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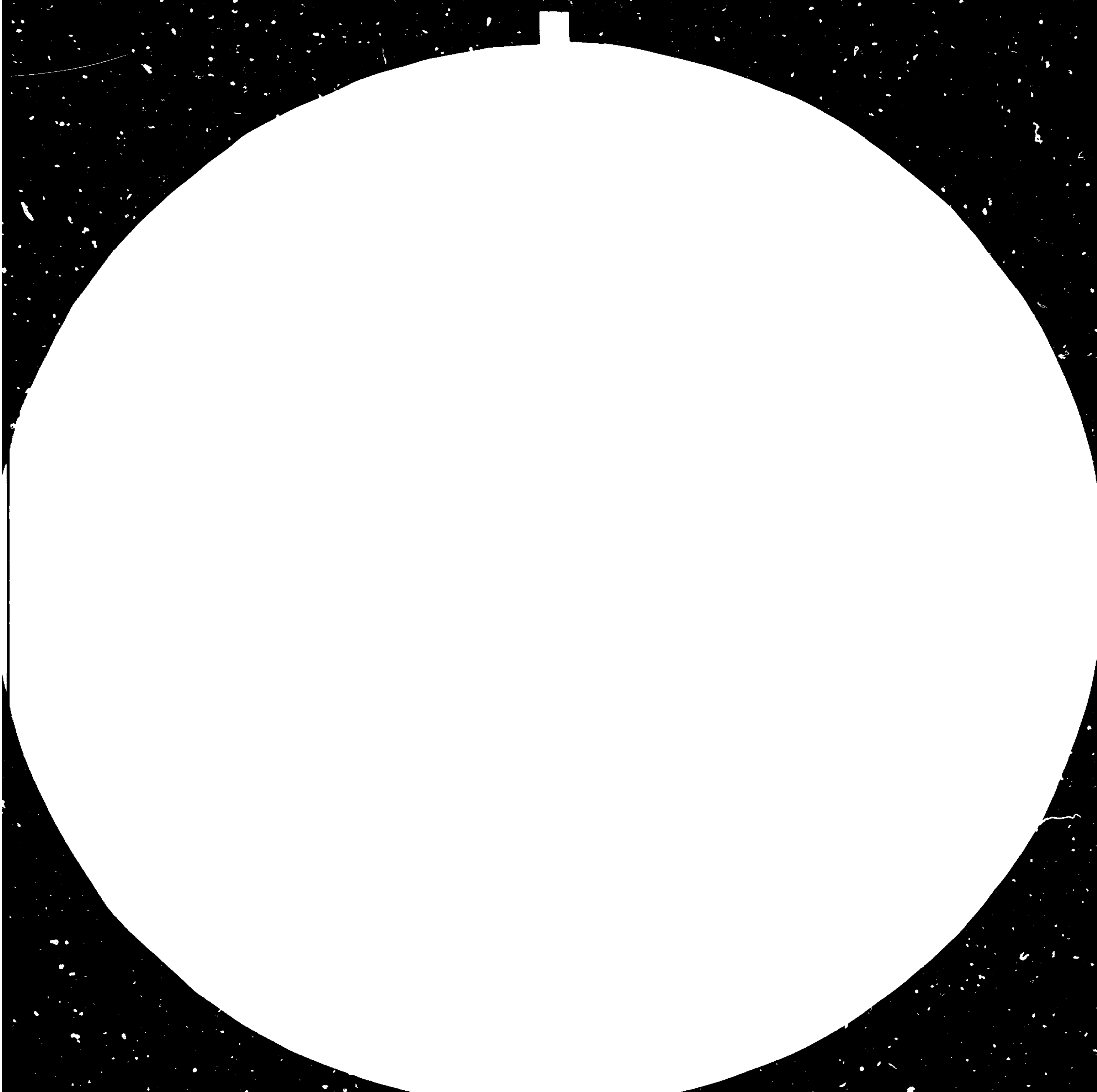
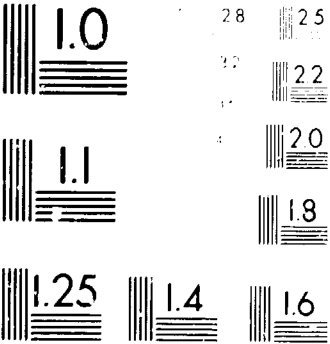
UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna International Centre, P.O. Box 300, 1400 Vienna, Austria
Tel: (+43-1) 26026-0 · www.unido.org · unido@unido.org





