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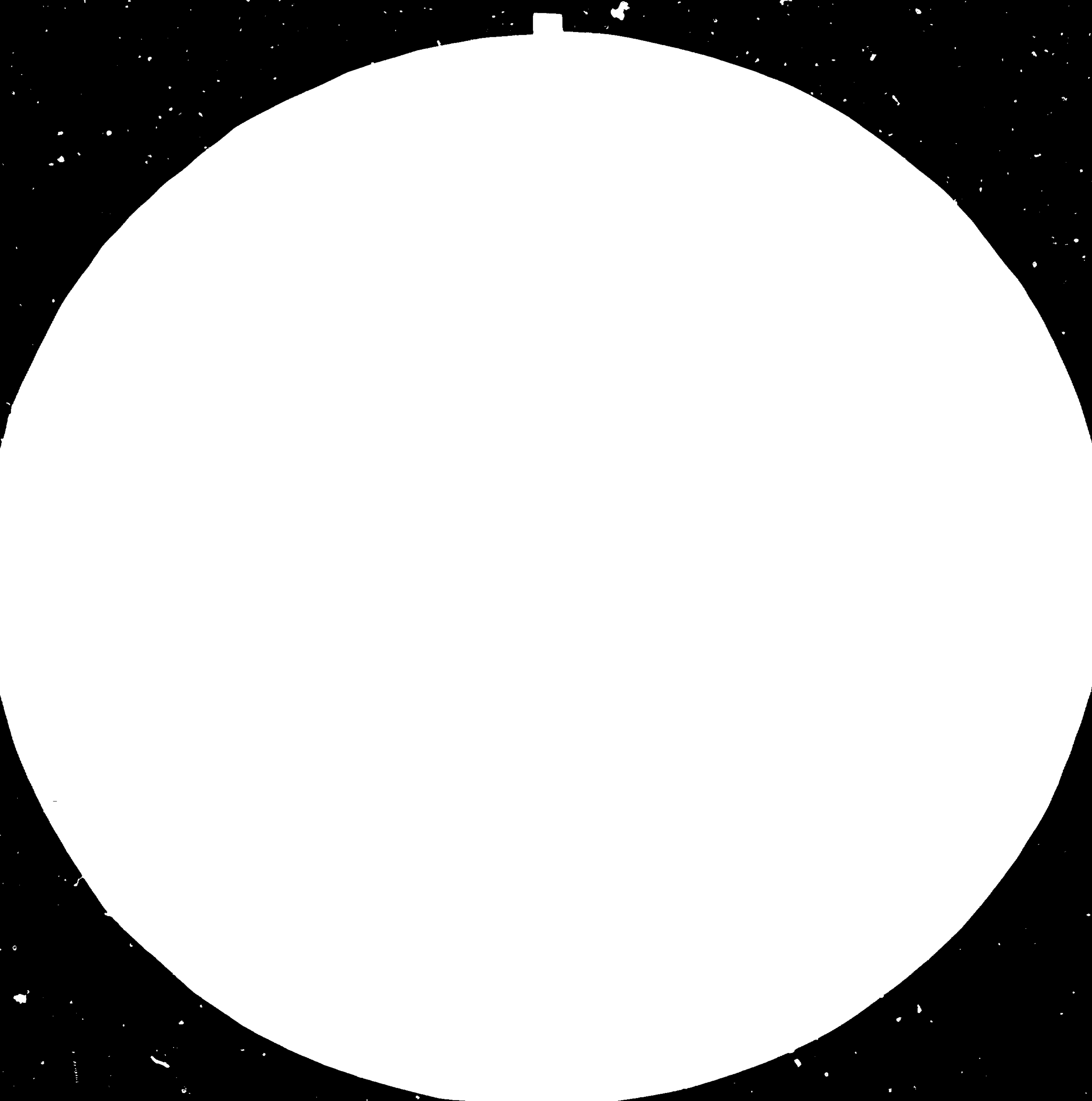

