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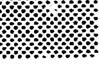

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UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION

INDUSTRY 2000 - NEW PERSPECTIVES

COLLECTED BACKGROUND PAPERS

VOLUME 1

INTERNATIONAL FINANCIAL FLOWS

Vienna, Austria

December 1979

FOREWORD

This volume presents some of the background material for the study Industry 2000 - New Perspectives published by UNIDO as ID/CONF.4/3 (Vienna 1979) for the Third General Conference of UNIDO at New Delhi, India, 21 January - 8 February 1980.

The volume contains an overview of the subject area by the UNIDO secretariat, as well as some selected consultants' papers. For the latter papers the respective authors bear full responsibility for the opinions expressed as well as for the material presented. The publication of a consultant paper must not be taken as indicating support or agreement, tacit or otherwise, with its content or form by UNIDO or its secretariat. It is hoped, however, that the publication of this documentation will make a contribution towards the understanding of problems connected with the industrialisation of developing countries.

UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
INDUSTRY 2000 - NEW PERSPECTIVES
COLLECTED BACKGROUND PAPERS

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ABBREVIATIONS

The following abbreviations have been adopted:

ACP	African Caribbean and Pacific States in association with the European Economic Community
CIEC	Conference on International Economic Co-operation
CMEA	Council for Mutual Economic Assistance
CPE	Centrally Planned Economies
DAC	Development Assistance Committee of OECD
DC	Developing Countries
DEG	Development Corporation of the Federal Republic of Germany
DFI	Director Foreign Investment
DMEC	Developed Market Economy Countries
ECE	UN Economic Commission for Europe
EEC	European Economic Community
EFTA	European Free Trade Association
FAO	Food and Agriculture Organization
FDA	Food and Drug Administration of the U.S.
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNP	Gross National Product
GSP	Generalised System of Preferences
IBRD	International Bank for Reconstruction and Development (The World Bank)
IC	Industrialised Countries (including DMEC and CPE)
ICC	International Chamber of Commerce
ICOR	Incremental Capital Output Ratio
ICPO	Investment Co-operative Programme Office (of UNIDO)
IDA	International Development Association
IFC	International Finance Corporation (of the World Bank)
ILO	International Labour Organisation
IMF	International Monetary Fund
INPADOC	International Patent Documentation Centre
INTAL	Instituto para La Integración de América Latina
INTIB	Industrial and Technological Information Bank (of UNIDO)
LDC	Least Developed Countries (according to UN definitions)
MNC	Third World Multinational Corporation
MSA	Most Seriously Affected (Countries)
MVA	Manufacturing Value Added
NIEO	New International Economic Order
NTB	Non Tariff Barrier to Trade
OAPI	African Intellectual Property Organisation
ODA	Official Development Assistance
OECD	Organisation for Economic Co-operation and Development

OPEC	Organisation of Petroleum Exporting Countries
R + D	Research and Development
SDR	Special Drawing Rights
SEC	Servicio Latinoamericano de Cooperación Empresarial
SITC	Standard International Trade Classification
TCDC	Technical Co-operation among Developing Countries
TIES	Technical Information Exchange System (of UNIDO)
TNC	Transnational Corporation
UNCITRAL	United Nations Commission on International Trade Law
UNCSTD	United Nations Conference on Science and Technology for Development
UNCTAD	United Nations Conference on Trade and Development
UNCTC	United Nations Centre on Transnational Corporations
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural Organisation
UNIDO	United Nations Industrial Development Organisation
UNITAR	United Nations Institute for Training and Research
WIPO	World Intellectual Property Organisation

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Overview by the UNIDO Secretariat

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CHAPTER I: INTERNATIONAL FINANCIAL FLOWS

1.1 Introduction

Shifting industrial production towards the South, as envisaged in the Lima target, requires a corresponding change in world patterns of investment, technology generation and diffusion, and trade. Since financial considerations have an important place in each of these, the attainment of the Lima target will require changes in the pattern of international finance as well. Furthermore, since the aggregate financial requirement associated with the Lima target far outstrips the savings capacity of the developing world, a continued high level of North/South financial flows will be required. Thus the financial challenge is twofold, namely to:

(i) identify means to increase the volume and improve the terms of aggregate North/South and South/South financial flows required to meet overall development goals;

(ii) identify financial policies, instruments and mechanisms to support changes in North/South and South/South patterns of investment, technolog nd trade.

1.2 The Impact of External Finance

It should be noted that this volume of the study deals exclusively with external finance. Wide measures hav to be taken within developing countries also to increase savings ratios and to reduce the investment-savings gap: the attainment of the Lima target is primarily in the hands of the developing countries themselves, using largely their own resources.[1/] Many countries have successfully sustained high growth rates in the past with very little foreign capital. The experience of the socialist countries since World War II and of Japan are of particular relevance in this context. Given certain conditions, external capital inflows are therefore not essential for fast growth. Domestic savings and capital formation must in any case be the basis for an industrialisation, aiming at economic interdependence. However, analysis of the actual patterns of development of many DCs shows that they are unlikely to make the political and structural changes necessary for self-financed industrialisation in the near future. Many of them would continue to need large external capital inputs for some time to come.

The relationship between endogenous industrialisation and external finance varies considerably between the numerous sources: aid, other forms of official assistance, debt relief, export credits, portfolio investment and private bank loans and other forms.

1/ See the discussion in UNIDO, World Industry since 1960: Progress and Prospects, Vienna, 1979, Chapter IX, Financing Industrial Development.

Aid has been closely linked with metropolitan-colony historical flows military "aid", tied purchases in the donor countries, and, in general, political and economic leverage on national polities that have made it difficult to reconcile with non-dependent economic growth. Nevertheless, aid remains indispensable for the resource-poor, low-income developing countries that can neither afford, nor have access to, the resources of private capital markets and direct investment. Aid, however, has been growing slowly - at about 3% per annum since the 1950s, and only a small proportion has gone to the industrial sector.

Private financial flows have acquired major significance only in the past six years, although export credits were offered in the 1950s to stimulate IC industries. The latter carry short-term (3-7 years) maturities and are of a tied nature, leading to large equipment imports embodying capital-intensive technologies. Private banks began to replace IC governments and multilateral aid agencies as the principal source of medium term external financing for DCs in the mid-1970s. The potentially unstable feature of this last component of external finance is the fact that Euro-market activities are outside the realm of control of both domestic monetary authorities and international official financial agencies. A recent study of eleven major DC borrowers in the Euromarket shows that the attitude of international private lenders to determining the credit-worthiness of prospective borrowers may be similar to that of foreign investors, concerned more with political stability, large market size and broad mineral resource base than with the quality of domestic economic management, or the use to be made of the loans.

The crucial link between external financing and endogenous industrialisation lies in the country's ability and capacity to manage its debt. Several countries have managed to accumulate large international reserves which can be used as a cushion against further payment deficits and as a guarantee that their debt obligations do not affect their credit-worthiness and negotiating capacity with suppliers of external finance. Effective debt management enhances endogenous industrialisation while still having recourse to foreign funds. The important result is to avoid prejudicing high rates of development investment, with the concommitant high import levels. Countries that have become heavily dependent through debt put at risk their own prospects for growth by having to cut back on essential imports.

The elements of debt management reside in operating on the terms on which the debt has initially occurred, the use made of the borrowed capital and the external environment facing the borrower during the period of repayment. Part of self-reliance in financial matters may be defined as developing the abilities to manage debt, in various fields such as training, marketing, pricing and information use. Small borrowers, for instance, who are distant from the main financial centres in the North, have little information on the nature and changes of private financial markets, and have to turn to expensive, possibly inappropriate, and possibly biased advice from investment and merchant banks which are not conversant with their development problems. The information required should enable borrowers to shop among alternative sources, to spot trends and

market innovations: these might encompass trends in margins, maturities and fees related to the terms of loans, general trends in international liquidity, competing demands for loans from TNCs and OECD governments, and innovations in the standard form of contract.

1.3 An Overview of the International Financial System

There are two sets of factors which in recent years have dominated the international financial system and which are likely to continue in the foreseeable future: first, the accumulation of excess liquidity in the private banks in the North: second, the continuing high rate of inflation, the severe monetary and exchange rate instability and the pronounced underutilisation of human and productive resources.

There are complex inter-relationships between the factors mentioned: taken together, however, their impact has been to make the International Financial System prone to crises and increasingly fragile. With growing interdependence of the world economy, this has generated a degree of uncertainty which had depressed incentives to invest in industry in both industrialised countries and the Third World. As a consequence, in the developed market economy countries, there have been stagnant growth rates coupled with historically severe inflation. This has led to increased protectionism in the North, tending to deepen the present recession and retard the progress of the South.

Some of the trends discussed above will be briefly illustrated in the following. The development of prices is illustrated by Table 1, which shows that consumer prices in certain major market economy industrialised countries rose at an annual average rate of over 10% between 1972 and 1977 as against 3.6% in 1960-1970. The change in manufacturing capacity utilisation is illustrated in figure A. The utilisation rates have been calculated at below 85% in 1977 for a number of the major markets economy industrialised countries. It is clearly seen from figure A that this is significantly below the utilisation rates in the period 1966-1974.

The combination of rising prices, underutilised resources and slow growth has been termed stagflation. On the monetery side, it has been accompanied by an extreme instability in exchange rates and interest rates, as shown in Table 2 and 3 respectively.

The factors identified have brought about a fundamental change in the international financial system, insofar as the economic health of the main industrialised market economy countries has been considerably affected. Change in shares of world official reserves is illustrated in Table 4: in 1960 a group of 11 industrialised countries held 77% of IMF members' official reserves, and in 1977 the corresponding figure had fallen to 50%. As can be inferred from the table the relative positions of individual countries within the group of eleven have also undergone major changes.

The influence of the industrialised countries on the financial system has been further weakened by the upsurge of the syndicated Eurocredit markets, in which deposits now exceed total official reserves, including gold and IMF reserves. Deposits in these markets have grown from about $ 15 billion in 1964 to about $ 500 billion in 1979: these markets emerged in the 1950s and are based on currencies being held on deposit in bank accounts outside the country of currency issue. The major currency in use is the US dollar, with about 80% of the funds currently held in dollars. Other major currencies are Deutsche Mark, French Franc, Yen. The growth of the Eurocredit markets is illustrated in Table 5.

The deposits in this market are primarily short-term, with upwards of 90% of funds being on deposit for periods of much less than one year: the Transnational Banks have been able to transform these liquid funds into loans whose maturities have varied with supply/demand market conditions. At the end of 1978 average maturities were in the range of 7-10 years, but in earlier years maturities have averaged 3-5 years for considerable periods. The major depositors and borrowers in this market are now government authorities from developed and developing countries, and Transnational Corporations. Borrowers interest costs are based on a "spread" or margin above the rates at which banks borrow from each other, namely the London Interbank Offer Rate (LIBOR) and the Singapore Interbank Offer Rate (SIBOR). These base rates are related to the discount rates applied by Central Banks of the country whose currency is used in the loan transaction, with the result that interest rates charged to borrowers and offered to lenders have fluctuated very considerably. Table 2 and 3 below indicate the range of fluctuation and hence of uncertainty of exchange rates and of interest rates in this matter.

The above mentioned phenomena and market characteristics are of major importance to developing countries, who since 1975 have borrowed more than 50% of loans floated in this market as shown in Table 6 below. Equally important to developing countries are changes which may occur in the functioning of this market, whether these changes are market determined or determined by the regulatory authorities of the market economy industrialised countries.

TABLE 1: Seven Major Industrial Countries: Dispersion of Inflation Rates 1960-1977

(Per cent)

	Mean Rate of Inflation 1/	Dispersion of Inflation 2/
1960-1970 Average	3.6	1.5
1972	5.3	1.1
1973	8.6	1.9
1974	14.6	5.4
1975	12.9	5.5
1976	10.0	4.5
1977	9.8	4.5
1972-1977 Average	10.2	3.8

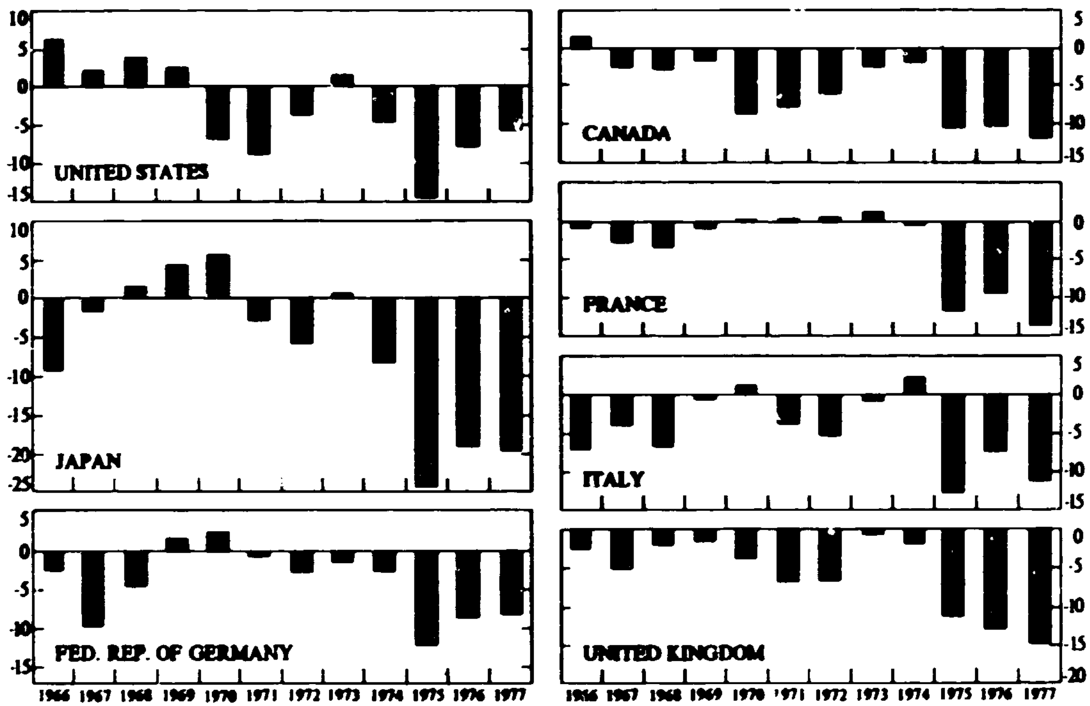
Source: IMF, International Financial Statistics

1/ The (unweighted) average annual rates of change of consumer prices for the United States, Canada, Japan, France, the Federal Republic of Germany, Italy and the United Kingdom.

2/ The measure of dispersion used in the standard deviation of inflation rates among the seven countries.

Figure A: Major Industrial Countries: Output Gaps in Manufacturing, 1966-1967[1/]

(Percentage of potential output)



1/ Difference between actual and potential output.

TABLE 2: Index of Change in Major Currency Exchange Rates Against U.S. Dollars 1975-1978

(First quarter 1975 = 100)

	DM	SwFr	Yen	FrFr	Stg	Lira
1975 (1st quarter)	100	100	100	100	100	100
1975 (2nd quarter)	99.3	98.9	100.2	105.0	97.3	101.4
1975 (3rd quarter)	91.6	93.5	98.4	98.4	89.1	96.0
1975 (4th quarter)	90.0	94.0	96.6	96.8	85.4	93.8
1976 (1st quarter)	90.8	96.6	97.0	94.8	83.6	83.8
1976 (2nd quarter)	91.4	99.8	98.0	91.1	75.6	74.1
1976 (3rd quarter)	92.3	100.5	100.7	87.3	73.9	76.0
1976 (4th quarter)	97.1	101.8	99.8	88.2	69.1	73.9
1977 (1st quarter)	97.6	98.9	102.7	86.0	71.7	72.2
1977 (2nd quarter)	99.0	99.1	106.5	86.5	71.9	72.0
1977 (3rd quarter)	101.3	103.9	110.1	87.6	72.6	72.2
1977 (4th quarter)	105.2	114.2	118.7	88.6	76.0	72.7
1978 (1st quarter)	112.6	129.2	123.5	90.1	80.6	74.0
1978 (2nd quarter)	112.8	130.0	132.9	93.0	76.7	74.0
1978 (3rd quarter)	116.4	148.8	152.2	97.6	80.8	76.1
1978 (4th quarter)	124.8	153.2	154.0	99.6	83.0	76.6

Source: International Financial Statistics, IMF, April 1979.