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PROGRAMME LENDING: AN OVERVIEW OF SOME POLICY ISSUES*/

prepared by

Negotiations Branch, Division of Policy Co-ordination

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Introduction

The current world financial situation is the fundamental context in which questions related to programme lending have to be placed, and serious note has to be taken of some of the components of this situation which is close to crisis. 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 resides in 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-terms 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, a foreign exchange liquidity crisis at the national level.

The very depth of the current economic crisis has forced the recognition of another aspect of the general problem of industrial development. Quite apart from all the problems related to establishing new industries that can be mentioned, there is now a pressing need simply to sustain utilization of existing industrial capacities - existing industrial enterprises - in the developing world. Shrinking export markets as well as a cash flow crisis in foreign exchange have gripped industry in the developing world. The whole issue of industrial programme lending not only for small-scale industry, but also for imported spare parts, intermediate and raw material inputs etc., "maintenance imports", has to be viewed today in this context. Existing industry in developing countries has already been damaged, and industrial reconstruction through adequate programme lending can no longer be avoided.

Programme financing versus project financing

In general, the financing activity which comprises programme lending provides financial support for the whole range of projects and investment activities carried out in developing countries. It assists in the implementation of these activities in the face of fluctuating foreign exchange earnings and government revenues. In contrast to project lending, programme lending can pay for imports unrelated to specific projects: developing countries have borrowing needs which cannot be satisfied by project financing. Unlike project loans, programme loans can be quickly disbursed and since the imports arising are sold domestically, local currency can be easily generated for the government; this regular stream of disbursements can provide not only support for the balance of payments, but can also help finance domestic costs including such costs on foreign financed projects. A shortage of local currency has been one major factor causing project implementation delays[1/], and programme financing can reduce losses arising from incomplete projects. Disbursement delays associated with project financing have hardly improved over time; thus in the early 1970s World Bank annual disbursements amounted to about 50 per cent of annual commitments, a figure which fell very slightly in 1978 and improved very slightly in 1982.[2/] In the experience of the World Bank, it takes on average 3 1/2 years from the identification of a project to the effectiveness of a loan, and another 6 years for project completion during which disbursements take place.[3/]

Some countries have substantial domestic industrial capacity so that foreign financing of capital equipment imports may be either unnecessary or of limited usefulness. As has been emphasized above, many developing countries have substantial excess capacity at the present

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1/ See World Bank Annual Report 1978, page 9.

2/ See World Bank Annual Reports 1978 and 1982.

3/ See p.614, The Brandt Commission Papers, IBIDI, Geneva - The Hague, 1981.

time which cannot be operated fully because of a shortage of foreign exchange for intermediate goods, spare parts, maintenance etc. These needs cannot be met by orthodox project financing. Similar considerations arise with respect to the financing required for working capital, especially in the export sector, an area which is crucial in many countries. Too great a reliance on project financing invokes two additional problems in investment programmes. First, large projects are often preferred to small projects, where bilateral and multilateral development banks perceive economies of scale in administrative costs, leading to an encouragement of capital-intensive projects and processes. Second, it is extremely difficult to bring about a structural diversification of an economy dependent on a limited number of raw materials without programme financing. The building of social, administrative and managerial structures required for such structural reorientation of necessity depends not only on project lending but also on programme lending.[4/]

There is of course no firm dividing line between project and programme lending. Instead, there is a spectrum of financing needs, with general purpose loans at one end of the spectrum and with financing of foreign capital goods for a specific project at the other end. In between are sector loans, i.e. those tied to specific economic sectors such as industry, agriculture etc., and there are also various kinds of lending for imports which arise indirectly as a result of capital investment. What is being suggested here is not that project financing activities of the orthodox type carried out by the World Bank and regional development banks are inappropriate, but rather that there is a range of financing activities which is inadequately covered by the existing multilateral finance institutions. Direct support for programme financing activities can be found in the concern expressed by the Development Assistance Committee that the disbursement problem