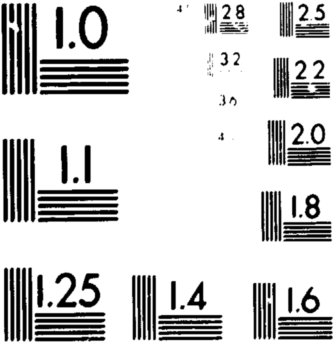

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13077

Distr.
LIMITED

UNIDO/PC.81
2 November 1983
ENGLISH

UNITED NATIONS
INDUSTRIAL DEVELOPMENT ORGANIZATION

Organisation for Economic Co-operation and Development/Development Centre in co-operation with the United Nations Industrial Development Organization

Experts' Meeting on Venture Banking in Developing Countries

Paris, France, 7-9 November 1983

A NOTE ON INDUSTRY AND VENTURE BANKING IN THE CURRENT ECONOMIC CONTEXT OF DEVELOPING COUNTRIES*/

prepared by
the secretariat of UNIDO
Negotiations Branch, Division of Policy Co-ordination

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V.83-63520

Introduction

1.1 The purpose of this note is to present an outline of the economic reality within which venture banks operate at the present time in developing countries. Developed and developing countries face a number of major economic problems at the present time. Any consideration of the role of venture banks in contributing to the development of the developing countries has to be seen within the framework presented by these major economic problems.

1.2 A sharp distinction is made between economic problems facing developing countries in the period up to about 1979 and the economic problems of the present time. This distinction is particularly relevant. Round about 1979, the international consensus on development of the Third World came to an end. To be sure, before 1979 there had been significant degrees of difference on development. But these differences for the most part related to the speed with which the Third World should grow and the gap between developing and developed countries narrowed. There had been the recognition that increases in financial flows for investment in developing countries were desirable, since it was normal for countries at the early stages of development to run deficits on capital account. Here too there had been some disagreement - on the relative efficacy of the various components of these investment flows - grants, direct foreign investment, including venture capital, loans on hard or soft terms, technical assistance etc.; but there was an international consensus that it was desirable to increase the total amount of such flows.

1.3 This consensus seems to be at an end. The three decades up to the end of the 1970s had witnessed an unprecedented and historically high growth in the economies of both developed and developing countries which most observers agree is at an end. To be sure, there had been some cyclical variation during this 30-year period, but these were variations about a rising trend. It seems that the bulk of the unemployment in the market economy developed countries is not a short-term temporary phenomenon, but has longer-term structural roots. With the exception of outright grants, financial flows to the developing countries have to be repaid, accompanied by interest (or dividends). Grants are financed by national budgets, but the national budgets of the rich countries have been squeezed in coping with their own economic problems. Repayments of other flows depend critically on the proceeds from export commodities -

for which demand has fallen - or the proceeds from exports of manufactures: these exports confront the cyclical and structural unemployment of the developed countries.

1.4 The present economic watershed may signal the first stage of the downward swing in the global economy of a long cycle of the Kondratiev type[1/] or may be a reversion to the normal and historic low growth rate, following the eventual end of the post-world war II period of reconstruction. Perception of this fundamental change has been slow in being formed. But past development priorities towards new investment - whether in industry, agriculture, infrastructure or social services - are being modified, with significant stress being placed on development financing modalities towards the support of existing productive capacities, i.e. programme lending, and more generally financial transfers in rapidly disbursing form.[2/] There has been the new stress on assistance for the maintenance of infrastructure and fuller use of existing capacity by both the World Bank Group and the OECD Development Assistance Committee,[3/] as well as within organs of the United Nations, such as the UNIDO System of Consultations.[4/] Similar modifications in approach have occurred within the forums of the developing countries, with a similar greater stress in programme lending for the support of existing productive capacities.[5/]

1.5 It must be recognized at once that this shift in emphasis with regard to existing capacities - including existing industrial capacities - does not represent an abandonment of growth and other development objectives by developing countries. It is but a recognition by these countries that given the immediate economic problems facing them, recovery must take priority. The problem, however, is how long will the "immediate" or "short term" be - two or three years, or ten to fifteen years, or longer than that?