TABLE 3: Eurocurrency Deposit Rates - January to December, 1978

(Prime Banks' bid rates in London, at or near end-of-month)

	1978											
	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
US DOLLARS												
One month	7.06	6.62	7.62	7.25	7.69	8.19	8.06	8.56	9.19	9.62	11.62	11.00
Three Months	7.25	7.19	7.50	7.62	8.00	8.69	8.50	8.87	9.44	11.37	11.56	11.69
Six months	7.62	7.62	7.81	7.87	8.44	9.19	8.81	9.25	9.69	11.87	11.87	12.31
Twelve months	7.87	7.94	8.00	8.00	8.56	9.19	9.00	9.25	9.69	11.87	11.62	12.00
DEUTSCHE MARK												
One month	2.87	3.19	3.31	3.31	3.44	3.31	3.44	3.31	3.31	3.12	3.37	3.19
Three months	2.94	3.19	3.31	3.31	3.44	3.37	3.50	3.44	3.56	3.50	3.69	3.31
Six months	3.00	3.19	3.31	3.44	3.56	3.50	3.75	3.62	3.62	3.56	3.94	3.69
Twelve months	3.19	3.19	3.31	3.50	3.69	3.69	4.00	3.87	3.75	3.75	4.12	3.81
SWISS FRANC												
One month	0.31	0.12	0.44	0.62	1.06	1.31	1.56	0.44	0.50	0.00	0.19	-.06
Three months	0.75	0.31	0.56	0.87	1.31	1.50	1.69	0.69	0.94	0.12	0.31	0.00
Six months	1.37	0.50	0.81	1.19	1.62	1.94	2.00	1.06	1.06	0.31	0.56	0.12
Twelve months	2.00	1.00	1.25	1.44	1.87	2.19	2.19	1.19	1.31	0.62	1.44	0.62
POUND STERLING												
One month	6.75	7.00	6.87	10.00	10.00	10.75	10.75	11.00	12.37	10.50	12.87	12.00
Three months	6.75	7.69	7.37	10.12	10.56	11.37	10.87	11.37	12.75	11.87	13.50	12.62
Six months	7.25	8.12	8.00	10.37	11.12	12.00	11.25	11.75	13.00	12.62	14.06	13.25
Twelve months	7.56	8.37	8.31	10.37	11.81	12.12	11.50	11.75	12.75	12.87	13.87	13.00
FRENCH FRANC												
One month	11.50	12.00	8.87	8.87	9.00	9.87	8.37	8.00	11.25	7.00	8.12	10.50
Three months	13.25	12.87	8.87	9.37	9.25	10.00	9.12	8.87	10.25	8.75	9.19	9.87
Six months	13.37	12.00	9.37	9.75	9.75	10.37	9.87	9.37	10.25	10.00	9.31	9.37
Twelve months	13.37	12.00	9.87	10.37	10.50	11.00	10.37	10.00	10.25	10.87	10.37	10.25
JAPANESE YEN												
One month	2.12	2.69	-.25	1.50	2.44	2.56	0.44	1.19	2.81	0.75	0.31	-.69
Three months	2.94	2.50	1.19	2.12	2.69	2.94	1.56	2.50	2.81	2.44	0.31	0.62
Six months	3.31	3.25	2.56	2.87	3.31	3.62	2.31	2.81	3.12	3.31	2.37	1.87
Twelve months	3.50	3.50	3.62	3.81	3.94	4.12	2.87	3.25	3.25	3.31	2.94	2.19

Source: World Financial Markets, Morgan Guaranty Trust Company of New York.

TABLE 4: Distribution of Reserves of 11 Industrialised Countries, End of Years 1960 and 1970-77

(Billions of SDRs)

	1960	1970	1971	1972	1973	1974	1975	1976	1977
Industrial Countries									
Belgium-Luxembourg	1.5	2.8	3.2	3.6	4.2	4.4	5.0	4.5	4.7
Canada	2.0	4.7	5.3	5.6	4.8	4.8	4.5	5.0	3.8
France	2.3	5.0	7.6	9.2	7.4	7.2	10.8	8.4	8.4
Germany,Fed.Rep.of	7.0	13.6	17.2	21.9	27.5	26.5	26.5	30.0	32.7
Italy	3.3	5.4	6.3	5.6	5.3	5.7	4.1	5.7	9.6
Japan	1.9	4.8	14.1	16.9	10.2	11.0	10.9	14.3	19.1
Netherlands	1.9	3.2	3.5	4.4	5.4	5.7	6.1	6.4	6.6
Sweden	0.5	0.8	1.0	1.5	2.1	1.4	2.6	2.1	3.0
Switzerland	2.3	5.1	6.4	7.0	7.1	7.4	8.9	11.2	11.4
United Kingdom	5.1	2.8	8.1	5.2	5.4	5.7	4.7	3.6	17.3
United States	19.4	14.5	12.1	12.1	11.9	13.1	13.6	15.8	16.0
Total, ind. countries	47.2	62.2	84.8	93.0	91.2	92.7	97.7	107.0	132.7
Total, all IMF members	61.2	93.2	123.2	146.6	132.6	180.2	194.5	222.4	262.8

Source: IMF, International Financial Statistics

TABLE 5: Growth of the Eurocredit Market, 1965-1979
(US $ billion)

End of Period	Total	Percentage increase over prior year	US$ portion (per cent)
1965	15.1	-	77
1966	19.9	32	81
1967	24.5	23	81
1968	37.4	53	81
1969	57.8	55	82
1970	78.3	35	77
1971	100.1	28	71
1972	131.8	32	75
1973	187.6	44	70
1974	214.1	14	73
1975	258.1	20	74
1976	286.8	11	76
1977	321.0	12	78
1978	392.6	22	81
1979	500 (estimate)	n.a.	n.a.

Sources: 1965-1975, Part I, Table 1, P. A. Wellons, Borrowing by Developing Countries on the Euro-currency Market, OECD, Development Centre, Paris, 1977.

1976-1978, Calculated from Borrowing in International Capital Markets, EC 181/784, World Bank, Washington, D. C., 1979.

TABLE 6: Borrowing by Developing Countries on the Euro-credit Markets 1973-1979

Year	Total Annual Borrowing (US$ Billion)	Developing Country Borrowing (US$ Billion)	DC Borrowing as a percentage of Total Borrowing (per cent)
1973	20.8	7.0	34
1974	28.5	9.7	34
1975	20.6	12.5	61
1976	28.7	17.3	60
1977	34.2	20.3	59
1978	71.6	37.9	53
1979	circa 100 (estimate)	n.a.	n.a.

Source: World Bank, Borrowing in International Capital Markets, various issues.

1.4 Specific Issues and Problems

(i) The pattern of financial flows to developing countries has changed markedly. The net external capital inflows received by developing countries increased from $20.4 billion in 1972 to $ 57.1 billion in 1977. This represents an increase of about 23% per year in money terms, or 9% per year in real terms.

Between 1970 and 1977, total receipts from abroad of all developing countries, including Southern Europe, almost quadrupled from $16.7 billion to $63.9 billion. At the same time, ODA little more than doubled, from $8.0 billion to $19.5 billion, while non-concessional flows increased five-fold, from $8.7 billion to $44.4 billion. In real terms, therefore, ODA grew at less than 3% per year over 1970-1977, the greatest part of the growth being in non-concessional flows. The bulk of the increases in total external flows to the DCs came from two sources; off-shore/Eurocurrency lending was almost as important as ODA which still was the single most important source of external finance, the respective flows being $17.8 billion and $19.5 billion over the course of the year.[1/] Non-concessionary sources provided more than 85% of the external financing for industry in 1977.

The rapid increase in international financial flows has meant that in 1977 OECD countries experienced a total net financial outflow equal to more than 1% of their GNP. However, ODA represented only 0.31% of GNP, lower than in some previous years. The contribution of centrally planned economies to ODA was much lower in relative terms than that of the OECD. By contrast OPEC countries have provided over 2.0% of their GNP in aid each year since 1974.

There has been a polarisation in the pattern of developing country borrowing, with concessional finance increasingly concentrated on least developed countries while other developing countries rely more on non-concessional flows. This has resulted in part from a switch in lending policies of bilateral and multilateral aid agencies towards applying soft loans to rural development and basic needs in the poorer countries, and in part from the greater investment opportunities and perceived credit-worthiness of the higher income developing countries in the eyes of international bank lenders. Industrial development in the latter countries has had to rely increasingly on non-concessional sources of finance, such as international bank lending, private foreign investment and export credits.

1/ Revised figures place Eurocurrency lending at $21.8 billion in 1977, thus exceeding ODA in that year. See p. 17, World Bank, Borrowing in the International Capital Markets, EC-181/784, March 1979.

It has been calculated that about 18% of total gross domestic investment in developing countries has been devoted to industry which UNIDO estimates at about $30 billion in 1975, at 1975 prices.[1/] Because of the problem of fungibility, i.e. external funds releasing resources elsewhere in the economy for other uses, it is difficult to estimate in any meaningful way the proportion of investment in industry which is supplied externally, but in 1975 it may have been around $11 billion, or about one third of total investment. By 1977, it may have risen to about $14 billion, approximately 40%.

In this connection, it should be noted that the available Eurocredit statistical sources show only about 15 per cent of developing country loans, in the period 1976-1978, as floated directly by industrial entities, the other major borrowing entities being the bank and finance sector and the petroleum and natural gas sector.[2/] It is likely, however, that the finance institutions lend a considerable portion of their external funds for industrial purposes. With respect to the petroleum and natural gas sectors, it is known that in a number of developing countries the companies carrying out these activities have considerable industrial processing and indeed manufacturing linkages associated with oil and natural gas exploration. While the latter are not strictly classified as industrial activities, there may well be a considerable flow of their external finance which may be invested in manufacturing activities. Thus, taking eurocredit borrowing destined to finance institutions as well as the oil and natural gas sector into account, eurocredit borrowing ultimately used for industrial investment might well exceed 40 per cent of the total.[3/]

(ii) Financing the investment requirements of the Lima target requires substantially greater capital flows. According to the latest UNIDO estimates, the achievement of the Lima target may require an annual investment in developing country industrial capacity of $450-500 billion by the year 2000, out of a total annual Third World investment in all sectors of around $2,000 billion (measured at constant 1975 prices). At these levels the proportion of investment which is allocated to industry may have to increase from about 18% in 1975 to 22-25% by the year 2000, implying that rather greater priority will need to be given to investment in industry as against investment elsewhere in the economy.

The exact extent of the total foreign capital inflows required to meet the Lima target will depend upon the developing countries' savings ratios, currency convertibility, balance of trade, and outflows of repayments, interest, and dividends. Any projections of these variables over a 20 year period, can only be, at the very best,

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1/ See UNIDO, op. cit, p. 288 and Financial Flows: Statistical Background, consultant paper prepared for this study by R. A. Kitchen (Chapter 2, this volume).

2/ See World Bank, Borrowing in International Capital Markets, EC 181/784, Washington, D. C. 1979.

3/ World Bank, op. cit. p. 119.

an illustration of magnitudes involved. The projections made by the UNIDO Secretariat and referred to above, imply an increase in the ratio of investment to GDP of the DCs from around 20% in 1975 to more than 30% in the year 2000. The domestic savings ratio on the other hand may perhaps reach only some 25% by the latter year.[1/] These figures would imply a considerable savings gap, which would have to be covered by external inflows. Assuming an inflow of ODA amounting to 1% of the GDP of the industrialised countries, the remaining financing requirements [2/] could be estimated to anything up to $750 billion as compared to $60 billion in 1975. As shown in chapter 9 below, the projections entail a remaining deficit on the balance of manufacturing trade. If this deficit were to be eliminated, the financing requirements would be reduced as well below $500 billion. It appears from the figures that substantial efforts will be required to generate capital flows to the developing countries to meet the Lima target. (Note that the above figures are all at cons ant 1975 dollars, that China is not included in any of the country groups and that they apply to the whole economy, not just the manufacturing sector).

(iii) The debt and debt service burden of developing countries is large and growing rapidly. Total debt of developing countries ran up from $74 billion in 1970 to $244 billion at the end of 1977. Over the same period, annual debt service increased from $9 billion to $36.6 billion.[3/] Thus while debt increased threefold, annual debt service increased fourfold. The debt service burden has grown more rapidly than debt because of the increasing proportion of non-concessional inflows relative to official inflows, which brings with it shorter maturities and higher interest rates. Variable interest rates associated with commercial borrowing makes debt forecasting, and hence debt management, more difficult for borrowing countries. Furthermore, dependence on medium-term private finance, whether of export credit or eurocredits, has produced a problem of bunching of maturities.

The debt problem is not evenly spread among developing countries.[4/] At the end of 1976, well over one third of the debt was accounted for by four borrowers (Brazil, Mexico, India and Indonesia), and two thirds by 20 borrowers. Many of these large borrowers depend on maintaining their rapid economic growth to continue servicing their increasing debt. But many smaller borrowers which number about 50 countries, may be more vulnerable despite their relatively smaller debt load if their lack of economic diversification exposes them to sudden balance of payments difficulties through an unexpected fall in export earnings or a rise in import costs.

1/ See paper prepared for this study by R. Kitchen, Financial Flows, Statistical Background.

2/ Further assumptions include i.a. payment of interests and dividends of about $400 billion.

3/ Figures include Southern European countries, for which debt at the end of 1976 was $19.2 billion, and for which debt service during 1976 was $3.2 billion.

4/ See UNIDO, op. cit., pp. 299-301.

Debt service problems may arise through circumstances beyond the control of the country concerned. Many developing countries' ability to service debt is vulnerable to sudden changes outside their control, such as commodity price changes, declines in international economic activity, reduced access to markets and natural disasters. Losses on bank lending to developing countries in recent years have, however, been lower than losses on their domestic lending: indeed, such lending has been extremely profitable for the transnational banks. This can be inferred from the fact that in 1976, more than half of the total profits of the ten leading US banks was derived from eurocurrency lending which had quadrupled over the preceding 5 years. In 1977, about 70 per cent of the total earnings of the two largest New York banks was derived from external lending. Information on the lending European banks shows a similar general pattern of high profits from external operations. It should be noted that more than half the loans from the Eurocurrency markets were taken by developing countries in 1976, 1977 and 1978. Experiences of the twelve developing countries involved in debt rescheduling between 1965 and 1978 suggest that a more flexible and sympathetic approach to the problem by the IMF is required in the future.

(iv) Changes in policies of industrialised countries towards their own domestic financial markets often have serious repercussions on the availability and terms of finance for developing countries. Industrialised countries' governments often resort to credit allocation, interest rate ceilings, controls on international capital flows and other interventions in their financial markets for domestic policy purposes or for stabilising their balance of payments position. In this connection, changes in the regulatory environment could become critical. The danger may be that regulatory measures designed to assure the stability of transnational banks could unwittingly cause sudden changes in the availability of finance to individual developing countries: this could trigger off the type of debt crises that regulatory measures are intended to prevent.[1/] Moreover, given the current fragility and instability of the international financial system, such debt crises may not be easy to isolate and may spread both inside and outside other developing countries. Thus current discussion on the regulation of the Eurocurrency markets could conceivably damage the borrowing prospects of developing countries. Some industrialised countries may not be aware of these effects or, even if they are, may give these impacts little weight while formulating their policies.

(v) There is a trend against increased official resource transfers for industrial development. Official transfers are increasingly targeted towards the poorest countries, rural development and human needs and, as a result, are less available for industrial development. Over 1975-1978, World Bank lending to industry and industrial development finance companies declined in absolute terms, and in relative terms from 33% to 20% of the Bank's total lending in 1978, although it has picked up somewhat in 1979.

1/ World Bank, World Development Report, 1978, Washington, D. C., 1978 p. 24.