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4/ For an elaboration of this point see Issue no.3: Can the possible industrial financing gap be overcome by the elaboration of innovative concepts leading to the acceptance of new mechanisms and/or institutions? ID/WG.377/1, UNIDO, Vienna, 1982.

faced by multilateral and bilateral agencies was a serious impediment to resource transfers.[5/]

The table below indicates the volume and type of capital flows to developing countries that had taken place in the years 1970-1975 and as projected to 1990 by the World Bank; the figure for projected requirements in 1990 amount to US$ 183.5 billion as against US$ 45.8 billion which had flowed in 1976. This table emphasizes the growing importance of private financing as compared to multilateral financing. While these figures are based on a number of optimistic assumptions,[6/] an earlier report notes that "uncertainty about the availability of capital from private sources and the insufficient maturities of these loans showed the importance of the growth of capital flows from the multilateral financing institutions and official export credit agencies".[7/] As is well known, many developing countries have little or no access to the private sources of programme financing available on the Eurocredit market. Equally, those few developing countries which have had access to private credit in the past have witnessed the drying-up of these funds. To be sure, programme lending is a necessity at the present time. In the longer term, programme lending on a relatively large scale would contribute to providing a better balance between private and multilateral project lending and would be mutually beneficial to industrialized countries which would gain through increased orders for exports, and to developing countries, since such lending would ensure that their growth objectives would not suffer where finance from private sources could not be obtained, or could be obtained only on inappropriate terms.

5/ See Development Assistance Committee, 1978 Review, Paris, 1978, p.23.

6/ See pages 8-10, World Bank Development Report 1979.

7/ See page 24, World Bank Development Report 1978.

Net disbursements of medium and long-term capital to developing countries, 1975-1990

	Billion Current US Dollars				Average Annual Percentage Growth Rate (at 1975 prices)	
	1976	1980	1985	1990	1975-85	1980-90
Private Direct Investment	2.4	8.7	14.0	33.5	0.3	3.3
Official Development Assistance	13.1	21.8	37.9	57.9	1.9	3.6
Grants	5.9	9.7	18.0	28.3	2.7	4.5
Bilateral Concessional Loans	5.4	9.4	15.3	23.5	0.5	2.9
Multilateral Concessional Loans	1.7	2.7	4.6	6.1	4.5	1.9
Medium- and Long-term Loans at Market Terms	30.3	39.4	69.8	103.1	2.9	3.4
Private	26.0	30.0	55.1	82.6	2.4	3.9
Multilateral	2.4	6.1	9.9	11.7	6.4	0.2
Official Export Credits	1.9	3.3	4.7	8.8	3.3	3.7
Total	45.8	69.8	121.7	183.5	2.3	3.4
At 1975 Prices	44.4	46.0	57.1	64.4		

Source: World Development Report 1979, World Bank 1979.

The quality of finance

Any consideration of loan finance, whether project tied or as part of a loan programme, would be incomplete without serious consideration of the quality of loan finance. In summary, the quality of loan finance is defined by the following elements:

(i) The interest rate: the lower the interest rate, the softer the loan: the converse is also correct. Floating interest rates can begin soft (or less hard) and in time can become hard; an additional penalty may have to be paid by the rational borrower in that the uncertainty in floating interest rates may deter the borrower and hence deter investment, including industrial investment.

(ii) The loan maturity: generally, the longer the time period contracted for repayment of interest and capital, the softer the loan (other things being the same, i.e. interest and exchange rates and procurement conditions).

(iii) The exchange rate: borrowers face uncertainty if the currency which they borrow is different from the currency they earn as a result of investment; if the currency they earn falls in value against the currency they borrow, the net result is a higher repayment of interest and capital. The converse is also correct. Uncertainty in exchange rates also deters investment.

(iv) Procurement conditions: a loan may be tied: to purchase of a particular product, or for a particular purpose, or in a particular market, or in a large number of markets. If the suppliers' market is competitive, the price paid for goods tends to be lower, but searching in a large market of potential suppliers also involves purchase costs. Procurement conditions also include various other constraints on how funds should be used and formal procedures and rules that borrowers contract to follow; to overcome both constraints and procedures involves costs and these costs tend to increase if the borrower is unfamiliar with the constraints and procedures. Disbursement conditions, i.e. the manner and timing of the receipt of the loan, can be considered to be part of procurement conditions.