1/ For an elaboration see W. Arthur Lewis "The slowing down of the engine of growth", Nobel Memorial Lecture, The Nobel Foundation, 1980.

2/ See Overcoming Economic Disorder, views and recommendations of the Committee for Development Planning, ST/ESA/133, United Nations, New York, 1983.

3/ See World Bank News, Vol.II, Number 7, 24 February 1983, Washington; and DAC Guidelines on Aid for Maintenance and Strengthening of Existing Services and Facilities, Press/A(82)74, Paris, December 1982.

4/ See Report of the First Consultation on Industrial Financing, consensus conclusions and recommendations, paras 14 and 19(a); and para.54, ID/293, UNIDO, Vienna, November 1982.

5/ See pp. 29-30, The Buenos Aires Platform: Final Document of the Fifth Ministeral Meeting of the Group of 77, TD/B(S-XII)/Misc.1, 18 April 1983, UNCTAD, Geneva.

The state of the world economy: the crash of 1982

2.1 There was no growth in world production in 1982 (table below), and world trade fell in volume and even more in value for the first time in the post-war period.

World production: percentage of annual change, by country group 1976-1982 */

	1976-1980	1981	1982**/
World	3.9	1.4	0.2
Developed market economies	3.5	1.3	-0.3
Centrally-planned economies***/	4.3	2.2	2.6
Developing countries	5.2	0.7	-0.7

Source: Department of International Economic and Social Affairs of the United Nations Secretariat, based on official national and international sources.

*/ Gross domestic product for market economies; net material product for centrally-planned economies.

**/ Preliminary estimates.

***/ Includes China.

2.2 The contraction of economic activity in the period 1979-1982 has been the longest and deepest in the past fifty years. It has deeply affected all groups of countries of the world, whatever their economic system or stage of development. The centrally-planned economies showed the greatest stability and continued to grow, although more slowly than in the 1970s, but many of them have been forced to retrench their plans. In the member countries of the Organization for Economic Co-operation and Development (OECD), unemployment edged up further, real income contracted, and soaring deficits in public finances became a universal concern. In most of the developing countries, however, the contraction caused a state of emergency: real per capita income fell for the third year in a row, shortages and budgetary cuts approached - and sometimes exceeded - the political breaking points and living conditions deteriorated. International development was in reverse gear.

2.3 The world-wide distress was not due to natural disasters that the international community could not deflect. It was partly due to structural disequilibria in and between national economies, but in large measure it was also due to the policies resorted to by certain major industrial market economies to control inflation after the increase in energy prices in 1979-1980 and to their attempts to maintain employment by protectionist measures. These policies increased the strain on other countries, but the interdependence of the world economy is such that economic distress cannot be exported without coming back in force. The volume of the industrialized countries' exports fell by almost 2 per cent, mainly reflecting the drastic cut-backs in imports by developing countries. World industrial production contracted by some 4 per cent in 1981.1/

2.4 Most observers agree that the crisis has two major components - a long-term structural component and a short-term cyclical component. The long-term structural component reflects the fact that over time there is a changing comparative advantage and disadvantage in industry of both the developed and the developing world. For example, in the developed world some industrial branches/sectors are in decline, and at the same time the so-called sunrise industries - informatics, genetic engineering, robotics etc. are growing. However, the present world economic crisis is also caused by short-term cyclical problems - there is a lack of effective demand in domestic and export markets, and this lack of demand is exacerbated by a very severe cash flow or liquidity problem at the level both of industrial enterprises as well as for many developing countries, i.e. a foreign exchange liquidity crisis at the national level. The liquidity problem is linked to the monetary and budgetary policy followed i certain major economies.