TABLE 7: World Bank Group Lending to Industry, 1975-1978

(US $ million)

	1975	1976	1977	1978	1979
IDFD/DFC [a]	543.7	743.6	756.2	909.9	676.8
Industry (Direct)	760.3	606.0	587.0	391.8	842.5
Non-project	520.0	229.0	216.5	155.0	381.5
IFC [b]	211.7	245.3	258.9	338.4	419.3
Total Industry	2.035.7	1,823.9	1,818.6	1.795.1	2,320.1
Total IBRD/IDA/IFC	6,107.5	6,877.7	7.175.7	8.749.1	10,288.1
Industry as percentage of Total IBRD/IDA/IFC	33.3%	26.5%	25.3%	20.5%	22.6%

(a) Lending by IBRD

(b) These figures overstate IFC investment to industry to the extent that a small part of these investments have non-industrial uses.

Source: IFC and World Bank Annual Reports (1979 are Bank estimates).

A large portion of official finance available for industrial development remains tied to capital goods purchases, so that its value is reduced and distortions are introduced into development programmes. Further, official finance tied to capital goods imports from the North hinders a shift towards new patterns of investment, resource allocation and production, continuing to favour North/South flows of capital intensive goods over domestic sources or newly emerging developing country suppliers of capital goods and less capital-intensive technology.

(vi) There is increasing reliance on Transnational Banks as sources of finance. This reliance has come about because of the relative ease of access to transnational banks (as compared to the multilateral finance institutions) and their substantial flexibility in lending. But borrowing from transnational banks rose from $0.6 billion in 1970 to $37.9 billion in 1978. This has increased the market power of these commercial banks, and more importantly has exposed developing country borrowers to risks with regard to refinancing, in that commercial banks may be either unable to unwilling to continue to extend credit on the basis they have in the past and, as a result, either shorten maturities or reduce the total volume of lending. There are a variety of reasons why this may take place. It may occur because of changes in the banks' own economic fortunes or because of changes in the policies of industrialised country governments towards their own banks' foreign lending activities, and for this reason this threat should be on the agenda of international discussions. An additional effect of the increased reliance on commercial bank sources is that it reinforces developing countries' almost exclusive reliance on debt instruments at the national level in contrast to financing at the enterprise level. One result of this shift towards national debt financing is that governments as borrowers bear the bulk of the risks associated

with the provision of finance at the project level. Another is that it does not link foreign sources of finance with specific industrial projects and thereby dilutes the stakes of the foreign investor/lender in the outcomes of these projects. In many cases this has had negative impacts on the incentives for performance by foreign suppliers of capital goods, technology or management advice.

(vii) International financial mechanisms which have evolved appear to be more favourable to larger borrowers than to smaller entities, both because of the greater sophistication of the larger borrowers and the greater interest of the international financial community in these large borrowers. This in turn is due to the lower risk involved in lending to larger units, and to economies of scale in lending activity. The preference given to large borrowers has implications not only for the relative ability of large and small countries to tap international markets for development purposes, but also for the relative ability of large and small firms or enterprises within given countries: most Third World countries and industrial firms are small. Thus existing international financial relationships lead to a sharp concentration of economic power within key countries and within key groups in certain countries, giving transnational banks near dominant positions.

(viii) A large number of developing countries explicitly or implicitly discourage international financial linkages at the level of specific enterprises or firms. The government or quasi government finance entities incur debt by international borrowing and channel this debt finance to individual enterprises. Further, as an increasing number of developing countries reserve key sectors of the economy for development by public or mixed enterprises, the ability to distinguish between the enterprise and the state is clouded. As a result, it is often difficult to determine whether internationally borrowed funds, on commercial terms, are being used economically and effectively. This presents no problem for those few Third World countries which have evolved sophisticated systems for allocating capital and controlling the performance of public enterprises, but not many have yet gained this expertise. Increasing difficulties with the management of large-scale externally-oriented enterprises, especially when these include the involvement of TNCs, either on an ownership or contractual basis, suggests that there is a major need to find new financial instruments which will allow some international financial linkages at the project or enterprise level, even in those countries where direct private foreign investment is either not feasible or not desirable.

(ix) The absence of South based financial institutions and South to South financial linkages inhibits the growth of financing centres in the South and at the same time consolidates their dependence on the North. There are many problems DCs face in mobilising financial capital within themselves of which the low level of per capita income and savings is only one.[1/] Despite generally low income, there are pockets of investible funds within DCs that could in theory be mobilised for industrial investment to help ease the DCs dependence on the North, however slightly, and to facilitate the achievement of the Lima target. In general, however, such mobilisation has been inadequate.

1/ For a brief discussion of these problems see UNIDO, op. cit. pp. 301-314.

Capital has appeared all too often to be more mobile internationally and intrasectorally than it has been intranationally and intersectorally. Thus funds accumulated by DC entrepreneurs in commodity and exchange dealing, import-export trade, government securities and real estate tend to be reinvested in these sectors, leaving a gap in the DC capital market for long-term investment funds for industry which foreign capital has to fill. DC entrepreneurs furthermore will often divert their savings abroad - into real estate, commodity speculation and industrialised country government securities, rather than run the perceived risks of long-term investment in the productive capacity of their home economies. While the establishment of more and larger South-based financial institutions, financial markets and appropriate financial instruments will not by itself guarantee that the intra-South flow of funds will be increased, it will make that development more likely and thus appears to be a pre-requisite of achieving that goal.

Although the South through the emerging NIEO, as manifested in OPEC, has increased its possibilities for financial independence, there have been two major impediments to the use of these surplus funds for purposes of expanding industrial growth in the South. The first is that there are considerable demands for industrial investment within some oil exporting developing countries and this may leave little for investment elsewhere. But even assuming the latter is overcome in the future, another difficulty remains: the capital surplus developing countries have typically preferred to invest surpluses through Northern banks and North controlled institutions, Northern industrial enterprises and the like. Investors must be convinced that investment in Southern industry and institutions holds out equal security and equal prospects of a high rate of return. Collective self-reliance requires that where surplus funds have expanded, not only should portfolio preferences be shifted in terms of locality and sector, but South-based financial institutions and appropriate financial instruments which can efficiently and effectively intermediate the changing pattern of investment flows, should be evolved. The need for new South based financial institutions goes much beyond the question of the current surpluses of a small group of developing countries. At present developing countries with debt rescheduling or balance of payments difficulties are overdependent on North based transnational banks and multilateral agencies which are dominated by industrialised countries. In a different context, manufactured exports of developing countries are inhibited for the most part by the weakness of national export credit and insurance schemes which are not comparable to those in the North. There is thus scope not only for an extension of the regional payments union concept, perhaps in an interregional dimension, but also for self-reliant export credit arrangements. It can be seen that there is a pressing need to create new institutional arrangements whose primary objective will be to reduce the financial dependency of the developing countries on the industrialised countries, and it is these new arrangements which will embody the New International Economic Order.

CHAPTER 2: GUIDING PRINCIPLES FOR FUTURE CO-OPERATION

2.1 Introduction

Various scenarios can be designed for the implementation of a New International Economic Order depending on the priority given to the strategy of furthering Third World Collective Self-Reliance on the one hand, and improving the terms for the South within the framework of Global Interdependence on the other. The two strategies, of course, have to reinforce each other, the distinction between them being made partially for purposes of analytical clarity. In the area of financial flows these ideas can be put in concrete form through the construction of new arrangements for the direct recycling of Southern surplus resources to Southern borrowers, thus increasing collective self-reliance in the South, or alternatively, improving the terms of South/North integration through new arrangements reflecting South/North partnership.

Given the objectives of the NIEO, two paths should be followed concurrently: the elaboration of a development strategy based on strengthening South/South links and a movement towards a better system of interdependence, different in essence from the relationships of the old economic order. The two paths are not seen as being conflicting. Rather it is envisaged that the first will grow up alongside the second, and gradually replace it in the South as collective slef-reliance increases.

2.2 A New Financial Order through South/South Co-operation: Third World Collective Self-reliance and the Role of OPEC Member Countries.

The demands of the South for the New International Economic Order form a consistent whole based on the view that substantial and lasting adjustment in the prices for raw materials, coupled with a reduction of debt and more favourable terms for international technology transfer, constitute the best means for improving the financing of a new stage of industrialisation and modernisation of the South.

One frequently discussed possibility for the achievement of the financial targets and objectives of a NIEO has been through mobilisation of surplus funds such as those of certain oil exporting developing countries. The oil price adjustment of October 1973 was an important turning point in world financial - and indeed political - history. Some countries in the South looked at the collective action of OPEC as a possible model for forming other commodity associations aiming at improving the South's terms of trade with the North, and for building a potential pool of Southern financial resources to further Southern economic objectives. In the event, very little else along these lines has so far materialised. Circumstances in the petroleum industry were in many respects unique. And surpluses have to some extent dwindled away and have been eroded by inflation - though the possibility exists that they can be revived and given a fundamental role in the financial restructuring that the NIEO required.[1/]

1/ This was written in April 1979.

Even if some Third World countries can be expected to generate future surpluses, other problems must be kept in mind. Surplus Southern funds, for the most part denominated in dollars, are recycled through the Northern transnational banks, both to the capital deficit oil producers as well as to semi-industrialised Third World countries. In the long run, this should change: Third World banking and finance institutions will eventually grow so as to take care of any recycling themselves. New financing instruments can be evolved for channelling these funds directly to Southern users, thus strengthening the collective stand of the South on which an NIEO is predicated; Furthermore, the new flows would not take the form of providing concessionary finance to the least developed countries - OPEC has already been extremely generous in this respect.1/ Rather, it is in the provision of non-concessional flows which could be used profitably for fostering industrial development on a broad front that the new financial mechanisms will be useful. Furthermore, by recycling a significant part of these surpluses to the South for real capital formation, the few capital surplus developing countries would reduce the effect of the potential vulnerability which could stem from their surpluses being tied up in Northern financial assets.

There are sound economic reasons for channelling a significant part of these surpluses directly into long-term loans and other forms of portfolio finance with equity features for DCs. Some investments in developing countries, because of untapped natural resources and other unrealised economic opportunities, may yield much higher returns than placements in the Western world: financial market friction and market imperfection, lack of knowledge and information, etc. may leave attractive investment opportunities unrecognised. Investing in economies with high growth potential - and the industrial sector of some of the developing countries has been or is capable of growing at much faster rates than that of any industrialised economy - can be extremely profitable. A further argument is the need for diversification as a hedge against risk. Investing in developing countries is generally held to involve high risks. But the concentration of placements in a small number of Western financial centres may also leave oil exporting developing countries vulnerable to actions that may be taken by these industrialised countries. No agreement was reached with the industrialised countries at CIEC in Paris, 1977, with regard to protection of the financial assets of the oil exporting developing countries.2/

2.3 A New Financial Order through Global Interdependence

Traditionally, the emphasis in discussions of international financing of development has been on finding ways to increase the volume of finance. This in large part reflected the fact that much international finance used to be of a concessionary nature.

1/ See UNIDO, op. cit.

2/ UN General Assembly: Development and International Economic Co-operation: Implementation of the Decisions adopted by the General Assembly at its Seventh Special Session. Report on the Conference on International Economic Cooperation, A/31/478/Add. 1, 9 August 1977, p. 150.

However, with increasing reliance on commercial finance, maximising the volume of external financial flows is no longer overriding: returns from invested funds have to exceed the costs of borrowed funds, and careful economic calculation is necessary. The decision regarding the magnitude of external finance involves a crucial trade-off between the additional resources it makes available for current consumption or investment, and the claims against future resources it represents. Further, the cost or burden implied by future claims depends not only on the total magnitude of external claims but on the relationship between debt service requirements and resources available for debt service under particular sets of future circumstances: the time stream of future revenues and expenditures. Thus there must be a close interaction between decisions relating to sources of financing, terms of financing and the volume of financing. As a result, a more complex set of specific guiding principles emerges.

Innovations or increased co-operation should be sought to:

(i) stabilise the flow of external finance and safeguard against sudden interruptions;

(ii) increase the choice of developing countries in terms of both sources and terms of finance to allow better matching of debt service repayments with revenues:

(iii) allow greater flexibility of repayment in order to reduce the chance of financial crises resulting from unanticipated revenue shortfalls:

(iv) relax external constraints on the volume of finance, since industrial projects in countries perceived by commercial bankers to be not credit worthy can often offer a commercial rate of return:

(v) distribute certain risks associated with development strategies to foreign lenders/investors by means of financial instruments which carry the profit sharing attribute though not the control attribute of conventional direct foreign investment.

(vi) increase the volume of official finance for industry, while raising its value through untying and increasing its leverage through new forms of co-financing:

(vii) reduce financial dependency on financial sources and institutions based in industrialised countries through the promotion of direct financial links between developing countries;

(viii) at the enterprise or project level, seek innovations to facilitate South/South flows of finance and technology, thereby making a greater volume of more appropriate resources available, and reducing dependence on the North.

These guiding principles have the objective of increasing the range of choice available to developing countries and providing some insulation from external events which at present limit their financial flexibility. They would allow developing countries to tailor external financing so as to minimise the debt burden and hence increase their ability to make use of external finance in pursuit of their development goals.

In addition to increasing the range of financing options open to developing countries, steps must be taken to deal with the problems of countries currently in a state of financial crisis. Much of the public debate over developing country borrowing has focussed on the *ex post* aspect, at times at the expense of discussions for improving financing conditions *ex ante*. An important guiding principle is that the two issues should not be allowed to cloud each other, since quite different solutions are required. The primary focus should be placed on structuring external finance so as to minimise the risk of crisis. However, a realistic appraisal of developing country prospects suggests that even with major improvements in the terms and structure of external financing, financial crises will occur. Thus, a New International Economic Order must include effective mechanisms which would minimise the economic and human costs of financial crises.

CHAPTER 3: PROPOSALS AND RECOMMENDATIONS FOR PROMOTING INTERNATIONAL CO-OPERATION

3.1 Introduction

Developing countries will find in the range of mechanisms proposed herein individual mechanisms suitable to their individual external financing and development strategies, given that there is considerable variation in these strategies.[1/] While some of the mechanisms (e.g. new global financing instruments or institutions) are intended to be used by all, others (e.g. relating to Eurocurrency borrowing) may only appeal to those countries which intend to use that market.[2/]

The proposals fall into three categories:

(a) proposals designed to give meaning and content to the concept of collective self-reliance within the South, by setting up an International Industrial Finance Agency, whose main task will be to serve as a channel for intra-Third World investment as well as to help build financial institutions, instruments and arrangements which can themselves serve as conduits for intra-Third World financial flows. This agency will contain a Third World export credit fund, designed to provide financial backing for the export, particularly of capital goods and technology, primarily within the Third World and sometimes to the industrialised countries.

(b) a proposal based on the "massive transfer" concept, involving a Global Fund for the Stimulation of Industry, designed to stimulate the stagnating economies of the market-oriented industrialised countries, and provide long-term, chiefly non-concessionary, financing to developing countries mainly for industrial imports from the industrialised countries.

(c) proposals and recommendations which take the existing financial system as given, but are designed to enable developing countries to make better use of the system. It is envisaged that the international actors in the financial system, including the World Bank Group, regional and sub-regional development banks, can be persuaded to make marginal changes in their activities, by adopting new functions and instruments to accelerate industrialisation in the developing countries.

3.2 Collective Self-reliance in Finance: The International Industrial Finance Agency

3.2.1 The Present Framework

The Old Economic Order is underpinned by an international financial system which is anchored in the North. The potential for collective self-reliance in finance has increased significantly recently. Mass surpluses generated by some developing countries are being deposited in North-based or North-dominated global institutions and banks, these funds being then lent to the South on terms and conditions determined by the North.

1/ For a discussion, see chapter 2 above.

2/ See expert Group Meeting on Industrial Financing, Final Report, ID/WG.287/10 and System of Consultations, ID/B/223, UNIDO, Vienna.

The major quantum of borrowing by the South is de facto from other South economies, but via Northern intermediaries, using mechanisms such as commercial bank credits, IMF credit tranche and special facility drawings, medium and long-term lending by bilateral and international organisations and private development loans. The reason for this dependency is that in the unreformed international financial system, the prior concentration of major institutions, skilled personnel and information in the North make it much easier and less risky to use these traditional channels. Direct South to South financial links may involve difficult experimentation with new channels, but it is unavoidable; the initial identification of common interests between some sources of funds and some users of funds, both from the South, is clear.

