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MOBILIZING OF FINANCIAL RESOURCES FOR INDUSTRIAL DEVELOPMENT

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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

Issue paper prepared by the UNIDO secretariat

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INTRODUCTION

1. Finance is a surface phenomenon of economic life inasmuch as financial problems are symptoms, rather than causes, of the underlying real economic problems. From this point of view, the problem of mobilizing financial resources for industrial development reflects to a large extent the underlying problems encountered in mobilizing physical and human resources for the same purpose. Nevertheless, the political reality of the modern nation-State as well and the use of national currencies divide the financial problems in a country into two distinct categories: (a) the problem of external finance; and (b) the problem of domestic or internal finance. This division has its obvious real counterpart in the fact that availability of external finance represents claims on foreign goods and services, while domestic finance represents claims on domestically produced goods and services. The distinction is particularly relevant for most developing countries because the non-convertibility (or "softness") of their currencies prevents them from interchanging their domestic and foreign purchasing power.

2. In mobilizing financial resources for industrial development, developing countries generally face both external and internal financing problems. In so far as financial problems reflect underlying real economic issues, they point to the structural rigidities in the mobilization of external and internal physical resources. At the same time, the two aspects of financing are interrelated: the degree of availability of external finance reacts upon the extent of domestic financial resource mobilization and *vice versa*.

3. It is the purpose of this paper to identify some of the major issues regarding both external and internal financing of industrial development and their interrelations. Attention is also drawn to chapters VI and VII of the background paper prepared for the Conference on the same subject (ID/CONF.5/13) which spell out some issues relating to the specific requirements of industrial financing, international co-operation and the role of UNIDO in this context.

I. SOME MAJOR ISSUES

A. Interlocking of external and internal finance

4. In a developing country with non-convertible currency, domestic finance represents generalized purchasing power applied to domestic goods and services. In most developed countries, the convertibility of their currencies ensures that domestic finance represents generalized purchasing power applied to both domestic and, up to a point, foreign goods. Since this distinction between domestic and foreign purchasing power is drawn far more strictly in most developing countries, their ability to finance their industrialization depends on their having adequate purchasing power to be applied separately to domestic and foreign goods and services. In this context, a lengthy policy debate has been taking place on the validity of separating the foreign exchange constraint from the overall domestic resource constraint in the

process of industrialization, highlighted, for example, by the so-called "two-gap" model in resource mobilization. Although it is evident that the validity of viewing domestic and foreign resource constraints separately depends ultimately on the ability of domestic resources to be transformed to meet the needs of industrialization that would otherwise have been satisfied by foreign resources, several important policy issues arise.

5. First, the "speed of adjustment", i.e. the time it takes to convert domestic resources in order to substitute them for foreign resources in sustaining the process of industrialization, has to be determined. To the extent that domestic products can be easily exported at a given price, the speed of adjustment can be relatively rapid. If for some reason, however, exports are limited either by the size of the foreign market or by sharply deteriorating terms of trade, the adjustment is both time-consuming and extraordinarily expensive in terms of domestic resources. In the more extreme case of some small least developed countries with a very narrow natural resource base, the substitution of domestic resources for foreign resources may be impossible within a given period. In times of stagnation in world trade and economic recession, with the consequent tendency to increase protectionism, domestic items are generally much less exportable. Thus, the Conference should consider whether or not it is important in times of economic recession to increase the availability of external financial resources for industrial development. For, on grounds of both protectionism and sharply deteriorating terms of trade with respect to raw materials, developing countries find it increasingly difficult to substitute domestic for foreign resources.

6. Secondly, there is the advantage to be derived from the fact that the increased net flow of foreign financial resources to countries of the South in times of economic recession in the North will produce a counter-cyclical management of international effective demand by stimulating demand by the South for goods from the North. And the larger the net flow earmarked for industrial development, the stronger this stimulation will be. The value of establishing a link between international demand management and adequate credit and aid to the South for its industrialization should therefore be seriously considered.

7. Thirdly, the interaction between internal and external finance in a developing country, particularly in the field of public finance, deserves serious attention from both developing and developed countries. It has been argued that external finance can either help or hinder efforts to mobilize domestic savings. For instance, there is the argument that some Governments in developing countries may take the "soft option" of replacing domestic savings by a larger inflow of foreign finance, so that domestic savings, particularly with respect to public finance and revenue collection, tend to slacken off as a larger inflow of foreign finance becomes available. While this argument merits attention in many specific instances, it must not be overstretched. There is now considerable statistical evidence that developing countries as a whole have markedly increased their domestic savings rate over the last two decades or so. It must also be emphasized that there are many circumstances of critical importance in which external finance complements, rather than replaces, domestic efforts to mobilize financial resources for industrialization. Identification of these critical circumstances, in which internal and external finance complement or reinforce one another in the overall effort for resource mobilization, is a matter deserving of attention by the Conference.