2.5 It should be noted immediately that opinion - whether in government, banking, industrial or academic circles - is divided as to the precise weight to be given to the various components of the current global crisis. Opinion is also divided as to whether a recovery is underway and as to the strength of this recovery and whether it will be sustainable. Above all, there is considerable doubt as to whether the recovery will spread to developing countries.

1/ See pp.9-10, Overcoming Economic Disorder, views and recommendations of the Committee for Development Planning, ST/ESA/133, United Nations, New York, 198[illegible].

in product markets, little depth, buyers' and sellers' monopolies, knowledge is highly imperfect, and skills often in short supply etc. Many countries which have long-term industrialization objectives are happy to accept direct foreign investment in certain branches which fit in with the development of certain strategic sectors or in those sectors which may be regarded as non strategic. Here we are not concerned with the more political question of domestic ownership versus foreign ownership. What is at issue here is that the direct and indirect output of a group of enterprises in the industrial sector is very often greater than the sum the individual outputs (direct or indirect) would amount to. Because of backward and forward linkages between enterprises, some enterprises in some industrial branches may be considered to be strategic and thus expected to act in particular ways.

3.4 Indeed, a major question which must face many developing countries at the present time of world economic crisis is whether overall development strategies with respect to the degree of openness of specific industrial branches and sectors to the external world are justified, given the painful lessons learned as a result of this very crisis. The evidence so far has yet to be gathered and analyzed in a systematic way, but there is a suspicion that those industries which have been highly interdependent with regard to bought-in inputs and external sales may have had greater difficulty in withstanding the crisis than those other enterprises or sectors in which the degree of interdependence has been smaller. If the more self-reliant enterprises and sectors have coped better with the current crisis, there may be significant lessons to be learnt here.

Venture banking at a time of economic crisis

4.1 If venture banking institutions are defined as finance institutions with a high propensity to accept risk, at least in some developing countries high risk/high return opportunities abound. Particularly in the Latin American region, we have seen the collapse of currencies and the collapse of stock markets; superficially at least, very attractive opportunities abound. Of course all this begs the fundamental question, i.e. precisely how are these countries and governments going to extricate themselves from the debt crisis in which they are currently mired? If the way out of the crisis could be made to look realistic, indeed there might be attractive opportunities for venture capitalists. To be sure, even with a realistic outcome to the debt crisis of the most heavily indebted countries, i.e. special arrangements for the refunding and conversion of short maturing debt into debt with realistic maturities, there would still be high risks, since economic recovery takes time and social/political structures and institutions would still be under stress. The latter factors would continue to be reflected by high risks at the enterprise level. It is doubtful that venture capital firms would be interested in operating in the still difficult conditions without the special arrangements mentioned above.

4.2 There is another side to this question, as has been recognized by Wellons: "The worst recession since the second world war is not the best time to launch a major expansion into foreign markets when you are selling non-essentials".[1/] One might add to this, of course, that such considerations also apply when you are selling essentials in competitive conditions or when a major expansion is considered in domestic markets where these markets face the worst recession since the second world war. Yet, the opportunities are there, since there is some evidence that some governments are changing, voluntarily or involuntarily, their laws regarding direct foreign investment, stock market operation etc. In addition to this, there are the depressed prices of fixed assets in many countries, indeed the "bankruptcy/distress sale" phenomenon in some countries. Latin American pesos are very cheap indeed relative to US dollars and stock markets are at all time lows; should such conditions be welcomed by venture banks? How will developing country governments act in the future on policies forced upon them under current "bankruptcy conditions"?