The weakness of South to South financial linkages inhibits the growth of financing centres in the South and at the same time perpetuates their dependence on the North. There are many problems developing countries face in mobilising financial capital within themselves, of which the low level of per capita income and savings in only one.[1/] Despite generally low income, there are pockets of investible funds within developing countries that could be mobilised more effectively for industrial investment, to help ease the developing countries' dependence on the North and to facilitate the achievement of the Lima target. In general, however, such mobilisation has been inadequate. For finance to flow directly between developing countries a prerequisite is the establishment of a greater number of more powerful South-based financial institutions and financial markets, together with the development of appropriate financial instruments well suited to facilitating these flows.

Collective self-reliance requires that where surplus funds have accrued, not only should portfolio preferences be shifted in terms of locality and sector, but South-based financial institutions and appropriate financial instruments should be evolved, which can efficiently and effectively intermediate the changing pattern of investment flows. The need for new South-based financial institutions therefore goes much beyond the question of the current surpluses of a small group of developing countries.

In a different context, exports of manufactures and technology of developing countries can be inhibited by the weakness of national export credit and insurance schemes. There is thus scope for self-reliant export credit arrangements. It can be seen that there is a pressing need to create new institutional arrangements whose primary objective will be to reduce the financial dependency of the developing countries on the industrialised countries, and it is these new arrangements which will embody a new international financial order.

1/ For a brief discussion of these problems, see UNIDO, World Industry Since 1960: Progress and Prospects, pp. 301-314, ID:CONF.4/2.

New initiatives have been taken in recent years to develop and strengthen co-operation between developing countries, on a sub-regional, regional and inter-regional basis. Only some of these initiatives have been successful. While the effective foundation of this Third World finance institution would not be a sufficient condition for effective inter-regional Third World co-operation, it certainly appears a necessary condition for strengthening such co-operation. In this respect, its anticipated impact in cementing Third World collective self-reliance, can be compared to the undoubted success of the World Bank in strengthening North/South interdependence.

Two issues have to be squarely faced in a consideration of this proposal for a new financing institution. The first issue relates to additionality, i.e. whether a new institution would attract new funds or merely divert funds from existing institutions. The second issue relates to whether there is in fact a shortage of funds for industrial financing or a gap in the international financial structure.

3.2.2 Additionality

Since by definition the global balance of payments must balance, funds attracted to this new institution would indeed represent funds from the South which otherwise would be deposited elsewhere: largely in near liquid form in the Eurocredit market, the commercial banks and government paper of the North. In the Eurocredit market alone, a significant part of an estimated $500 billion in near liquid deposits is owned by countries of the South. One aim of this proposal is to transform part of this near liquid finance into stable forms of long term industrial investment by means of a mechanism controlled by the South: there may well be a preference by Southern investors to lessen their dependency on the Northern financial markets where they exercise no control, and where their investments are in instruments which are not protected against inflation. Investments made through the medium of the Agency in equities would offer to the subscriber to its capital the kind of protection provided by an inflation-indexed bond. Moreover, the Southern investor would also have the assurance that the capital value of investments placed in the Third World in this way, would be relatively more stable because of geographical diversification of risk, free from the potential control of the North. The need for a restructuring of the international financial system is reflected by the excess liquidities of the system which persists despite the long-term industrial investment requirements of the Third World. The international financial system is presently anchored in the North, especially in the Transnational Banks. This proposal aims to get away from the monopoly focus in the North by providing a bridge across the South. It would represent the beginning of the restructuring of the international financial system, and would ensure an additional flow of long term investment into Southern industry.

3.2.3 The Gaps in Industrial Financing

Two separate gaps exist in finance flowing to Third World industry. First, progress towards the Lima target requires a significant expansion of investment in industry beyond the levels that can be expected of existing channels for investment, whether financed through domestic savings in developing countries or from foreign sources.1/ Second, the finance available is almost wholly in the form of fixed-term bank lending, rather than in the form of long-term risk capital. Risk capital offers an advantage over straight debt financing in that interest of dividend payments can be designed to fluctuate with profits or output. The financial markets of the North have been unwilling or unable to develop suitable risk finance instruments which can substitute for direct foreign investment and the Transnational Corporation.

From the standpoint of Third World users of funds, the institution would offer the possibility of obtaining equity investment in a manner acceptable to many Third World governments, on terms which respect sensitivities concerning national control, sovereignty and domestic objectives, and confer upon the Third World investor the safeguards and degree of security expected by any foreign investor. Through its institution-building activities it would add to the number of commercially viable investment projects in developing countries. Financial mechanisms could be found within the Agency which would also provide export credit financing for promoting exports of industrial output, especially in the area of technology sophisticated goods and services, within the South as well as to the industrialised countries.

In a consideration of industrial financing gaps, of some relevance are recent trends in Northern agencies, bilateral and multilateral, towards "basic needs" and rural development. Whether the policy prescriptions behind these trends are correct or incorrect, the net results seem certain to lead to a decrease in the proportion of Northern ODA available for industry. Of perhaps equal relevance is the pessimistic perception that at a time of declining industrial competitiveness in the North, Northern bilateral and multilateral agencies may be unwilling to increase financing available to potential competitors, i.e. Southern industry. Table 7 above shows World Bank lending to industry: the proportion of funds lent to industry seems to be declining, and has not even kept pace with the rate of inflation.

1/ For estimates of the financing requirements in industry, see UNIDO, Industry 2000 - New Perspectives, ID/CONF/4/3, pp 113-115.

Lastly, a cliché frequently heard in some quarters is that if a larger number of "good" industrial projects were available in developing countries, finance would be readily available. Whatever the validity of this claim, one major recommendation, for an Industrial Project Preparation Facility,1/ ties in closely with this proposal for a new Industrial Financing Agency: the project preparation facility would be a crucial instrument for seeking out and promoting in bankable form new industrial projects, thus increasing the absorptive capacity of least developed countries.

The Proposal

This proposal is designed to deepen the content of the concept of collective self-reliance within the South by setting up an International Industrial Finance Agency (IIFA) whose main task will be to:

(a) serve as a channel for intra-Third World investment;

(b) promote and help to make effective independent Third World financial institutions, instruments and arrangements which can themselves serve as conduits for Third World financial flows;

(c) provide a Third World export credit fund designed to facilitate financial backing for exports, particularly of manufactured exports, capital goods and technology, both within the Third World and to the industrialised countries.

3.2.4 Advantages of an International Industrial Finance Agency

A basic aim of the IIFA is the establishment of institutional arrangements controlled by and located in the South to facilitate long-term investment on non-concessional terms of surplus funds from the capital-rich countries of the South.e.g. certain oil-exporting

1/ See UNIDO, Industry 2000 - New Perspectives, op.cit., p. 235.

developing countries and other Third World countries, to the industrial sector in other developing countries including those which are well advanced along the road to industrialisation.[1/] The justification for the establishment of such institutional arrangements lies in the need to create direct links between the suppliers of capital and the users of capital without the requirement of having Northern financing institutions, banks and enterprises interposed between capital surplus and capital deficit countries of the South. Not only does the latter interposition strengthen the dependency of the South on the North, but also increases the cost of financing and therefore the profits of the transnational banks providing this intermediation.

In this connexion, even ignoring the perceived disadvantages associated with direct foreign investment and the transnational corporations, i.e. restructions on the transfer of technology, transfer pricing, possible loss of sovereignty, export market restrictions, etc., these same foreign enterprises often obtain a significant proportion of their own finance from the South: there is the phenomenon of transnational corporations using Third World funds for direct foreign investment elsewhere in the Third World. A related phenomenon is the great concern sometimes expressed by eminent persons in the North about the equity holdings and control of developing countries in Northern industrial firms, including transnational corporations.[2/] There is a distrust of the holders of oil surpluses and a reluctance to allow such holders to participate in forms of investment where they might be protected against inflation.

The strengthening of direct links, which already exist in rudimentary form at the present time, is particularly relevant in the area of industrial finance, especially relating to the raw material and mineral processing sectors, where benefits can be gained by both the surplus and deficit developing countries. More specifically, it opens to capital deficit developing countries the possibility of procuring of long-term financing on commercial terms in both debt and equity forms, from sources of investment which, while requiring the conventional degree of security associated with such investment, may be more responsive to broader issues involving national control and sovereignty. Moreover, financial resources obtained in an unpackaged form, i.e. separate from the package of finance, technology and management which comprises direct foreign investment, are often more desirable to those developing countries which, while holding high capability in specific industrial sectors, lack financial resources.

1/ See ID/CONF.4/2, op.cit., pp. 39-42.

2/ For the report of a recent debate see International Herald Tribune, 18 July 1979. See earlier discussions and reports in The Wall Street Journal, 22 January 1974, 26 February 1975, 5 March 1975. See also US Senate, Committee on Banking, Housing and Urban Affairs, Subcommittee on Securities, Foreign Investment Act of 1975: Hearings 94th Congress, first session and Hearings 93rd Congress, first session, serial no. 93-71.

The IIFA would offer several advantages for investors from developing countries. While requiring conventional investor protection, these countries see the importance of investing at least a part of their savings, particularly where the savings are based on non-renewable natural resources, in financial instruments which provide a measure of protection against inflation, i.e. through investment instruments with the equity characteristic of profit sharing. A return that could have been earned by a diversified portfolio drawn from four Latin American countries over 1950-1968 has been calculated at over 6 percentage points above the return of shares on the New York stock exchange in the same period.[1/] Equally important to the surplus developing countries are benefits to be derived from placing at least a part of their investment portfolios in countries of the world outside the control or potential control of countries of the North. Established financial theory advises the rational investor concerned with long-term returns to diversify his portfolio. Risk diversification applies to all types of risks, including the political risk of asset and foreign exchange reserve seizure, confiscation or freezing. The concentration of placements in a small number of Northern financial centres may leave capital-surplus developing countries vulnerable to actions that may be taken by these industrialised countries. No agreement was reached with these industrialised countries at the CIEC (i.e. the "North/South" Conference) in Paris, 1977, with regard to the protection of the financial assets of the oil-exporting developing countries.[2/]

3.2.5 Aims of the International Industrial Finance Agency

It is proposed that an International Industrial Finance Agency,[3/] be founded by developing countries with the following aims:

(a) To further the economic development of developing countries by encouraging the growth of productive enterprises, particularly by direct financial linkages between developing countries.

1/ See Development Committee, Developing Country Access to Capital Markets, Washington, D. C., 1978, pp. 91-92 "Risk and Return on Investment in Developing Country Securities". See also Lessard, International Portfolio Diversification: An Analysis for a Group of Latin American Countries, Journal of Finance, June 1973, pp. 619-633. See also Lessard and Wellons, Financing Development: Innovation in Private Capital Markets. April 1979, paper commissioned for Industry 2000 - New Perspectives, ID/CONF.4/3.

2/ UN General Assembly, Development and International Economic Co-operation: Implementation of the Decisions adopted by the General Assembly at its Seventh Special Session: Report on the Conference on International Economic Co-operation, A/31/478/Add. 1, 9 August 1977, p. 150.

3/ While there is some similarity between this proposed agency and the International Fund for Agricultural Development, there are significant differences in its orientation towards industry, South/South linkage and the promotion of additional investment channels, its emphasis on non-concessional funds, and the mixed public/private institution emphasis.

(b) In association with public and private investors in developing countries, to assist in the promotion, financing, establishment, improvement and expansion of productive enterprises, including regional and sub-regional industrial enterprises and multinational enterprises, which would contribute to the development of its member countries, with or without the guarnatee of repayment by member governments, as appropriate.

(c) To seek to bring together industrial project and programme investment opportunities, domestic and other developing country sources of capital, technology and management.

(d) To seek to stimulate, and to help create conditions conducive to the flow of private and public resources, originating principally within and between developing countries, through the promotion of financial instruments, advice, arrangements and institutions appropriate to the social. cultural and economic environment of member countries.

(e) To foster mutual benefit based on equality and self-reliance between all developing countries.

3.2.6 Membership and Capitalisation

It is envisaged that membership of this Agency would be open to governments and financial entities of all developing countries. Control and management would be exercised strictly by the Third World, with an appropriate voting structure, to protect the interests of all parties. A number of arrangements are possible for solving this issue, but it is recognised that this paper is not the place for attempting to reach a determination on the issue. The initial resources of the Agency would consist of paid-up and callable share capital in agreed proportions. The initial capital of the Agency is envisaged to be of the order of $ 5 billion, with $ 500 million paid in, leaving 90 per cent as callable capital. The Agency would be authorised to augment its resources by the issue of debt instrments in international markets as well as through bilateral arrangements in the developing countries, against the security of its callable capital and through earnings accumulated from its operations. It will operate on a basis which will yield a renumerative rate of return to subscribers of its capital, through appropriate investments and placement of funds.

It is envisaged that while control of this Agency would be wholly in the hands of Third World entities, this would not preclude mutual arrangements, on appropriate terms, with governmental, intergovernmental and private institutions and enterprises of the industrialised countries. However, its bias would be towards the Third World and accordingly it would be neutral with respect to private enterprise, direct foreign investment and transnational corporations, recognising the diversity of developing country perceptions of these latter phenomena. While there is some similarity between the aims of the institution proposed here and the aims of the World Bank affiliate, the International Finance Corporation, there are also significant differences: this proposal aims towards

direct financial linkages within the Third World, i.e. South to South interdependence based on equality; in this connexion the composition of voting power existing in the IFC is shown in table 8 below. It is recognised that there is some diversity in Third World perceptions of the role of the public sector and state participation in productive enterprises, and the management of the proposed agency would be expected to be fully sensitive towards this diversity of perception.

The clients of the agency would include both state-owned as well as private firms from the South. Positive consideration would be given to investment partners supplying management and technology from Third World sources, including Third World Multinational Corporations, and while collaboration with transnational corporations would not be precluded, such collaboration would also be sought from the medium-sized firms of the OECD countries as well as similar firms from the socialist countries. In this connexion, the recommendation for mobilising the potential of medium-sized enterprises and other non-TNCs[1/] would be supportive of the Agency's activities in this regard.

Table 8: Voting power of member countries of the International Finance Corporation, 1978

Country	Voting power	Country	Voting power
United States	31.8%	Canada	4.3%
United Kingdom	8.6%	Other OECD countries	13.6%
Federal Republic of Germany	5.7%	All OECD countries	69.4%
France	3.6%	Other countries (including developing countries)	30.6%
Japan	1.8%		

Source: Annual Report, IFC, 1978.

3.2.7 Operations

Staffing

The Agency would employ its own management and professional staff, competent in the workings of the market place, for financial and project operations. While this technical staff would collaborate with staff from existing North-based bilateral and multilateral institutions, care would be taken both to avoid dependency on this collaboration and to avoid the growth of an enlarged bureaucracy. In this connexion, it should be noted that although the existing multilateral financing institutions are less subject to some of the immediate commercial and political pressures and preferences that can afflict the Northern bilateral finance agencies and more objective in their geographical lending allocations, they are nevertheless considerably under the influence of the North. Equally, major practices and assumptions have become established in the past in management and staff perceptions, and this affects many aspects of investment policy and procedures.

1/ See Industry 2000 - New Perspectives, op.cit., pp. 168-170.

3.2.8 Investment

The Agency will use its own funds to provide finance in conventional and innovative forms of debt and equity to productive enterprises, particularly industry in the Third World. Depending on the capital structure of the Agency, it ought to be possible for it to function inter alia as an investment trust, placing some portion of its funds in a diversified portfolio of investment instruments in the Third World. It is envisaged that the Agency can complement this purely financing function by also acting in the nature of a Third World investment bank; it will in this manner put together financing packages for the development of commercially viable industrial ventures, entering into suitable co-financing arrangements with private banks. To the extent to which the Agency caters to the entire Third World, it will pay particular attention to the setting up of multi-country or multinational industries, taking account of particular regional circumstances and of the need to expand export markets.