B. Crucial areas in which external finance complements domestic resources in industrial development

8. Certain problems encountered in the process of industrialization cannot be overcome, at least within a reasonable span of time, without adequate access to external finance.

9. For instance, external finance is essential for buying new capital goods. In so far as the advanced technology embodied in new capital goods can be purchased in the international market, access to adequate external finance implies at least partial access to new technology. This point has been largely borne out by the experiences of some of the newly industrializing countries during the last decade or so. The fact that a number of them had substantial access to external finance, mostly from commercial sources, allowed them to initiate a relatively modern industrial structure. The obverse of this needs emphasis; an inadequate flow of external finance for purposes of industrial development may restrict the flow of technology in some respects.

10. Furthermore, in an uncertain economic world, some degree of flexibility is essential in the process of industrialization. This flexibility can largely be achieved through an adequate reserve or "credit line" for external finance, which allows a developing country to tide over temporary shortages and imbalances in various lines of production. In particular, the need for imports of maintenance and repair requirements for the effective utilization of capacity emphasizes the importance of availability of external finance to maintain a steady domestic production. The Conference should therefore pay special attention to identifying all areas of industrial finance in which the opportune availability of a relatively small amount of external finance acts as a catalyst or multiplier in the domestic mobilization and utilization of resources for industrialization.

C. Judging the adequacy of industrial finance for development

11. Even when the strategic role of external finance in industrial development is accepted, there can be serious difference of opinion as regards the adequacy of external liquidity for industrial development. Some maintain that "good" and "bankable" industrial projects always find the necessary finance, while others claim that "good" projects are often thwarted owing to the lack of adequate external finance. Since both these views seem to arise out of the practical experience of bankers, planners, investors and financiers, it would be worthwhile for the Conference to disaggregate this general question into a set of sharper issues.

12. At the macro-level, it is useful to concentrate on the question of developing countries' access to external credit. It is known that commercial and private sources of credit are usually influenced by considerations of "country risk", in addition to "project risk", particularly in regard to publicly guaranteed credit. This raises a fundamental question: even a

worthwhile project in a particular country may not find external finance from private sources if considerations of "country risk" happen to be of overriding importance. The least developed countries as a group have been particularly unfortunate in this respect, since they have had to rely almost entirely on a dwindling real volume of official development assistance (ODA) and export credit to finance their industrialization. Thus, the emphasis on "country risk" would seem to cast some doubt on the somewhat complacent view that the South can always obtain enough credit for "good" projects. Indeed, two related questions must be posed in this context:

(a) How to ensure that "good" projects in a country of high "country risk" will find the complementary external finance to initiate them;

(b) What the investment criteria are for selecting industrial projects, for example whether conventional business "cash-flow" analysis, social cost-benefit analysis or cost-effectiveness analysis are to be used. How to treat economic and social infrastructure investment, including the training of required manpower and skill formation in such cost calculation remains an open question.

13. The problems of discriminatory allocation of private credit to developing countries and their industrial projects have assumed increasing importance over the last decade and a half because of the growing relative importance of private credit in overall credit to the South. It is estimated that the proportion of private credit has increased from about one third (in 1967) to almost two thirds (nearly 60 per cent in 1981) over this period. In view of this increased privatization of the international capital market, the Conference should discuss its implications (some of which are mentioned above) for industrial credit to the South in general and specific country groups in particular.

D. Barriers to private sources of external credit and attributes of industrial finance

14. The increased privatization of the international capital market and the subsequent debt-crisis that now looms large make it imperative to analyse past experiences and suggest new ways of dealing with the problem. Several important issues have to be tackled in this context.

15. First, the high debt-service burden, particularly for heavy borrowers, has by now resulted in a two-way debt-trap. The borrowers have to keep on borrowing at an increasing rate, if only to meet their repayment obligations; the lenders also have to keep on lending if only to avoid the risk of a catastrophic financial crisis, which could be triggered off by the "technical default" of one or two major borrowing countries. Conventional banking methods of dealing with lenders' risk by charging a higher risk premium in terms of higher interest (i.e. higher spread over the interbank offer rate) seem totally inadequate to deal with the situation, since higher interest on flexible-interest loan arrangements only heightens the future debt-service burden and thus deepens the debt-trap. Nor is conventional credit-rationing of much help: rationing credit to a heavy borrower will simply further reduce

his ability to repay. Obviously, less conventional ways of meeting the crisis have to be found, in which neither the international banking system nor the need for rapid industrialization of the developing countries is sacrificed in an attempt to impose "financial discipline".

16. Even for some major developed countries, a main issue in this context is how to enhance the ability to repay of the developing countries so that they are not forced to default. Since most heavy borrowers are newly industrializing countries, the argument that protectionism against industrial products from developing countries should be reduced through special "buy-back" arrangements etc. assumes exceptional significance. It should also be noted that an expanding two-way trade in manufactured goods between the North and the South is an essential precondition for expanding the ability of many borrowers in the South to meet their debt commitment over a period of time.