On the notion of bankruptcy in developed and developing countries

5.1 Mirroring the economic disruption in the market economy developed countries has been the high rate of bankruptcy last seen in the 1930s. In this group of countries in the normal course of events, structural

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1/ See P.A. Wellons: "The case of the 'Grupo Pliana' in Mexico", OECD/DAC, September 1983.

adjustment follows bankruptcy, unskilled and semi-skilled labour may be displaced temporarily, but essentially bankruptcy leads to structural adjustment: the splitting-up of industrial enterprises and the merger of such split-up segments with more powerful competitors. For these countries, as a group, the net result is often a structurally more powerful and technologically more advanced industrial sector. To be sure, within the group of market economy developed countries national rivalries have caused problems. Despite adherence to perceptions of free markets etc., in a number of industries (such as the automobile industry, iron and steel, shipbuilding and the electronics, telecommunications and computer industries) reasons have been found by most of their governments for the preservation of various forms of domestic ownership and control. Note is taken of the fact that the rationale for protecting these industries is quite different from the rationale for protecting industries clearly in decline, such as textile and garment manufacture, foot-wear and leather industries etc. While it is correct that both groups of industry face difficult market conditions, rising factor costs etc., the group comprising automobiles, iron and steel, shipbuilding, as well as electronics, telecommunications and computers, can be considered "strategic" with a high interrelationship - upstream and downstream linkages etc. - with other industries and sectors of the economy. In addition, problems and constraints faced by the sectors earlier mentioned - automobiles, iron and steel etc. - have served to throw into sharp focus questions related to the role, powers available, and control exercised by governments.

5.2 The impact of the crisis in the developing countries can be seen by looking at the impact of the crisis in the developed countries through a glass which distorts and magnifies. The fall in foreign exchange earnings accruing from commodity exports, excessively high rates of interest, continued fluctuations in exchange rates, and the very interdependence of the industrial sector in the developing countries have produced a situation which in some developing countries amounts to de-industrialization. More precisely, the interdependence reflected by the import of intermediate industrial inputs, necessary spare parts and raw materials have produced capacity utilization rates of catastrophic proportions, social dislocation, and heavy bankruptcy.

5.3. Given the severity of the current recession, it is of some interest to try to examine the precise impact of the phenomenon of bankruptcy in various types of developing countries. We have suggested above that one result of the "economic shake-out" which has occurred over the past two or three years in developed countries has been a structural adjustment process in which industry has become leaner and fitter with an increased ability to innovate and to grow. Can this result be viewed as realistic in most developing countries? It can be suggested that as a result of the current difficulties in developing countries, the result might often fall between the two ends of a continuum: at one end we find because of devaluations and domestic stock market perceptions enterprises with a high profit potential becoming candidates for take-over and more especially for take-over by foreign interests. At the other end of the continuum there is the possibility that enterprises may have been unable over the past years to carry out necessary repairs, maintenance and replacements so that capital equipment is operating for technical reasons way below installed capacity. Such past operation may have caused permanent damage in some kinds of equipment. At this end of the continuum factories may have been closed two, three or four years ago and their capital assets may have faced physical deterioration and disrepair. Similar impacts may also have occurred in the labour force which once operated these establishments; social conditions in most developing countries do not allow even for the kind of unstable security provided by the State welfare arrangements of developed countries: the result of the crisis at the level of skilled industrial workers in many developing countries might be the permanent loss of skilled labour services through internal or external immigration, a permanent transfer to other activities etc. Emphasis should be given here to the great difficulty and relatively high costs faced by many developing countries in building up skilled labour forces, managerial and technical cadres, various types of skilled workers etc. It is well known that the costs in terms of human and physical infrastructure for the start-up of the industrialization process are high. These costs may now have to be regarded as sunk costs unlikely to be recovered.

5.4 In discussing the impact of the crisis on industry in developed countries above, reference is made to the concept of "strategic" industrial branches. The same concept is valid in the context of developing countries, except that in these countries, because of the lack of density of the fabric of the industrial economy, there are likely to be two separate impacts arising from the crisis. Not only will some enterprises face a first round impact of bankruptcy, but the surviving industrial economy may face a second round impact arising from a cessation of production by economically complementary producers of industrial and other intermediate inputs. Thus, these indirect costs of the crisis will magnify the immediate or first round costs arising when bankrupt enterprises cease production.