3.2.9 Project Packaging in Mineral Processing

It is envisaged that in its project financing operations, fundamental consideration would be given to control by Third World entitites, financial viability and national economic viability. In recognising that many developing countries are relatively small with limited markets, and that there are significant economies of scale in the production of certain industrial goods, the Agency will give attention to the promotion and financing of viable regional, sub-regional and Third World multinational industrial enterprises. An important area of the Agency's activity would be in the financing of projects in the mineral and mineral processing areas, since it is recognised that in these areas many Third World countries possess considerable comparative advantage. In this connexion, the recommendation for joint efforts for marketing, exploration, processing and financing,[1/] which envisages, inter alia, regional processing facilities run by regional multinational corporations, would clearly benefit to a considerable extent by the operations of this Agency. It is envisaged that the Agency itself would have a comparative advantage as a supplier of finance in the latter area, since developing countries are particularly sensitive to the exploitation of their national "patrimony" by transnational corporations, i.e. the Agency's activities in this respect could provite an alterantive to the North-based transnational corporation. In the same context, the Agency is envisaged to be active in project packaging, i.e. bringing together non-TNC Third World technology suppliers, Third World finance sources and Third World raw material producers in "down-stream" processing ventures. In this connexion, it is sometimes forgotten that Northern investors and institutions have a near monopoly of information regarding investment opportunities, and that when attractive investment opportunities arise, these Northern investors have often the "right of first refusal". The activity of the Agency, provided it makes its presence in the marketplace effective, should go some way towards counteracting this symptom of dependency, at the same time increasing alterantive sources of finance and technology.

1/ See Industry 2000 - New Perspectives, op.cit., pp. 212-213.

3.2.10 The Promotion of New Institutions

While the Agency would itself be a channel for finance in both debt and equity forms, once the Agency becomes fully operational, its second main task would be to foster the growth of additional channels of direct linkage between Third World entities. Thus, in concert with Third World governemtns acting bilaterally/regionally/intraregionally/ multilaterally, it should assist in the promotion, strengthening and development of financial institutions, particularly specialist industrial financial institutions, through which direct linkage could be accomplished. In the long run, it will be desirable for the South to build up financial markets, mechanisms and institutions comparable to those in the North. Only in this way will the South achieve parity in financial development. The proces process of developing such financial strength is likely to last well beyond the year 2000, but it is desirable that steps should be taken to move towards parity with the North as soon as possible.

The essential requirement is that financial institutions should be developed which are owned, financed and managed by the developing countries, and are located among them. Such institutions may be national or multinational, private sector, public sector, or mixed. They should include banks, insurance companies, pension funds; organised money and capital markets capable of mobilising funds swiftly and efficiently; supra-national institutions for central bank settlements and balance of payments assistance; and payments unions, monetary unions, and other institutions for co-operation, for example in trade finance. It should be recognised that for developing countries to establish such institutions will take considerabl time, and probably involve many teething troubles. It may also require the rejection of "North-dominated" proposals which may work better in the short and medium term, in favour of "South-dominated" proposals which may take off more slowly, but which may be more satisfactory in the long run.

3.2.11 The Promotion of New Finance Instruments

In keeping with its main thrust towards direct linkage and collective self-reliance, it is envisaged that the Agency would also be innovative with regard to the financial instruments used with the Third World.

Thus while the specific financial instruments used by the latter institutions will include the conventional instruments, such as long-term bank loans, underwriting and the purchase of equity shares, bond issues, etc., a number of new financial instruments might be equally appropriate. It must be emphasised that concurrent with changing industrial technology of the North, there is in the North the development and application of new financial technology in response to the needs of changing markets: the floating rate note, certificates of deposit etc. In a like manner, financial instruments reflecting the needs of the developing countries - both of the suppliers of finance and the users of finance - have also to be developed.[1/] Thus an important activity of this Agency charged with the

1/ The Development Committee has identified a number of new financial instruments to facilitate North/South interchanges which are of great interest. See Development Committee, op.cit.

promotional activity identified above would be the development of new financial instruments to facilitate exchange and investment among the nations of the South. The search for and application of new financial instruments are of crucial importance. The activity of the Agency should go well beyond the introduction of "conventional" debt and equity instruments into financial arrangements for profit sharing and risk sharing at the enterprise and national levels without control features, i.e. non-voting and non-controlling equity instruments. It must be emphasised that the financial arrangements and instruments developed in Western Europe in the 19th century and earlier, came into use to serve the economic and social needs of specific societies with specific needs:[1/] it cannot be assumed that these social and economic conditions are replicated in the Third World in 1979.

Innovations have to be sought to substitute for the TNC's presence: some Third World countries perceive risks in using the mechanism of DFI, in particular the mechanism of the transnational corporation; they may prefer either to dispense with the DFI mechanism or to limit DFI only to specific industrial branches.[2/] Alternatively, they seek to control transnational corporations; this control may be either inadequate and thus unsuccessful or if adequate may deter the TNC from co-operating with the developing country. Alternatives to the transnational corporation as a supplier of technology have been indicated above: alternatives to the transnational corporation as a supplier of finance include national and regional unit investment trusts, bonds indexed to commodity prices, trade-linked bonds, flexible credit lines, bank loans indexed to commodity prices,[3/] etc. Another alternative may be the joint investment company, an innovation which has been resorted to in arrangements between oil-exporting and other Third World countries. Yet another alternative may be conventional DFI which incorporates the "fade-out" principle, whereby the foreign partner contracts in advance that the developing country partner becomes the owner and controller of the business under certain conditions.[4/]

The Export Credit Window

One task of the Agency will be to provide export financing through a Third World Export Credit Fund. A number of developing countries have increased their industrial capability in the capital goods and producer goods sectors[5/] to the extent where they have

1/ The Stock Exchange was founded in London in 1773. Joint Stock banks (other than the Bank of England) were founded in England in 1826. Before 1773 and 1826 the social and economic need for these institutions was either unrecognised or non-existent. The Moscow Narodny Bank was established in London in 1919: in 1959 it was sub-titled "Bank for East-West Trade". The same rationale, i.e. social and economic need by the "actors" concerned, applied to the founding of both sets of finance institutions.

2/ For example, see Industrial Priorities in Developing Countries, UNIDO, 1979. This latter publication examines industrial policies, inter alia, regarding direct foreign investment in Brazil, India, Mexico, the Republic of Korea and Turkey.

3/ See section 5.5.2 on the promotion of new risk capital finance instruments, ID/CONF.4/3.

4/ See a New United Nations Structure for Global Economic Co-operation, United Nations, New York, 1975, pp. 83-85.

5/ See paper by Lall, S., Third World Technology Transfer and Third World TNCs, commissioned by Industry 2000 - New Perspectives, op.cit. See also below.

been able to compete successfully with a wide range of these goods produced by industrialised countries; Third World producers have been able to compete successfully in the markets of both developing and industrialised countries. There is, however, a need for a new mechanism through which developing country exports in the latter sectors could be strengthened in a manner mutually beneficial to Third World purchases and producers. In order to encourage South/South and South/North trade in capital goods and to assist in making the conditions on which these goods are purchased competitive with products from the industrialised countries, it is proposed that a Third World Export Credit Fund should be established[1/] as one of the finance windows of the IIFA.

The Fund's main task would be to refinance credit, made available by domestic banking sources, using its own first class name to secure more favourable financing terms than would otherwise be available. Its primary function would be to provide export credits for South/South trade in manufactures including capital goods and technology, but it could also provide credits for such Southern exports to the North. An important element of the finance provided, whether in the form of buyers or suppliers credits, is that it would seek to be on terms comparable with those terms by which industrialised countries make credit available to their own industrial capital goods producers, as appropriate.

It is noted that discussion on a Multilateral Export Credit Guarantee Facility has taken place over a considerable period of time in both UNCTAD[2/] and the World Bank;[3/] the same concept also received attention and support in the recommendations of the Pearson Commission.[4/] These activities deserve the fullest support and it is to be hoped that the problems which still need to be resolved can be brought to a rapid conclusion. The eventual setting up of a multilateral facility based on the concept of North/South interdependence, would effectively complement the activity of this export credit window of the International Industrial Finance Agency. Moreover, some of the work in solving the strictly technical issues arising in export credit would be useful inputs to the resolution of similar issues facing the Export Credit Window of the Agency.

It has to be recognised, however, that in certain industrial sectors a facility based on the concept of collective self-reliance would be more effective in meeting the considerable competition for export markets of manufactures: not only do the governments of the North compete among themselves for such markets, but also there is considerable competition among the commercial banks in providing such financing for Northern enterprises.

1/ In this connexion, some of the features of BLADEX, the Banco Latino-Americano de Exportaciones, opened on 1 January 1979 in Panama, might serve as a useful model.

2/ See Export Credits as a Means of Promoting Exports from Developing Countries, UNCTAD, TC/B/494, 1974.

3/ A proposal for a Multilateral Export Credit Facility was first discussed at the Annual Meeting of the Governors of the World Bank in 1972.

4/ Partners in Development, Report of the Commission on International Development, Pearson, L.B., Chairman, Washington 1969.

Thus, at a time of declining competitiveness in certain industrial sectors in the North, Northern agencies may be unwilling to facilitate export financing availability to Southern competitors in these sectors.

Consideration might be given to arrangements for the provision of buyers credits on semi-commercial terms, as appropriate, to the poorer members, these funds being constrained to purchase manufactured goods and services strictly from Third World member countries.

Technology exports among developing countries have grown significantly in recent years. A major problem with this trade, however, is the inadequacy of financial support. The Fund would, therefore, have a special task in this area. Several developing countries have already attempted to offer financial assistance to corporations exporting technology abroad in various forms. Present financial arrangements have, however, three areas of weakness:

- Export and import credit arrangements for both buyers and sellers of technology in developing countries;
- Insurance facilities which would allow adequate cover for the transactions;
- Financial guarantees for tenders and other forms of international bidding for technology contracts.

As is well known, credit, insurance, and guarantee systems allow the realisation of economies of scale and hence a relatively small input of financial resources through the Fund should be sufficient for several technology exporters to receive support. At the same time, international action of this type ought to provide more acceptable risk coverage for those cases where developing country exports of technology have to compete with perspective sales from the industrialised countries. The activities of the Agency with regard to the financing of Third World technology exports would be fully in concern with another major proposal presented to this Conference, namely the proposal for an International Industrial Technology Institute.[1/] This Institute could collaborate with the Agency in the provision of technology in the fields of energy and mining and mineral processing.

It is recognised that a number of technical issues will have to be overcome in an appropriate forum. Among these issues are the initial capitalisation, proportions of paid-up and uncalled capital; the control and management structure together with the voting powers of participants; the number of windows engaged in various finance activities; the scale, distribution and terms of finance among members; relationship between the Agency and central and commercial banks; arrangements with other finance institutions, exporters and importers; relationship between the Agency and non-Third World entities, etc. These important issues, many of which are technical and complex, have not been dealt

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1/ See Industry 2000 - New Perspectives, op. cit., pp. 192-195.

The major political issue is whether the international community can agree on the desirability of an International Industrial Finance Agency, based on the concept outlined here, and furthermore whether the international community is prepared to provide an instrument which could lead to the formation of the International Industrial Finance Agency.

The Secretariat invites the Third General Conference to approve in principle the concept outlined above for the establishment of an International Industrial Finance Agency and to designate an appropriate international body or bodies to provide a forum and to initiate negotiations with member countries, international organisations and international and regional financial institutions to set up the Agency.

3.3 Global Fund for the Stimulation of Industry: Global Interdependence

3.3.1 Introduction

This proposal starts from a recognition of the crisis in the international economy: global recession coupled with global inflation and instability of the international monetary and financial systems. The Global Fund for the Stimulation of Industry seeks to make quick disbursing programme financing loans to developing countries, of extended maturities between 12-20 years, in significant amounts building up to an annual level of over $15 billion, with a total callable capital in the range of $75-100 billion. Finance would be obtained for the most part by borrowing on international markets backed by the latter guarantees of callable capital, such borrowed funds being only lent at commercial rates to developing countries, and at below commercial rates to least developed countries, the subsidy element being provided through an interest subsidisation account.

3.3.2 Background: The Rationale

The rationale for the proposal for a Global Fund for the Stimulation of Industry is as follows. The world economy has been sustained during the current prolonged recession by the buying power of the developing countries. Today the developing countries absorb about 25% of US exports and 40% of EEC exports. In 1975, a time when the European Community reached a low point in the recession, and its exports to other industrialised countries were declining - by 17% to the US and by 3.3% to other industrialised countries - it was exports to the developing countries which increased substantially by 25%.[1/] One result of this buoyancy of Third World purchasing power was that unemployment in the developed world was significantly less than it might have been: it is estimated that there would have been at least 3 million more unemployed in the Community area alone, if capital deficit developing countries had been obliged to cut their imports of manufactured goods by the amount needed to pay for the oil price adjustments after 1973. However, the level of unemployment has remained high, between 2.2% for Japan and 7.7% for Canada, with the EEC countries lying between this range.

Manufacturing capacity utilisation rates for 1977 have been calculated at below 85% for a number of the major market economy industrialised countries, and for all these countries, stand at levels significantly below average utilisation rates for the 1964-1974 period as shown in figure A above. Accompanying this underutilised capacity have been the steep rises in prices which have occurred in the 1972-1977 period in certain major market economy industrialised countries, where the inflation rate has averaged about 10% p.a., with certain countries showing even higher rates shown above in Table 1 in the introductory chapter. Moreover, there seems to be every indication that these higher rates of inflation will continue for a considerable period.

1/ See Commission of the European Communities, Europe and the Third World. A Study of Interdependence, Brussels, 1978, p. 54.

Two sets of factors have thus recently dominated the international financial system and these are likely to continue in the foreseeable future: first, the above-mentioned continuing high rate of inflation and the pronounced under-utilisation of human and productive resources: second, the accumulation of excess liquidity in the private banks of the North together with severe monetary and exchange rate instability.

The purchasing power of developing countries derives from their export earnings and from their net international borrowing. In recent years, however, it was substantially increased borrowings which sustained their demand, especially as their export earnings had tended to suffer in a climate of international recession: thus, between 1972 and 1977, net external capital inflows increased from $20.4 billion to $57.1 billion, for the most part as non-concessional terms.1/ It is generally accepted that the present macro-economic equilibrium of the world economy depends significantly on developing countries' borrowings from the Northern private banking system, and borrowing must continue to increase if the momentum of world growth is to be maintained. For example, had nearly $40 billion not been added to world trade in 1978 through private bank lending to developing countries, recession in industrialised countries would have been more intensified. The dependence of some developing countries on access to the Eurocredit market is shown in Table 6 above in the introductory chapter of this paper.

What is new in the present situation, is that doubts are being entertained about the ability of the private banking system to cope with the additional strains recently imposed upon it for recycling additional financial surpluses. Countries that have borrowed in the past are for reasons of prudent debt management cutting back on their borrowings significantly, while the short-term flow of funds into the private banking system threatens to increase substantially in the wake of recent oil price adjustments. The viability of private banks is threatened in such a situation of demand/supply imbalance for funds: also, unless an effective mechanism is found for rechannelling surplus liquidity, there is no alternative to an intensification of global recession, further aggravating protectionist tendencies.

1/ "The present equilibrium of the world economy depends to a considerable degree on a continuing flow of private lending to the non-oil producing developing countries (and to the Soviet Union and Eastern Europe) on a scale unheard of before 1974 and would be called in question by any impediment to that flow. This flow of lending is also of interest in the Community context - because a significant proportion of the loans has been made by banks resident in the EEC". Commission of the European Communities, Annual Economic Review 1978-1979, Brussels, 1978, p. 8.2

What gives cause for concern is that additional strains imposed upon this market could have serious consequences. Deposits in the Eurocurrency market are primarily short-term, with upwards of 90% of deposits being for periods of much less than one year. The major private banks have been able to transform these liquid funds into medium-term lending. Problems are very likely to arise in this market because of the very considerable Interbank lending which supports the market, i.e. banks lending to one another in order to maintain the borrowing of their large customers. Problems could also occur, if one or a number of their large borrowers were to fail. In this connection, mention might be made of the banking crisis which occurred in the mid-1970s, when two not particularly large banks, one in the United States and one in the Federal Republic of Germany, failed. At that time it was thought by a number of observers that the private banking system as a whole could be considerably affected by the failure of these two banks.1/ It should be noted, however, that while the repayment record of developing country borrowers in this market has been excellent, a measure of the potential problems that may arise from such borrowing by developing countries is reflected in the six-month interest rate (in US dollars), which had stood at about 6 1/2% p.a. in the last quarter 1976, but had risen to over 15% p.a. in the last quarter of 1979.