(v) Conditionality: a loan may be tied also to the condition that a borrower (private or government) changes certain of its economic, social and political policies; the consequences of conditionality can therefore be far reaching. In general, the greater the conditionality, the greater the "hardness" of the loan as perceived by the borrower. Loan disbursement is sometimes directly linked with conditionality.

Programme lending conditionality

Estimates of creditworthiness involve both quantitative and qualitative assessments, i.e. objective economic factors, past repayment record, and current and future policies. It is the case that the crucial question is the use made of qualitative assessment, since this too easily strays into areas having little to do with borrowers' ability to repay. The major conditions which would need to be imposed should be intended to assure the use of funds in productive industrial activities.

Where the investment programme under consideration in a developing country focuses on the development of an integrated set of industrial activities, such as the agro-industry sector, the conditions would refer to the size and composition of the interrelated investment programme - incorporating production, storage, processing, transport, marketing etc., as well as the adequacy of domestic resource mobilization and balance of payments management.

Where a lending package to support a programme of industrial reconstruction is being considered, a degree of attention may need to be given to arrangements for sample audits of various parts of the programme. Due attention would also need to be directed towards acceptable levels of domestic resource mobilization and balance of payments effects through increases in export earnings or reductions in import requirements.

It is desirable that programme loans from multilateral or bilateral sources should not be guided by any particular world view or specific theory of economic policy, but would be based on the specific circumstances of each country, including short and long-term effects of the programme on the borrowers' growth, welfare and financial position.

Borrowers' view of conditionality

To be sure, conditionality, i.e. the terms and conditions attached to loans, is essential in all finance operations. But conditionality has been a source of considerable friction between developed and developing countries because it has been a reflection of one particular view of the world or of the objectives of economic policy. Technical solutions can be found which, while appropriately protecting the rights of creditors, do give due regard to the legitimate interests of borrowers.

From the viewpoint of the developing country borrower of programme loans, the attractiveness of such arrangements is in direct relationship to the conditions attached. By way of example, it should be noted that the frequency of use of the Compensatory Financing Facility (set up by the IMF in 1973 to protect developing countries from shortfalls in commodity earnings arising from market instability) over time has been due to changes in the conditions attached to such use. Thus, changes occurred in September 1966 and above all in December 1975 when the conditions were liberalized considerably. These changes were mirrored in the use of the facility, i.e. 1963-1966 - SDR 97 million; 1966-1975 - SDR 1,134 million; 1976-1978 - SDR 3,127 million. This indicates that the level of demand for any particular type of loan programme will be very sensitive to the terms and conditions under which the loan programme is offered; in the example quoted, the amount drawn in the three-year period after the liberalization of December 1975 was over two and a half times the amount borrowed in the first thirteen years of the facilities.8/

8/ See the paper by Justinian Rweyemamu "The International Monetary System", p.589, The Brandt Commission Papers, IBIDI, Geneva - The Hague, 1981.

There also needs to be a greater recognition of the essentially "judgemental" and subjective basis of lending criteria, whether we consider criteria for project loans or programme loans. Thus, we can draw the distinction between the criteria or formulae for lending (disregarding for the moment whether these criteria favour the borrower or not) and <u>the way in which these lending criteria are applied in practice</u>. In this connection, it should be noted with regard to the IMF's Compensatory Financing Facility that the IMF statement to the UNCTAD Committee on Invisibles on 2 November 1978 indicated that 33 per cent of actual commodity earnings shortfalls were compensated by the Facility. However, in TD/B/C.3/152, UNCTAD estimates based on IMF criteria and formulae for calculating such shortfalls show that the shortfalls were compensated up to an amount of 10 to 11 per cent only.[9/]

Lending criteria for industrial projects allow no greater objectivity. A close examination of investment decision "rules" in the face of future uncertainties reveals a set of <u>conventions</u> which pretend to have a scientific basis, but actually are mere conventions for action. The various decision "rules" related to long-term industrial investment projects - the pay-off period, the recoupment period, internal rate of return, private or social cost-benefit analysis - illustrate how economic <u>conventions</u> are often presented as precise scientific calculations.[10/] Moreover, conventions set for evaluating long-lived industrial projects have an additional dimension: in the lender/borrower relationships, the one who is in a stronger bargaining position (e.g. the lender/finance institution) may be able to set the conventions that the weaker party must accept - simply because the weaker party is in an inferior bargaining position. The wide acceptance of "cost-benefit analysis" as the criterion of project evaluation follows precisely from this fact.