5.5 With respect to our consideration of bankruptcy above, the adjustment measures imposed on many developing countries are sometimes represented as a form of necessary adaptation to new conditions in the world economy, laying the basis for future growth. As we have indicated above, such results might well be achieved in the economies of developed countries. No such positive results can be expected in the economies of developing countries; bankruptcy and regression are much more likely, and given the very interdependence between developing and developed countries, with export markets of developing countries of major importance to suppliers from developed countries, it is difficult to escape the impression that one of the most serious threats to world recovery would be that developing countries actually carry out the adjustment programmes pressed upon them.[1/]

5.6. The picture we have painted above is a stark one. It is based on deductive reasoning in trying to deduce the effects at the level of the enterprise, of massive devaluation, or a massive shortage of foreign exchange, or a massive increase in real interest rates for domestic and foreign loan finance etc. The statistics have not yet been collected,

1/ See p.4, ST/ESA/133, op.cit.

and there is a need to rely on evidence appearing in the economic and financial press - for the most part scattered and anecdotal. There have been many news items of bankruptcy, restructuring with and without foreign partners, the halting in construction of incomplete projects etc. It is likely that in one or two years' time when the statistics have been compiled and collated that a clearer and perhaps even different picture will emerge. But in considering the question of the type of finance required by industrial enterprises in developing countries at the present time, a start must be made in trying to map out the precise contours and dimensions of the problems afflicting industry in the Third World now.

The external borrowing policy of developing countries in the pre-1932 period

6.1 It is fast becoming the conventional wisdom that developing countries were unwise in allowing their current mountain of debt to rise to such heights in the period up to 1982. This conventional view needs to be examined, and if necessary refuted, for a number of reasons not the least being that out of such an examination developing countries would be better placed in defining future development and industrialization policies for the years to come.

6.2. Developing country borrowers can generally be placed into two categories; there are the countries highly indebted to the commercial banks, for the most part these countries are oil producers or the so-called newly industrialized countries (NICs). It is true that other developing countries have significant debt burdens, but for the most part this represents debt borrowed from official sources.1/ Both groups of borrowers have faced difficulty in servicing this debt and even in repaying interest on this debt (from whichever source) because of the world economic crisis, i.e. the historically low level of receipts from commodity exports and the deterioration of proceeds accruing from the export of manufactures. It has to be emphasized however, as we have

1/ Bilateral and multilateral finance agencies and publicly guaranteed export credits.

indicated above, that one major component of the current crisis, the severe liquidity squeeze and the accompanying high real rates of interest, are phenomena that have arisen through the monetary and budgetary policies of certain major industrialized countries. More than that, in determining and implementing these policies, these industrialized country governments forced a decisive break in a trend which started in the beginning of the post-war period. Thus, developing country governments can hardly be blamed for lack of prudence, except in a theoretical sense (in that the future involves uncertainty which may lead to hardship); should all government decision-makers as well as enterprise managers be requested to adopt as "normal" policies which anticipate the worst that the economic environment can offer? The treatment of uncertainty in management textbooks and business schools is well developed; the frequency with which certain types of market fluctuations occur and their duration have been established well enough for decision-makers to operate in a "reasonable manner". Plainly, however, this body of techniques and conventions - if not established knowledge - has been ineffective in coping with current economic problems.

6.3 One further point remains to be made in this context. It is that a charge of reckless borrowing, levelled in the North, against borrowers from developing countries is but the other side of the coin of an equal charge of reckless lending which can be levelled at the Presidents and Chief Executive Officers of the major commercial international lending institutions. Thus, if it is correct that some developing country governments borrow recklessly, equally it is correct that many of the giants of international finance lend recklessly. But the use of "reckless" applied to both borrowers and lenders is somewhat unreal, since it carries with it the requirement that these decision-makers should have had perfect foresight; the foresight required to have anticipated the debt crisis of 1982 and 1983 is of the same order as that required to have anticipated the crash of 1929. Indeed, perhaps even greater foresight was required, since economic decision-makers had been brought up to believe that the community of nations had organized its affairs, through, for example, the Bretton Woods institutions, to avoid the economic catastrophies manifest at the present time.