One of the significant results of the gr th of the Eurocurrency markets in the 1973-79 period is that although developing countries are the major borrowers, direct access to these funds is limited to only a few developing countries, with six of them accounting for about three quarters of all Euromarket borrowing by developing countries.2/ Although 50 to 60 other developing countries have had occasional access to these markets, to many developing countries the market is virtually closed. The essence of the solution is to channel these funds under a mechanism of collective guarantee of the international community to the widest possible range of developing country borrowers who, taken separately, might not otherwise have access to the private banking system.

3.3.3 The Proposal

One way of providing this collective guarantee is through the mechanism of a Global Fund for the Stimulation of Industry, with a modest initial paid-in capital3/ contributed by industrialised and developing countries accompanied by substantial, say 90% to 95% callable capital which in effect would constitute a system of limited joint and several guarantees against which the Fund could borrow in the market place. Its functioning in this respect would be precisely analogous to the functioning of the World Bank which borrows in capital markets against its callable capital. The crucial difference, however, is that the total

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1/ See Euromoney, 1974 and 1975 issues, London.

2/ World Bank, Borrowing in International Capital Markets, various issues, EC-181.

3/ The initial paid-in capital could range from 5% to 10% of the Fund's total callable capital of $ 75 - $ 100 billion; so that the paid-in amount would have a lower limit of $ 3.75 billion.

amount to be raised by the Global Fund will be utilised for programme rather than project lending, so that the necessary momentum can continue to be imparted to the world economy in procisely the same manner in which private bank lending has been able to do in recent years. It goes without saying that such programme loans will be spent on industrial goods. A second crucial difference is that an interest subsidy element will of necessity have to attach to the Global Fund's lending operations, so that it can reach out to the least developed countries and the most seriously affected countries, whose overall circumstances require the resort to concessional finance.

One method of financing this subsidy element might be IC government contributions to an interest subsidisation account, evaluated as a small proportion of the value of incremental industrial exports from these countries to the DCs financed from the proceeds of the Fund: it is recognised that industrialised country tax revenues would show a net increase as a consequence of the impact on economic activity in the industrialised countries.

The Global Fund for the Stimulation of Industry has been drawn up on the basis of a number of common elements taken from several disparate earlier proposals which have called for a co-ordinated global stimulation programme.[1/] It takes their positive elements and integrates these into a new conceptual framework of the mutual benefit of industrialised and developing countries. The Global Fund proposal contains the general outlines of a co-ordinated strategy, incorporating mutually supportive and reinforcing elements, which are designed to promote non-inflationary growth in both developing and industrialised countries, and thus lead to some reduction in enemployment and imbalances in international payments.

3.3.4 The International Consensus

In the essential respects described above, the Global Fund falls squarely within an International Consensus which has been gradually evolving over the past year or so, and which was further confirmed at UNCTAD V in Manila.[2/] The proposal for a Global Fund represents a particular mechanism for bringing about what has been termed "the massive transfer of resources" which was the subject of a consensus resolution and which has also received the endorsement of senior officials of international institutions.[3/] The consensus at UNCTAD V held that "substantially increased transfers of resources to developing countries are an indispensable factor for accelerating their pace of development

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1/ Muller, R,E, and Moore, D.H. (TASC), A description and Preliminary Evaluation of Proposals for Global Stimulation, consultant paper submitted to UNIDO for this study, March, 1979. For a recent contribution to the debate, see Jayawardena, L, Towards a New Economic Order: Some Issues for Discussion. The Third World as an Engine of World Growth, Speech before Sri Lanka Association for the Advancement of Science, December 1978.

2/ Resolution 129 (V) Part IV, UNCTAD, Manila, 1979.

3/ See the statement of Mr. De Larosière and Mr. Ripert to UNCTAD at Manila, 1979.

and could help stimulate global economic activity, particularly in a medium- to long-term perspective". It further specified that operational proposals to give effect to such transfers should be formulated in time for decisions to be taken by the relevant bodies either before the next special session of the General Assembly or on that same occasion, and to take into account the possibility of interest subsidy mechanisms.

The consensus also specified a set of guidelines to be observed by proposals for substantially increased resource flows. Proposals should:

(i) be compatible with the development priorities of developing countries and should take due account of their debt servicing capacity over the longer term;

(ii) give special attention to all developing countries which depend primarily on concessional funds for external financing for their development, particularly the least developed among developing countries;

(iii) be largely raised in international financial markets for project development and execution and programme finance purposes.[1/]

The present proposal for a Global Fund for the Stimulation of Industry addresses itself to the programme financing aspects, as shown in this outline, as being the readiest way of accomplishing the global stimulus that is needed; a framework for industrial project development is elaborated in another proposal presented to UNIDO III, for establishing an International Industrial Finance Agency. The Global Fund also meets the requirements of these guidelines by incorporating an interest subsidy element representing the difference between the cost of funds in financial markets, and the terms acceptable to countries requiring concessional finance. What needs emphasising at this stage is that the innovative element in the proposal consists not so much in the idea of a massive annual transfer of resources, but in the fact that it is raised in the context of furthering the hope that the stimulus to industry in the developed world that would be created in the medium term, would both revive industry and maintain economic activity in a non-inflationary manner.

It is the aspect of inflation which requires to be frontally addressed in appraising the international consensus on proposals for massive resource transfers. This consensus appears adequately summarised by Mr. de Larosière, the managing director of the IMF, in his UNCTAD address, where he argued that action extending beyond the scope of what may prudently be available through the International Monetary Fund was necessary in the case of "countries that are deeply embedded in underdevelopment". In his view, in such cases "domestic policy adjustments would not be sufficient, even if they are supported by

1/ Resolution 129 (V), UNCTAD, 1979.

considerable medium-term credits" through the IMF. He continued: "In such cases, monetary mechanisms must not be used alone, as there is the risk of their breaking down or causing members to endure intolerable levels of deflation. It is the transfer of greater real resources that is at issue. It is paradoxical that industrialised countries - most of which are not using their productive potential to the full - are hesitating to increase their financial aid to poor countries. This is despite the fact that such aid would result in increased global demand and thus contribute to a reactivation of world trade and a recovery of production. There is nothing in the present state of deflationary chain reactions in the industrialised world (stagnation feeding inflation) which would argue against such an increase in financial aid" (emphasis added).

3.3.5 Membership and Decision-making

The founder members of the Global Fund would be governments of industrialised and developing countries, with a decisive role being played by the latter. Programme lending on a substantial scale would have to be accompanied by that degree of policy conditionality and forward planning necessary to enable countries to bring about the necessary changes in their economic structures. Conditionality as exercised by multilateral financing institutions is perceived by developing countries to be perhaps over-rigid, with the result that borrowing from private banks on arguably too permissive a scale has become an attractive proposition, to the point when private bank financing is sometimes held to have abdicated from the responsibility of imposing any conditions at all.

More specifically, it is perceived by a number of developing countries that the conditionality provisions imposed by the International Monetary Fund bring sudden changes in their domestic economies often accompanied by significant social unrest, and in the short run at least, sudden fluctuations in the disposable incomes received by different social classes. Moreover, the result of these changes has often been a significant degree of social and economic dislocation. Thus, for policy conditionality to be acceptable to the developing countries, the governing and management structures of the Global Fund must be seen to embody a decisive weight of developing country decision-making, for purposes of approving loans to developing countries. From the standpoint of raising money from the capital markets and for establishing the market standing of the Fund, a different voting structure can be resorted to for decision-making by the Governing Body of the Fund.

It is increasingly recognised that between Bretton Woods and the 1970s the international monetary system was designed and run by and for the OECD (and really the Group of Ten[1/]) countries, taking little account of the needs of developing countries. The fundamental issue is the proper relationship between the international monetary system and development, and the historical assumption that what is "good" for the North is also "good" for the Third World. The International Monetary Fund's role in the management of industrialised economies has been drastically reduced, with the advent of floating exchange

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1/ Canada, United States, Japan, France, Federal Republic of Germany, Italy, United Kingdom, Belgium, Netherlands and Sweden.

rates, central bank swap arrangements, and most recently the European Monetary System. Somewhat incongruously, the IMF is now left with being predominantly concerned with the problems of developing countries, armed with policies and management dominated by the North and an apparently inflexible package of conditions which may be quite inappropriate and contrary to continued economic development: internal deflation, exchange rate devaluation and trade liberalisation.

It should be noted that important countries are not members of the Bretton Woods institutions. The Global Fund for the Stimulation of Industry should be fully universal and include as members the USSR, China, and other non-market economy countries; benefits of mutual experience and a large scope for international co-operation would flow from the participation of all countries.

The question of conditionality is indispensable in lending, but a source of difficulty has been its interpretation in the light of one particular view of the world. Thus technical solutions, while protecting creditors' rights, have to be found, so as to take into account the legitimate interests of borrowers. Conditionality at the level of country borrowing, which is inseparable from responsible economic management, can be acceptable only if, through the medium of the Global Fund, recipient countries are seen in effect to discipline themselves by having a majority of their representatives both on the governing body and at crucial levels of management. Precedents for a decision-making structure of this type already exist in the case of the International Fund for Agricultural Development (IFAD) and the Common Fund set up under UNCTAD's Integrated Programme for Commodities.

3.3.6 Capitalisation

The Global Fund for the Stimulation of Industry would need a sufficient capital base to be able to borrow in the market place, amounts of the order of $ 15 billion per year. While existing multilateral institutions are required by their statutes to keep the level of their outstanding loans below the sum of their capital and reserves, this is not the case with the European Investment Bank where the ratio of loan to capital is approximately 2.5 and which has secured AAA status in the market place. It is suggested that the Global Fund, while seeking AAA borrower rating, might work with an intermediate loan to capital ratio of 1.0 with a capital base of the order of $ 100 billion. As indicated earlier, only a small part of this sum would be paid-in capital, perhaps 5 or 10 per cent, with the remainder in the form of callable capital replicating in effect the system of limited joint and several guarantees used by the World Bank and the regional development banks.

3.3.7 Operations

It is envisaged that the global fund would have the necessary authority to lend and to guarantee loans to member governments and their private and public entities, as well as to other international organisations such as regional or subregional finance institutions. Such lending would be given only on receipt of government guarantees. Loan maturities, rates of interest, grace periods etc. would depend on the economic prospects of the particular developing country as well as conditions on international financial markets and on the level of funds available to the interest subsidisation account; as indicated earlier, however, the global fund would pay due regard to countries which are in a specially disadvantaged economic position.

To the greatest extent possible, the global fund would seek to use the facilities of existing development finance institutions for the appraisal, administration, implementation and disbursement of its lending programme. However, there would be preference on promoting decentralisation and effectivity by entrusting regional and subregional institutions, as well as national finance institutions, with a graduated degree of responsibility for lending activities. It is recognised that programme lending on a significant scale would be a new departure for many lending institutions and a substantial technical assistance effort might be required in this direction.

3.3.8 Recent Proposals for Increased Capital Transfers

A number of proposals, some by governments and others by prominent public figures, have recently been advocated for increasing the flow of long-term capital to developing countries, primarily through borrowing from private sources of capital backed by a multilateral guarantee system. These proposals have for the most part been based on a recognition of growing interdependence in the world economy: more specifically, that unless developing countries have access to long-term finance, their capacity to purchase manufactures including capital equipment from the OECD countries will decline; also there has been the recognition that a continued reliance on the private banking system for recycling financial surpluses gives rise to a precarious debt structure which is vulnerable to shocks, and uncomfortable for both creditors and debtors. Lastly there has been a growing recognition of the need for programme finance in contrast to project finance which has been described above. A number of these proposals are described in the outline below.

The Venezuelan Initiative

A study was commissioned by Venezuela in 1977 which was discussed by ministers of a number of capital surplus developing countries; in December 1977 a press conference was held in Caracas, in which OPEC's interest and support for this idea was announced. The essence of the initiative was that a pool of OPEC and OECD funds, private as well as public, would be placed in a special trust fund of the multilateral and/or regional

development finance institutions; a proportion of the financing would be raised from OPEC nations and private investment, through bond flotations in international capital markets, using the underwriting services of the private banking system: the bonds would be guaranteed by OPEC and by the World Bank family. It was envisaged that a proportion of the total funding agreed upon would be channelled to the least developed countries, and that $10 to $12.5 billion per annum with a maturity of 12 to 20 years could be raised in this way.

The financing arrangement was envisaged to act as an international long-term credit mobiliser absorbing the underutilised savings of both OPEC, and OECD private investors now held in liquid short-term assets. It would employ the underwriting and intermedia-- tion services of the international private banking community, avoiding OPEC's technical and administrative involvement in the riasing of monies but ensuring a decision-making role on the end uses of funds.1/ The involvement of the private financing institutions would allow a readily available secondary market in the bonds, and provide flexibility in bond purchases over time.

The Mexican Proposal

In the May/June 1978 meetings of the Interim Committee of the IMF in Mexico, the Mexican representative proposed the design and implementation by the World Bank of a long-term recycling fund of $ 15 billion for the purchase of capital goods by developing countries. The proposal welcomed the past short-term recycling of international surpluses by the private banking system, but noted that the international community had not additionally faced the long-term structural problems that affect developing and developed countries: emphasis was placed on the establishment of a long-term recycling mechanism. The financial mechanism would be similar to the Venezuelan initiative, i.e. a World Bank facility operated as a managed trust fund using SDR denominated debt instruments to lenders with 15-year maturities at a market rate of interest, with the industrialised countries providing additional guarantees to the bond issues. In the original proposal no mention was made of the distribution of loans between different groups of developing countries. This proposal relies on the technical expertise of the World Bank in approving project loans and originally no mention was made of tripolar decision-making in the facility. However, as in the Venezuelan initiative, it was emphasised that the proposal would generate breathing time for developed nations to make necessary structural adjustments. It is understood that this proposal may still be under examination in the Interim Committee.2/

1/ For details see "A description of a preliminary evaluation of proposals for global stimulation" by Muller, Ronald E. and Moore, David H., specially commissioned by UNIDO.

2/ See Muller/Moore op.cit.

The OECD/DAC report

In May 1978 the Development Assistance Committee of the OECD released a draft report on "elements of a programme of investment in the Third World in the context of interdependence, key issues and choices". The objective of the programme proposed in the report was to initiate a major increase in investment flows from the OECD and OPEC countries in the short run for development within the Third World by stimulating demand and increasing production in both developing and industrialised countries. The time perspective of this global stimulation effort was envisaged to be 3 to 5 years, but implications were recognised regarding long-term structural changes in the world economy. Investment flows of some $ 10 billion per year were mentioned, facilitated through the use of various co-financing operations by the World Bank, the regional development banks and private commercial banks. Financing would be targeted to Third World projects in the field of energy, and non-energy raw materials and infrastructure. Third World manufacturing industry would not have **direct access** to these funds. While details on participation in management decision-making were not specified, the need was noted for a greater share of Third World responsibility in decision-making.[1/]

International Loan Insurance Fund

During the 1977 IMF/IBRD meetings, Prof. X. Zolotas, Governor of the Bank of Greece, suggested the creation of an insurance agency to provide guarantees for private bank lending to developing countries: an international insurance fund was necessary both to service longer-term needs of developing countries and to ensure financial stability in the Euromarket. The objectives of this proposal were to open the Euromarket to lower income developing countries, to assure continued access but with longer maturities and at lower cost to developing countries currently in the market and to insulate all developing countries from roll-over problems arising from short-term variations in Euromarket liquidity. While this proposal envisaged an independent agency, it was suggested that it would co-ordinate with the existing multilateral gencies, i.e. IMF and the World Bank. Among the features of the proposal was the suggestion that there would be superior risk assessment by the Agency which would be in possession of information, held by public agencies i.e. multilateral and developing country agencies, not normally available to the commercial banking sector.[2/]

1/ See Muller/More op. cit.

2/ See Muller/Moore, op. cit.

