bear the brunt of this task, UNIDO will have a pivotal function to fill.

UNIDO as a spokesman for industrial financing requirements

218. Given the present mode of discussions and interests of the parties involved, it is unlikely that the explicit role of industrial financing will be effectively recognized unless it is presented by a proper spokesman. UNIDO could play the role of spokesman for the industrialization of developing countries in the international discussions on financial and monetary reform. This could be achieved through:

(a) Active participation in the international negotiations and discussions on financial reforms in co-ordination with other institutions such as the World Bank, IMF and UNCTAD;

(b) Follow-up to the recommendations of the First Consultation on Industrial Financing and the organization of a second Consultation on this subject;

(c) Proposal and promotion of new financial mechanisms and institutions.

219. Whereas the above functions mainly concern the external role for UNIDO, there are also many measures that can be taken within the present mandate and present organization of UNIDO. Concrete proposals and suggestions for new financing institutions, for financing packages covering infrastructure and training project components, even design and promotion of programmes for sectoral development, could be worked out and implemented. Both project identification and investment promotion services could be strengthened and expanded into new areas, for instance, tripartite arrangements between developing countries, centrally planned economies and market economies. New methods could be devised to ensure the operational impact of the study work of UNIDO and - even more important - that operational activities are placed within a necessary systematic framework, in line with the industrialization strategies of developing countries.

220. UNIDO could design and promote programmes for development in specific industrial sectors. Financing would be sought for coherent and viable plans for the development of an industrial sector or subsector (or perhaps an industrial complex within a country). The whole process could be monitored and supervised by national development banks. Targets would have to be agreed on for the future performance of the sector, e.g. concerning physical output,

exports, output of trained personnel and their integration into industry. Plans and programmes would, however, basically be developed by the countries themselves and be accepted by them as conducive to their development goals.

221. Whereas UNIDO as an organization has an important role to play in the area of industrial financing, it cannot be denied that the efficiency of all measures, including those indicated above, hinges on the direct access and availability of financial resources. The question of an independent institution for financing the industrialization of developing countries, which would efficiently implement innovative ideas, with special concern for the poorer developing countries, but also for a true mutuality of interests between members of the world community, will have to remain on the order of the day for all international deliberations aimed at a revitalization and acceleration of the industrialization of developing countries.

Notes

1/ See Industry 2000 - New Perspectives (ID/237) and Industry 2000 - New Perspectives: Collected Background Papers, vol. I, International Financial Flows (ID/324).

2/ Industry in a Changing World: Special Issue of the Industrial Development Survey for the Fourth General Conference of UNIDO (United Nations publication, Sales No. E.83.II.B.6).

3/ "A statistical review of the world industrial situation" (UNIDO/IS.368).

4/ See Overcoming Economic Disorder: International Action for Recovery and Development (United Nations publication, Sales No. E.83.II.C.2); and World Bank, World Development Report 1983 (Washington, D.C., 1983); see also Euromoney, August 1982 and "Handbook of world development statistics, 1982: major economic indicators showing historical development trends" (PPS/QIR/5/1982 and Corr.1).

5/ Ibid.

6/ See United Nations Conference on Trade and Development,"Trade and development report, 1983", part I, "The Current World Economic Crisis" (to be issued later as a United Natons sales publication).

7/ For a more detailed discussion, see "Types of finance for industry" (UNIDO/IS.417).

8/ For a detailed discussion of related problems, see Industry 2000 - New Perspectives, Collected Background papers, vol. I, International Financial Flows (ID/324).

9/ Development Assistance Committee of the Organisation for Economic Co-operation and Development Annual Report, 1982 (Paris, OECD, 1983).

10/ International Finance Corporation, Annual Report 1983 (Washington D.C., 1983).

11/ Stephan F. Frowen, "The economic rationale for a new international institution in the field of industrial financing", background paper for the meeting of a special advisory group of experts on international industrial financing, held at Vienna from 27 to 29 January 1981.

12/ For information on capacity utilization in various sectors, see Peter F. Marcus and Karlis M. Kirsis, World Steel Dynamics (New York, Paine Webber Mitchell Hutchins, Inc., 1983); Japan Iron and Steel Exporters' Association, Forecast on Demand and Supply of Steel in ASEAN Member Countries in 1982 (Tokyo, 1982); "A survey of the Latin American agricultural machinery industry", Sectoral Studies Series No. 6 (UNIDO/IS.407); Asian Productivity Organization, Factors which Hinder or Help Productivity Improvement: Country Report - India (Tokyo, 1980); ibid., Country Report - Singapore (Tokyo, 1980); "Agricultural machinery and rural equipment in Africa - a new approach to a growing crisis", Sectoral Studies Series No. 1 (UNIDO/IS.377); and "World-wide study of the leather and leather products industry", second draft, Sectoral Study (UNIDO/ICIS.134).

13/ Brandt Commission, Common Crisis North-South: Co-operation for World Recovery (London, Pan Books, 1983).

14/ Commission on International Development, Partners in Development (New York, Praeger Publishers, Inc., 1969).

15/ For a discussion of some of the issues relating to cost-benefit analysis see, for example, the report entitled "How 'scientific' is cost-benefit analysis?" (ID/WG.358/5).

16/ "Issue No. 1: Is there a quantitative and qualitative gap in external financial flows for industrial investment in developing countries?", (ID/WG.377/4), paper submitted to the First Consultation on Industrial Financing.

17/ Stokes Tolbert and Keith Marsden, "Financial requirements for industry in the less developed countries in the 1980s", paper presented to the International Symposium on Industrial Policies for the 1980s, held at Madrid from 5 to 9 May 1980.

18/ See ID/B/261/Add.7.

19/ For detailed and comprehensive information on these and other industrial investment and financing services, see UNIDO, Financial Resources for Industrial Projects in Developing Countries, 3rd ed. (PI/61/Rev.1).

20/ W. Brandt, North-South; a Programme for Survival, Brandt Report (London, Pan Books, 1980).

21/ A full description of the proposals discussed, with complete references, is given in "Proposals for reform of the international financial system: implications for industrial financing." (UNIDO/IS.432).

22/ For further discussion of the situation of the least developed countries, see the background paper for agenda item 5(h): "The least developed countries: implementation of the Substantial New Programme of Action" (ID/CONF.5/10).

23/ For a detailed discussion see "The role of South multilateral institutions in industrial finance" (UNIDO/IS.419).

24/ For a detailed discussion of the issue and the analysis of a survey of banks performed in this connection, see "Exchange of information among developing countries' banks to facilitate industrialization" (UNIDO/IS.418).

25/ For a further discussion of South-South co-operation, see the background paper for agenda item 5(i): "Strengthening economic co-operation among developing countries" (ID/CONF.5/4).

26/ See, for example, the Declaration of the Ministers for Foreign Affairs of Non-aligned Countries (A/38/494, annex).