17. At the same time, every attempt has to be made to stabilize the terms of trade between manufactured goods and raw materials so that the export revenue of the South is not increasingly squeezed by adverse terms of trade.

18. Efforts must be made to avoid the problems that lead to gross underutilization of existing industrial capacity in the South, even if such underutilization is only temporary. The factors involved could, for example, include the lack of imports of maintenance and repair requirements, and worsening labour relations brought about by a sharp reduction in the living standards of the industrial labour force, which in turn could be the result of an austerity programme imposed by debt repayment considerations. It has to be recognized that the ability of developing countries to produce at nearly full capacity will enhance their ability to meet their debt-service burden: the mutuality of interest between North and South should be obvious.

19. A major attribute of industrial finance, particularly for setting up new industries, is the long maturity period of typical industrial investment and the substantial risk associated with it. The sharp fluctuations in interest and exchange rates that have characterized recent international capital markets naturally tend not only to inhibit industrial investment but also to increase the project risk substantially. In order to ensure an adequate flow of finance to industry under these circumstances, various insurance policies would be required, including forward-market hedging and product-sharing, so that industrial investment would be less prone to exchange and interest fluctuations in developing countries. The heightened uncertainty in industrial investment has been at least partly a consequence of the present international financial system, which has led to a vicious circle of lower industrial growth in both developed and developing countries.

E. South-South co-operation in industrial financing

20. An increasingly uncertain climate for industrial investment, the heavy external debt service burden, the low level of ODA and various barriers to access in the private capital market suggest a dramatic change in the fundamental parameters of international finance as far as developing countries are concerned. The net flow of private credit to the South is already meagre and may even turn negative. Under these circumstances, there are historical imperatives for greater collective action in the area of finance for

developing countries, so that trade and investment among these countries are at least partly insulated from the adverse effects of the present international financial arrangements. In particular, this is an opportune moment for the Conference to consider:

(a) The use that can be made of payments in local currencies in South-South trade and the clearing arrangements that must support such trade;

(b) The possibility of product-sharing joint investment and all other forms of industrial collaboration that will reduce the cost of industrial investment to individual countries;

(c) The longer-term institutional changes in the international monetary system that are needed for an adequate flow of finance for the steady industrialization of the South;

(d) South-South co-operation through a sharing of "know-how" in the mobilization of domestic and external finance.

21. Undoubtedly, South-South or regional co-operation, especially in the field of finance, gives rise to many intricate problems and difficulties. In the final analysis, financial relations among nations are a reflection of international power relations and they will not be easy to change. Nevertheless, to accept passively the status quo in finance may imply a stagnation or even retrogression in the process of industrialization of the South. To forestall such a possibility, the historical compulsions of greater South-South co-operation in finance, trade and investment must be recognized.

II. CONCLUSIONS AND RECOMMENDATIONS

22. This paper and the relevant background paper (ID/CONF.5/13) have highlighted several issues. Basic to all those issues is the question how, given the pivotal role of industry in development, measures can be taken to ensure that industrial financing receives the explicit treatment it deserves in national and international finance so that the requirements of industrial finance are specifically properly met.

23. The maximum effort should be made to mobilize domestic resources for industrial development without resorting to the soft option of foreign finance.

24. This calls for South-South co-operation in the sharing of financial know-how and in the identification of the critical minimum area in which foreign finance plays an essential complementary and catalytic role in mobilizing domestic finance. In particular, UNIDO has a crucial contribution to make by disseminating information on industrial finance and identifying and promoting projects that enhance financial capability in the South.

25. The developed countries must pay serious attention to the link between country risk and project risk. In particular, viable industrial projects in the least developed countries should not be thwarted because of the country risk involved.

26. A mechanism has to be found to ensure a high degree of capacity utilization in industries already in place in developing countries. This will require programme financing so that existing capacities are not under-utilized because of a lack of adequate imported maintenance and repair requirements and measures for rationalization, modernization and structural adjustment are undertaken. UNIDO should be actively involved in the creation and nurturing of such new mechanisms and instrumentalities.

27. Industrial investment, with its typical long maturity, is especially prone to the risks of interest and exchange rate fluctuations. These risks have to be reduced to a minimum to improve the climate of industrial investment in developing countries, if necessary by creating a special window for borrowing for industrial investment on a long-term basis.

28. The mutuality of interest between heavy borrowers in developing countries and the international banks has to be recognized. The debt crisis must not be allowed to result in a situation in which the net flow to these countries becomes negligible or even negative, as this will have disastrous consequences both in terms of exports from the North and in terms of the financial catastrophe it could precipitate.

29. In the ongoing activities of UNIDO in the field of industrial finance, project identification and investment promotion services could be strengthened and diversified and the design and financing of coherent and viable sectoral development plans could be promoted. UNIDO could also play the role of spokesman for industrial finance 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; and

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

30. The direct access and availability of financial resources remains a central issue. 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.