The Nakajima Proposal

This proposal "for the global infrastructure fund" made in August 1978 by Mr. Masaki Nakajima, President of the Mitsubishi Research Institute and former Managing Director of the Mitsubishi Bank, suggested the establishment of a new international institution investing $ 13 billion per year, contributed to by the USA, FRG, Japan and other industrialised countries and the surplus OPEC countries in major international projects of a pioneer nature. The proposal saw the need for "a global new deal" arising from both the failure of post-war Keynsian economic policy to prevent stagnation in the North and the urgency of eradicating poverty in the South. It emphasised global stimulation as the only viable means of sustaining growth in the context of continued technological progress, and recognised danger in the inflationary bias of strictly national deficit-financed stimulation efforts and the collapse of the Bretton Woods international monetary system. Funding would come from public sources requiring a 30 per cent increase in ODA from the industrialised countries, and the need for a new agency was placed in the context of outdated management and decision-making structures in the Bretton Woods institutions.1/

The Kreisky Proposal

This proposal was first outlined by the Chancellor of Austria, Dr. Bruno Kreisky, in 1976 as an idea for aiding growth in developing countries while stimulating the economies via the stimulation impact of the industrialised countries. Mr. Claude Cheysson of the EEC Commission, another early proponent, suggested a "new Marshall plan" for the Third World amounting to $ 10 billion per annum for 3 to 5 years, viewing this as a short-term anti-cyclical device based on traditional Keynsian theories applied on an international scale. The International Fund for Economic Co-operation and Structural Adjustment was developed from the original Kreisky proposal which aimed at directly matching Third World project financing to the use of excess industrial capacity in participating industrialised countries. The fund would get paid-in capital based on national quotas of participants, raise finance in capital markets, and the proposed initial $ 1 billion would be invested in projects primarily in industry and infrastructure.2/

The Swedish Initiative

In November 1978 Sweden and eight other nations held a "special meeting of the like-minded countries on transfer of resources" to discuss stimulation proposals. The meeting emphasised that the massive transfer concept was a means for inducing long-term non-inflationary growth for the OECD and the world economy, and as a means of avoiding intreasing OECD protectionism by addressing the problem of structural adjustment. The meeting took the view that a massive transfer could overcome the existence of excess capacity in OECD nations while decreasing poverty in the Third World.3/

1/ See Muller/Moore op. cit.

2/ See Muller/Moore op. cit.

3/ See Muller/Moore op. cit.

Other Proposals

The Commonwealth Governments at the meeting in London in June 1977, in reviewing a Commonwealth expert group report calling for a major increase in the transfer of resources, endorsed the report as a constructive contribution towards a specific action-oriented development programme. In 1978 Mr. Edward Heath, former Prime Minister of the UK, proposed that the EEC borrow substantial amounts from the OPEC countries, and use these funds in both industrialised and developing countries for general economic development and for mining and raw material expansion. In April 1978 Senator Jacob Javits and seven other US senators proposed the establishment of a capital pool of $ 50 - 100 billion for productive investment in developing countries as a means of stimulating world economic activity and achieving development objectives.[1/]

The Brandt Commission Proposal

The Independent Commission on International Development Issues (Chairman, Mr. Willy Brandt, former chancellor of the Federal Republic of Germany) consisting of a number of eminent persons from industrialised and developing countries, will reportedly propose[2/] a World Development Fund to provide massive finance for a variety of purposes, including general and sector programme financing, energy and raw materials exploration and processing, agricultural investment and infrastructure development. The bulk of the funds would be raised on the international capital market, as well as from bilateral arrangements with capital surplus countries, and there would be an interest subsidisation account financed possibly through a number of "automatic" transfers such as royalties from the recovery of seabed minerals and taxes on the arms trade.

The Arusha Proposal

The Arusha proposal, contained in the Arusha programme for collective self-reliance and framework for negotiation was adopted by the Group of 77 at Arusha, Tanzania, in February 1979. This proposal was notable in that the call for massive transfer of resources to developing countries in the course of promoting global economic recovery ceased, for the first time, to be the exclusive concern of a few isolated individuals or countries, whether in the North or in the South. The proposal argued that in the restoration of full employment in the North, meeting the needs of the developing countries would have a decisive role to play,in a situation where purely domestic reflation in developed countries would be no substitute, since the existing production capacities for export markets had been developed over three decades of export growth. The proposal called for an additional financial transfer inthe range of $ 35 - 50 billion, in the context of a recognition that needed structural adjustments in the pattern of production

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1/ See Muller/Moore op. cit.

2/ See the report in the International Herald Tribune, 10 October 1979.

and trade would be facilitated in both developed and developing countries by a climate of economic expansion rather than stagnation. It was noted that for the resulting revival in effective demand to lead to the restoration of investment and growth initially in the developed world, international monetary stability was an essential prerequisite. The proposal also suggested the mechanism of raising funds under the collective guarantee of the international community in international markets, and their disbursement to developing countries over a long-term period with an interest subsidy element as appropriate, in the form of both project lending and programme lending for structural change. The proposal urged inter alia the exploration of more "automatic" mechanisms than are envisaged today, e.g. a tax on exploitation on seabed resources, with a view to financing the interest subsidy element of the proposal. This proposal also expressed a sense of deep disquiet with the imbalance inherent in the decision-making and management arrangements of Bretton Woods institutions, between debtor and creditor, and between donor and donee. It was felt that there was a need for equality in decision-making.[1/]

3.3.9 Programme Finances and Conditionality

It is recognised that two important elements in the Global Fund concept would eventually require adequate elaboration which is not possible in this present document. However, the outlines of these two elements, viz., programme financing and conditionality are provided below.

3.3.10 Programme Financing versus Project Financing

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,[2/] and programme financing can reduce losses arising from incomplete projects.

1/ UNCTAD, The Arusha Programme, TD/236, February 1979.

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

Some countries have substantial domestic industrial capacity so that foreign financing of capital equipment imports may be either unnecessary or of limited usefulness. Equally, some other developing countries have substantial excess capacity 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 invoke 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 sucn structural reorientation, of necessity depends not only on project lending but also on programme lending.

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 not 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 faced by multilateral and bilateral agencies was a serious impediment to resource transfers. If continued, this trend will weaken the debt servicing capacity of developing countries and strengthen uncertainty concerning the adequacy of future capital availability to meet investment needs. In this, the IBRD and regional development agencies seemingly committed to these present procedures for project financing, are not in a position to pay a fully adequate role.[2/]

Table 9 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 requirementa in 1990 amount to US$ 183.5 billion as against

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1/ Indeed this experience led to the conclusion of the OECD Development Assistance Committee that the disbursement of "official capital has not kept pace with the rapid expansion of private capital". See Development Assistance Committee, 1978 Review, Paris 1978, p. 23.

2/ DAC 1978, ibid.

US $ 45.8 billion which had flowed in 1976. This table emphasises the growing importance of private financing as compared to multilateral financing. While these figures are based on a number of optimistic assumptions,[1/] 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".[2/] As already demonstrated above, many developing countries have little or no access to the private sources of programme financing available on the Eurocredit markets. 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 industrialised 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.

Table [illegible]: Net Disbursements of Medium- and Long-term Capital to Developing Countries, 1975-90

	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.

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

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

3.3.11 Conditionality and Decision-making

It is recognised that programme lending on a substantial scale would have to be accompanied by a degree of borrower policy conditionality and forward planning to ensure that borrowed funds are productively used, i.e. policy conditionality would have to ensure responsible economic management by borrowing countries.

Since the Global Fund for the Stimulation of Industry would rely heavily on market borrowing, there would be no place for inefficient management in such a new institution nor could there be any complacency towards deficient economic management by borrowing countries. Thus the Global Fund would need to ensure that its lending activities contribute optimally to raising productive capacity and not to such activities as unnecessary consumption or expenditure on arms; all Global Fund loans would have conditions attached and monitoring provisions intended to assure the productive use of funds. These conditions would have to cover, _inter alia_, such questions as the size and composition of the investment programme, management of balance of payments and the efficacy of domestic resource mobilisation and savings efforts. Conditions would take into account the circumstances of each borrowing country, the short-term and long-term effects of its lending decision on economic growth, welfare, and the financial position of borrowers.

It is recognised that lending conditions may have a profound impact on domestic policy priorities, income and employment levels, and particularly on the income distribution. Therefore, in the setting-up of loan conditions it will be necessary for borrowing countries to participate fully in a co-operative manner. Such conditions of loan and monitoring would only be acceptable to developing countries if, through the medium of the Global Fund, developing countries are seen in effect to discipline themselves by having their representatives form the majority on the governing body and at crucial levels of management of the new institution.

Conditionality exercised by multilateral financing institutions is perceived by the developing countries to be perhaps overrigid;[1/] thus, the organisational and decision-making structure of the Global Fund would need to reflect to the greatest extent the equal participation of all members. This implies that the Global Fund would operate on the basis of interdependence reflected in a voting and management structure in which no particular country or group of countries dominates. Thus a structure midway between the voting system of the UN organisations, i.e. one state, one vote, and the system of the Bank and the IMF, i.e. votes weighted by the capital subscription of particular states , might be envisaged. A key principle could be equality between the industrialised and the developing countries as groups.

1/ See Outline for a Programme of Action on International Monetary Reform, The Group of 77 Position Paper presented at the Annual Meetings of the IMF and World Bank, Belgrade 1979, pp. 7, 11.

3.3.12 Transitional Operations

Even with full guarantees from its member governments, it would be some time before the new Fund could establish that high standing on international capital markets which would allow it to obtain its financing on the most favourable terms. It is important, however, that programme lending begins fairly rapidly in amounts which go some way towards off-setting any reduction in financial flows from private banks, whether for the reason of reluctance on the part of lenders or prudence on the part of borrowers.

During this transition period of three or four years, a possible approach might be for borrowing to proceed on negotiated terms from countries with large reserves. Thus, it might be possible for about one half of the Global Fund's requirements during this period to be on the basis of negotiated loans from both capital-surplus industrialised countries and capital-surplus developing countries. In this connection, it is envisaged that capital-surplus developing countries might undertake to make negotiated purchases of bond issues or similar negotiated loan arrangements during this transition period, while similar arrangements might be possible with other countries with large reserves. If such a means of loan financing could be agreed during the transitional period, the Global Fund would be able more quickly to obtain the remainder of its needs in the international capital markets. At the end of the transition period of course, the Global Fund would obtain all its borrowings from the international capital markets.

It is to be noted that if those developing countries whose names are well known in the international capital markets, were also to associate themselves with the Global Fund from its inception, through their participation in a system of limited joint and several guarantees, this would enable action to be taken fairly rapidly. Thus the Global Fund could begin initially solely on the basis of interested countries; in other words, this phase can operate precisely in the manner envisaged by the Mexican Proposal[1/] without the formal paying-in of capital subscription for the reason that at a later stage the Global Fund could be negotiated on a universal basis.

1/ The Mexican Proposal placed before the Interim Committee of the IMF, May-June 1978, Mexico City.

This transition period can be availed of by industrialised countries to set in motion measures of structural readjustment/redeployment to be implemented over the medium term pari passu with the onset of economic recovery. Industrialised countries would in the context of the expansionary impact of the Fund find it easier to accept gradual increases in their imports of manufactures from developing countries.

3.4 Recommendations for Supporting Programmes Under Third World Collective Self-Reliance

3.4.1 Industrial Finance Information and Negotiation Network

The Network could provide two basic services needed to permit developing countries to use transnational banks and export credits more effectively: financial information and assistance in negotiations.

Prospective borrowers need to be concerned with trends in specific terms (margins, maturities, fees) as well as more general trends (international liquidity or the competing demand for loans from transnational corporations or OECD governments),[1/] together with quality and price information on capital goods. In planning financing policies in respect of borrowing in the Eurocredit markets borrowing governments need to anticipate changes, such as proposed or actual regulation either of international banking activities in general or of lending to developing countries specifically, and borrowers should keep abreast of innovations in the markets. In dealing with lenders, it is extremely useful to be able to point to a precedent for a proposed change in the standard form of contract. Similar considerations apply with respect to the use of suppliers credits, where purchasers/borrowers need to have the information to exercise sound judgement.

Borrowers also need to know about differences among lenders, including currency preferences, and also about the scope for negotiation, between different lenders in the case of syndicated credits, and between various suppliers in the case of suppliers credits. Any useful information and negotiation system must differentiate among lending banks to the extent that differences have operational consequences for borrowers. Preliminary research suggests that differences in the corporate strategies of the major international banks make some banks more responsive to DCs, and definable groups of banks allocate and price their resources differently among DCs. If bank lending strategies are classified according to specialisation and risk/yield policies, one discovers variations in pricing and allocation according to whether in a strategic sense DC business is integral to the bank, an important constituent of the bank's operations, or merely derivative of another market segment, such as transnational corporations.

For a borrower, financing needs vary, and there are times when it is important to tap or avoid one or another of these types of banks. But less experienced borrowers, thousands of miles from a financial centre, are hard pressed to identify differences among banks: contacts with the central banks of OECD countries could

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1/ Data from the World Bank and IMF do not fill the needs of less experienced borrowers: more and faster analysis is necessary. A regional initiative with some of the elements of this proposal is being considered in Latin America through the Centro de Estudios Monetarios Latinoamericanos (C.E.M.L.A.) in Mexico City.

prove counter-productive; the Central Bank X may recommend a commercial bank Y to an inquiring DC because the bank's margins on DC loans are above average and so the bank is judged safe. However, the developing country borrower seeks just the opposite. Similar considerations may apply with respect to currencies: loans denominated in a currency that the borrower does not earn in the bulk of his export trade may be regarded as inherently risky,[1/] even where interest rates appear low; in any event, loans in the Eurocredit markets carry floating interest rates, and as shown in table 5 (3) earlier, fluctuations in these rates have been very considerable. Thus perceptive judgements have to be made with respect to both choice of bank and of currency. The Network must therefore provide information about banks' reputations and services and about currencies, in a way that enables a prospective borrower to identify what it means to use one major international bank instead of another.

The clear need for cross-fertilization between developing countries prompts the suggestion that the Network provide information to borrowers that goes beyond simple terms on loan agreements. One finds among DCs a wide range of instruments and institutions that serve as mechanisms for access to finance from international banks. The Network should provide not merely general data about these mechanisms, but an indication of their advantages and costs, together with training and technical assistance.[2/]

The second major function of the Network could be to assist in negotiations of loan and export credit agreements. This extremely difficult function demands highly skilled, mobile negotiators not connected with suppliers enterprises or lending institutions who bring a good sense of the needs and capabilities of the specific country. Assuming that the personnel requirements can be met, the negotiators must prove their worth and this requires a high degree of institutional credibility in the organisation responsible for this Network. It should be emphasised that in borrowing funds from transnational banks, developing countries pay commercial prices for these funds: the transnational banks, i.e. lenders, are vendors of medium-term funds in a market in which information is scarce. Information on the attributes of banks/vendors, prices charged, currency, conditions of contract, etc. is of central importance; this may help to explain why the profits of transnational banks on their external lending operations have been so considerable, as indicated in section 5.2.1 above.

It is to be noted that the recent activity of the World Bank and the IFC, in assisting the access of developing countries to capital markets and in co-financing, which is supported elsewhere in this study and in which further innovation is suggested (see section 5.5.2), consists inter alia of the provision of information to transnational banks on developing countries' economic management, economic and

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1/ See Lessard and Wellons, op. cit., p. 73.

2/ For UNIDO activity in this area, see UNIDO, Annual Report of the Executive Director, 1978.

financial policies, etc. as well as project related information.[1/] All this information is provided to prospective banks/lenders/vendors of finance. Similarly, it is felt that developing countries might be given reverse information on prospective banks/lenders/vendors of finance as well as their policies and the impact of currencies used.

Within the Framework of both Global Interdependence and Collective Self-Reliance

3.4.2 Promotion of Risk Capital Financial Instruments

A number of innovative financing techniques, relatively independent of the goodwill of industrialised country regulatory authorities and of interest to investors in certan developing countries is proposed below. These techniques offer particular attractions where risks inherent in specific production activities are high, such as in the processing of raw materials and other products where price fluctuations are significant. The objectives of improving the international flow of risk capital are to increase the volume of total resource flows and to adjust the balance between fixed interest non-risk flows and risk-sharing (i.e. equity portfolio) resource flows. In this connection it is recognised that the problem associated with straight debt financing is that such financing normally carries with it the contractual commitment to repay fixed sums of capital and interest over a fixed period of time; moreover, such fixed-term bank finance has normally been available only for terms well short of the periods required for prudent financing of long-term industrial projects. The latter is particularly the case with respect to investments involving the processing of mineral resources and to investments involving major integrated industrial projects, as in the petrochemical and fertilizer fields and in other industries basic to the foundation of a process of modern industrialisation. It is fully recognised that asking investors to bear part of the risk associated with industrial projects would require an appropriate premium for the bearing of such risks. However, it may be an acceptable trade-off for a number of developing countries to share some of their profits, when such profits occur, with external investors.