9/ Rweyemamu, op.cit.

10/ See p.1, Amit Bhaduri, How "scientific" is cost-benefit analysis? ID/WG.358/5, 16 December 1981, UNIDO, Vienna.

To illustrate the last point, the use of existing international prices in project evaluation entails that projects have to be viable in terms of the pattern of the existing international division of labour. But developing countries have no logical reason to accept such procedure for evaluation, since in trying to industrialize they are attempting precisely to alter the existing pattern of the international division of labour. Another example can be found in the fact that cost-benefit analysis of externally financed industrial projects continues the convention of "scientific calculations": to accept or reject projects without taking into account the fact that a project may be viable at certain mixes of interest/exchange rates and not at others. All this is in complete disregard of the wild gyrations of exchange and interest rates of the past ten years.[11/]

Programme lending from official sources of credit

In a sense, programme lending is nothing new from official sources of credit. Indeed, this is the normal form of IMF assistance, i.e. the IMF does provide programme finance - freely usable capital - but on a short-term basis, and usually carrying extremely tough conditions. IMF assistance normally is tied to specific policy requirements to liberalize imports, devalue, reduce subsidies, including subsidies on basic necessities and curtail domestic credit, particularly to the public sector. In negotiation between the IMF and a number of developing countries, the speed in implementing the above-mentioned policy measures, the quantitative nature of some conditions, and that institution's adherence to a free trade ideology, have been the subject of major disputes.[12/]

Recently, the World Bank has apparently revived its interest in the programme lending approach. It is a revival in its interest, since despite some controversy as to whether programme lending was permitted by its Articles of Association, the Bank saw no difficulty

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11/ See Bhaduri, op.cit.

12/ See pages 567-600, Brandt op.cit.

in programme lending to its various developed country members in the early post 1945 years. Its lending to developing country members has been almost purely in the project financing mode, until about 1980, when there was some (slight) change in policy in this area. It began its structural adjustment lending in that year "in response to the markedly deteriorated prospects that were then foreseen for developing countries during the 1980s". In the World Bank's view, the objectives of structural adjustment lending have been to support a programme of specific policy changes and institutional reforms designed to achieve a more efficient use of resources and thereby contribute to a more sustainable balance of payments in the medium and long term, and to act as a catalyst for the inflow of other external capital to help ease the balance of payments situation. The Bank's experience to date (and the experience of developing countries with the Bank) is somewhat limited, but it has reported that despite some disappointments and some delays in the implementation of agreed policy measures, structural adjustment lending had enabled the Bank to respond more fully than would otherwise have been possible.[13/]

It should be noted that on the basis of the 1980-1982 experience, the Bank held the view that its structural adjustment lending operations and IMF programmes were, in practice, both complementary and mutually reinforcing. Among the issues which the Bank has considered are the relationship between structural adjustment and project lending; the appropriate percentage of total Bank operations for structural adjustment lending; the impact of structural adjustment on low income groups; and the number of countries that have negotiated structural adjustment lending operations. It should be noted that the Bank's progress report on countries signing up for such arrangements concluded that "only thirteen of the Bank's seventy-five active borrowers have so far concluded a structural adjustment lending agreement"

13/ See p.39, World Bank Annual Report 1982, Washington, D.C., 1982.

reflecting the fact that such lending is appropriate where there is "a government that is both able to formulate and implement a credible programme of reforms and wishes to have the Bank's financial and technical support for its programme". Seemingly, the Bank's financial support on such programmes can only be obtained together with its "technical support" so as to "assist in the design of suitable reforms".14/ Developing countries will have to suspend judgement as to the overall effect of this new form of lending. No doubt, as the global economic crisis has bit deeper, more than the thirteen countries identified in the 1982 Annual World Bank report have had to take the step. It is to be hoped that the provision of the Bank's financial support in such cases has been accompanied with fewer of the frictions associated with IMF adjustment measures.

The North-South dialogue on programme financing

At the recent UNIDO Consultation on Industrial Financing which was attended by 180 participants from 81 countries or international organizations, including government representatives, there was international consensus recommendation that UNIDO should, inter alia, "use its best endeavours to promote the use of programme lending on a wider and more imaginative sectoral basis, including financing of related services, pre-investment work, and repair and maintenance". Moreover, UNIDO was also requested to promote "the adoption of more flexible rules and regulations to make possible the supply of risk capital and/or more effective lending to small and medium-scale industries on a broader sectoral basis by channelling external finance through national development finance institutions, recognizing that the growth and stature of these institutions provide the opportunity for relaxing conventional requirements, such as the taking of collateral security and the monitoring of disbursement procedures, thereby also recognizing that it is in the nature of small-scale industry that its

14/ See pages 40-41, World Bank, ibid.

collateral normalty can have limited value.15/

Developing countries have called for significant increases in programme lending in Official Development Assistance flows, as well as improvement in modality, composition and quality of these flows, so as to avoid adjustment processes which jeopardize development, including industrial development. More specifically, the World Bank was asked to enlarge its programme lending from the limit of 10 per cent of total lending to 30 per cent. Concern was expressed of pressures on the multilateral finance agencies to adopt a politically motivated approach to conditionality which would be inconsistent with development and structural adjustment.16/ There have been calls by developing countries that the multilateral institutions in prescribing adjustment measures should take fully into account circumstances and factors beyond the control of developing countries. The World Bank was asked to raise the share of programme loans to at least 25 per cent of total lending, and to revise the conditions of structural adjustment lending before the end of 1983 so that they are brought in line with the social and economic conditions prevailing in developing countries.17/

The Development Assistance Committee of the OECD has set new guidelines on aid for maintenance imports and for the strengthening of existing services and facilities in Third World countries. The new guidelines cover the overcoming of maintenance problems to improve industrial production, thus ensuring the productive use of existing installations and the proper functioning of essential services.

15/ Para.19, First Consultation on Industrial Financing, report, ID/293, UNIDO, Vienna, 1982.

16/ See paras. 29A(ii), (ix), (xii); and para.52, Economic Declaration of the Seventh Conference of Heads of State or Government of Non-aligned Countries, NAC/CONF.7/Doc.6/Rev.3, New Delhi, March 1983.

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

There was a recognition that deep-rooted structural problems had led to a scarcity of budgetary and foreign exchange resources, exacerbated by the impacts of unfavourable world economic conditions; the maintenance and rehabilitation of existing capital stock should have received priority attention from ODA donors and bilateral agencies, as should foreign exchange provisions for staffing, training, and working capital for such inputs as fuel, raw materials and foreign technical staff. There was also a call for more flexible attitudes by donors to maintenance support at macro and sectoral levels, and for non-project aid, such as for restructuring of a particular sector or broader budgetary support.[18/]

It is difficult to estimate at the present time the response of the developed countries and the multilateral institutions to these requests. It is notable, however, that the World Bank has launched a special action programme to help developing countries maintain development momentum in the face of the current international economic crisis. The objectives of the programme emphasize, inter alia, high priority operations which support policy change; expand lending to help maintain crucial infrastructure and fuller use of existing capacity, particularly in export-oriented activities, and expand the Bank's advisory services in the design and implementation of appropriate policies, including the reordering of investment priorities.[19/] One question which is still unanswered relates to the share of programme lending in total World Bank lending: non-project lending, including lending for structural adjustment, accounted for 9.5 per cent of commitments in 1982, up from 8.2 per cent in 1981. Nevertheless, the Bank regards a 10 per cent limit as the ceiling for the time being.[20/]

18/ See DAC Guidelines on Aid for Maintenance and Strengthening of Existing Services and Facilities, Press/A(82)74, Paris, December 1982.

19/ See World Bank News, Vol.II, Number 7, 24 February 1983, Washington.

20/ See pages 12 and 40, World Bank Annual Report 1982, Washington D.C., 1982.