(i) New Instruments for Shifting of Risks - Commodity or Trade-Indexed Bonds

The development and promotion of innovations designed to shift risks internationally should be vigorously pursued. Interesting financial instruments for many countries heavily dependent on a small set of commodity exports appear to be narrowly-drawn contracts which shift the risks of commodity price fluctuations, risks which by and large are outside a country's control. These include long-term

1/ For greater detail, see Development Committee, Developing Country Access to Capital Markets, Washington D.C., 1978, under the heading "General and Specific Mechanisms to Improve Access", pp. 73-75.

futures contracts and long-term sales contracts (which serve to stabilise revenues but do not provide a time transfer of resources) and commodity-indexed bonds which combine the functions of time and risk transfer.

The primary advantage of such instruments from the producer countries' viewpoint is that they shift risk without shifting control. From a capital market perspective, these instruments could provide an attractive return for the risks they involve: the return on commodity-indexed bonds could be tied to a product price or commodity index; when prices rise, investor returns would rise in tandem, and so also would producer countries' ability to pay. The converse would occur with a fall in commodity prices.[1/] Investors would still face the risk that a government might default on the contract, but this risk is not likely to be any greater than that of conventional bonds. A possible advantage of commodity-indexed bonds relative to long-term contracts is that the securities could be sold on a recurring, competitive basis rather than through infrequent bargaining sessions typical of long-term sales contracts. However, both types of instruments are complementary, and the choice between them depends on a wide variety of industry and country specifics. Commodity-indexed bonds appear to have an advantage in dealing with countries with open well-developed capital markets and hence for South/North risk transfers. Long-term contracts, in contrast, are likely to be more suitable for risk transfers among developing countries, and between developing countries and socialist countries.

An instrument to shift risks associated with overall trade flows could have attractions to those developing countries which choose industrialisation strategies premised on a significant volume of manufacutred exports. These countries are exposed to fluctuations in export revenues due to fluctuations in aggregate world economic activity, changes in the conditions of international trade including industrialised country protectionism, and changes in competition from other exporters. Such developing countries might wish to share the risks/rewards of overcoming such problems through the issue of a trade-indexed bond. The terms of such bonds would have to be drawn narrowly to make the bonds acceptable to foreign investors, since such investors have no control over export activities. A trade-indexed bond could carry provisions similar to a cumulative preferred share in which investors would be entitled to a particular periodic cash payment (which could be a dividend, interest, or principal payment depending on the specific contractual vehicle) as long as the country's export trade in particular defined products or to specific markets, exceeded a certain level. Any shortfall should be carried forward at a commercial rate of interest, repayment falling under the same constraint.

1/ See Lessard and Wellons, op.cit., pp. 90-94. Also see D. Lessard, Risk Efficient External Financing Strategies for Commodity-Producing Countries, Working Paper, Sloane School of Management, MIT, Cambridge, Mass., November 1977, and Cuadernos de Economía, August 1977.

(ii) New Opportunities for Foreign Portfolio Investment

The orthodox method of dealing with risk is direct foreign investment. The innovations below as well as currently acceptable arrangements such as joint ventures provide risk-transfer without some of the unwanted aspects of DFI. Opportunities for foreign portfolio investment exist at present in a number of Third World countries. International agencies could greatly facilitate foreign portfolio flows, including South to South flows in particular, by engaging in activities designed to promote, regulate, co-ordinate and control such flows; in substantive terms, such activities can be implemented through forms of technical assistance,[1/] including institution building and consultations/negotiations at the national, regional, intraregional and international levels. These activities would have the following objectives:

(a) To promote foreign portfolio flows to certain Third World countries by a code of conduct subscribed to and agreed to by those developing countries which find such arrangements acceptable; this code of conduct will be designed to protect foreign portfolio investment and to ensure that foreign portfolio investors would obtain a fair return on their investment. This recommendation is made in the recognition that this form of financial transfer may be more acceptable to certain developing countries than direct foreign investment which can involve losses through exercise of sovereign authority, unconnected with the financial risk/reward attributes of equity investment. If such measures were pursued vigorously, it should be done concurrently with the establishment of an appropriate regulatory framework to protect the fragile and limited equity markets existing in those Third World countries. Individual developing countries could be assisted in establishing their own national investment trusts which will allow foreign investors to participate in a selected set of local securities. In this way, the extent of foreign ownership of developing countries' enterprises could be controlled, since only indirect rather than direct access to local capital markets would be allowed. Where appropriate, special incentive provisions could be made within the above mentioned code of conduct to facilitate, promote and encourage financial resource transfers from other parts of the Third World, both intraregionally and interregionally. Thus the formation of regional industrial investment unions will be promoted, as a means to allow investors/ institutions within a region/subregion to participate in firms based within specific regions. Equally, such arrangements would allow an industrial firm located in a specific country to broaden and deepen its financial base, thus improving its industrial capability. Similar arrangements, containing appropriate guarantee provisions and safeguards are envisaged as a means of promoting portfolio flows on an intraregional basis, particularly from capital-surplus developing countries. By these means, the mobilisation of capital from both individual investors and institutions

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1/ The IFC has provided valuable assistance to a number of developing countries in work designed to improve the operation of their domestic capital markets. See IFC Annual Report 1978.

(e.g. pension funds and insurance companies) may be increased and allocated with greater economic efficiency, and opportunities will be provided for Third World investors to directly make use of their savings resources without the recycling intermediation of Transnational Banks. While it is recognised that such financing instruments would be viable for any type of productive investment, including investment in such areas as agriculture or tourism or in the modern services industries, the largest single sector which could benefit in many developing countries from such non-concessional financial transfers would be the industrial sector.

(b) At a global level, and based upon the type of national regulatory frameworks envisaged above, a collaborative international regulatory framework should be promoted, through which financial institutions (of a transnational or intergovernmental nature) would create investment trusts whose shares could be sold to private and/or public investors, thus providing these investors with an internationally diversified package of developing country equity securities. Within this framework, the promotion of an International Industrial Investment Trust, as well as Regional Industrial Investment Trusts should receive attention.1/ Special incentive provisions should be provided to facilitate intra-Third World financial resource flows. In this regard it is recognised that certain Third World investors are not interested in exercising management prerogatives and control, but are more interested in obtaining investment vehicles which provide a prudent measure of protection against inflation in countries outside the direct control of Northern governments and their regulatory agencies.

3.4.3 Promotion of Barter or Buy-Back Related Long-Term Investment

At the enterprise level, financial flows from the North should be structured to increase the likelihood of project success, where feasible, by incorporating incentives for design, performance and management. This may suggest some selective re-packaging of finance with technology, capital goods and management flows through some new non-DFI financial instruments which may run counter to the unpackaging approach.2/

The possibility of increasing linkages at the enterprise rather than the national level calls for governments to be aware of the activities of their enterprises, and to advise them where necessary. This is particularly true in the case of barter and buy-back arrangements, and the experience of socialist countries of Eastern Europe in this regard can be instructive.3/

1/ For a discussion of some of the issues see Development Committee, op.cit., pp. 87-103. See also Lessard and Wellons, op.cit.

2/ See Outters-Jaeger. Part 2 this volume.

3/ See Dobrocyychinski. Part 2 this volume.

Issues arising from the degree of liability accruing to vendors of turnkey plant for the proper functioning of plants are stressed in the discussion in chapter 6 on intragovernmental framework agreements and turnkey projects. While barter forms of exchange are often only theoretically second-best, a direct link between investment and quantity/quality of plant output exists in the forms of barter-like or buy-back investment arrangements; these arrangements can therefore be placed in the class of financing associated both with risk transferal and with orthodox debt. In this connection it is important to recognise that to a considerable extent the development of stable long-term exchange between two groups of industrialised countries, namely the market economy countries of the West and the centrally planned economies of Eastern Europe, has been much facilitated by the development of this form of exchange which, while providing for the transfer of financial resources and of technology on equitable and mutually beneficial terms, has stopped well short of the foreign control and dilution of sovereignty characteristics of direct foreign investment.[1/]

An essential prerequisite for a successful buy-back arrangement is that the developing country is well informed not only about its own market alternatives, but equally about those of its contractual partner, i.e. a systematic monitoring of international price movements and of development in international product markets. Since developing countries generally possess less developed market intelligence systems than their industrialised partners, they are often at a disadvantage. Successful development of barter-related investment projects will require that the information gaps be filled. The participation of a financing institution is usually a necessary condition for closing these investment gaps, but many banks are unwilling to become active in this area.[2/]

Another prerequisite for negotiations of barter-like exchange is sound knowledge about international norms and standards of industrial goods. Successful practical experience in barter trade has indicated that it is also necessary to have access to a well developed machinery of domestic economic and industrial administration. Developing countries entering into negotiations on barter-like investment arrangements without well determined objectives, plans and negotiating strategies are clearly at a disadvantage.

It would seem that barter-related investment arrangements could be an effective way of increasing the volume of investment for industrial projects, of broadening the choice of sources for external investment, of gaining access to new sales markets, and of facilitating the transfer of technology through ensuring a degree of commitment

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1/ See, UNIDO, Possibilities for Increasing Trade and Economic Co-operation between Socialist Countries and Developing Countries with Special Regard to Payments Arrangements, ID/WG.287/9, December 1978.

2/ Ibid.

by the equipment supplier.[1] It is recognised that a barter-related investment arrangement can sometimes be a second-best way of facilitating these exchanges. However, it is equally recognised that in many cases the only alternative may be direct foreign investment through a transnational corporation and that some developing countries sometimes prefer not to use this alternative. Arrangements would be facilitated by the following activities:

- Provision of information and advice to developing countries about market alternatives of goods exchanges as well as on international norms and specifications;
- Provision of technical assistance in determining objectives, plans and negotiating strategies;
- Technical assistance in the drafting of barter laws;
- Promotion of means by which financial institutions can facilitate barter and buy-back related investment arrangements.

CHAPTER 4: ADDITIONAL SUGGESTIONS WITHIN THE FRAMEWORK OF GLOBAL INTERDEPENDENCE

4.1 Facilitating the Access for the South to the Financial Markets of the Industrial Countries

There are several institutional changes which could be agreed upon very quickly which would improve the terms of access of the South to Northern capital markets. With regard to Official Development Assistance authorities with the responsibility for the allocation of ODA should recognise that there is a strong case for the allocation of a greater proportion of ODA finance to industry, in particular circumstances. Specifically, greater attention needs to be directed towards the provision of finance to small- and medium-scale industries in general, and in particular to such industries in those developing countries which do not have access to foreign capital on commercial terms, and also to industry generally in the least developed countries. It should furthermore be recognised that decisions with regard to capital allocation, whether by aid agencies, multilateral or bilateral, or by developing country authorities as to the use of concessional finance should take into account not only macro-economic balance-of-payments constraints but also the expected rates of economic return as well as the overhead costs associated with the provision of finance. Developing countries should attempt to reverse recent trends in aid agency lending policies which discriminate against the provision of ODA on concessional or non-concessional terms to industry.[2] It is important that

1/ See the Report of the Expert Group Meeting on Buy-Back Agreements, UNIDO/EX.78, Vienna, 29-30 March 1979.

2/ It is estimated that about 5% of bilateral ODA went to the manufacturing sector in 1975-76. See OECD, Development Co-operation, 1976 Review, Paris, 1976.

industry should be recognised as the most dynamic sector of most developing economies, and that it is industrial development which is most likely to accelerate economic growth. Present aid policies merely serve to perpetuate the status quo, the old international economic order. It should be emphasised that over 35% of external financing for industry is from non-concessional sources.

In connection with the availability of financial resources on commercial or near-commercial terms the regulatory authorities of industrialised-country governments should show a degree of flexibility with regard to the financial instruments, including new financial instruments used for the provision of transfers to developing countries. It is appropriate to notice that these regulatory authorities have been very sensitive and flexible with regard to a new environment within their domestic financial markets, witness the accelerated growth of the market for short-term financial paper, certificates of deposit (CDs), the acceptance of barter and buy-back related investment mechanisms, as well as industrial leasing to facilitate long-term exchange with the socialist countries of Eastern Europe, the complex network of holding companies, subsidiary branches, etc. All represent a dynamic response to a changing domestic financial, economic and political environment. Greater attention needs to be directed by these regulatory authorities to the opportunities for mutual advantage arising from the changed conditions in many developing countries, where for a number of reasons orthodox direct foreign investmany may, in many cases, not be the appropriate means for the provision of industrial capital on commercial terms. It must be emphasised, therefore, that increased attention should be given to non-DFI forms of commercial financial transfer.

4.2 The Promotion of Levered Official Transfers

In order to improve the effectiveness of the limited offical finance available, multilateral and bilateral aid agencies should seek to utilise the gearing principle more fully and actively than in the past, by combining aid with transnational bank lending.[1] This should be done by assisting bank lending to those developing countries which do not otherwise have access to the Eurocurrency and other commercial markets and by facilitating bank lending to countries who are up against their borrowing limits; it is recognised that such activities would have to be accompanied by careful economic calculations.

Aid agencies may assist access to commercial bank finance in the following ways:

- Co-financing associated with bilateral ODA;
- Providing repayment guarantees;

1/ The World Bank and the IFC have become active in this area in recent years. See IFC, Annual Report 1978, pp. 10-12.

- Providing funds to stabilise interest rates or repayment schedules at an agreed level;
- Providing funds to safeguard borrowers against the effect of appreciation of the loan currency against the borrower's currency.

As such measures would be used to assist borrowers who would not otherwise have access to the market, they would serve to increase significantly th- total volume of financial flows. Moreover, the volume of aid involved could be very small relative to the total loans assisted. It is clear, of course, that these suggestions are meaningful strictly within the context of the appropriate economic and financial analysis. It is not intended that risks be removed from conventional bank lending, nor that poor countries be burdened with repayment for equipment supplied primarily by way of subsidy to the equipment manufacturer: technical assistance to this end may be necessary.

The two bilateral financing institutions, one based on the EEC group, the other based on the CMEA group, should be strengthened so as to more effectively provide finance to industry in the developing countries with which these groups are associated. Equally, there needs to be a strengthening of the linkages between these institutions and the appropriate organisations of the UN family. It is suggested that these finance institutions pay particular attention to the channelling of concessional and non-concessional resources to medium- and small-scale industrial enterprises in their developing country members via the medium of the industrial development banks in these countries.[1/] In this connection, the emphasis placed here on small- and medium-scale industry is a strict reflection of economic reality in developing countries; small markets, populations and resource bases characterise many developing countries.

It is recognised that for this financing activity to take place on a significant scale, the institutional strengthening of the industrial development banks referred to may be required. In particular, it should be noted that the African, Caribbean and Pacific group in association with the EEC comprises a considerable proportion of the world's least developed, most seriously affected, geographically disadvantaged, small developing countries. The central problem associated with the financing of small/medium-scale industry is that overhead administrative costs are high relative to amounts disbursed: appraisal/disbursement/supervisory costs etc. are relatively large for small projects, and it would be inefficient for the bilateral institutions to lend directly at the enterprise level. It should be emphasised that the national industrial development banks have the possibility of collecting information more economically on domestic industrial projects, have considerable knowledge of local economic, social and industrial conditions as well as government regulations, and can be in a good position to provide a sensitive supportive service to their

1/ The European Investment Bank has been used by the EEC as a channel for industrial credit to ACP states.

industrial clients. For these reasons, the European bilateral specialist financing institutions would need to delegate a very significant part of their responsibility, other than general regulations incorporating interest rates and lending floors etc. and other than the responsibility for periodic audit of the use of funds to local industrial development banks. Special attention would have to be given to strengthening these industrial development banks which are an essential part of industrial infrastructure.[1] The bilateral institutions identified could also facilitate the use of non-concessional credit, raised in the Euromarkets, by their developing country members. In this connection it is envisaged that the bilateral institutions could in time assist in introducing a number of their clients to the international financial markets.

4.3 The Promotion of Access to Industrialised Country Capital Markets

In addition to measures to improve the level and effectiveness of official flows to industry, there is ample scope for actions that would improve the terms of access of DCs to IC capital markets. Thus, market economy industrialised countries might be persuaded to accept the principle of giving developing countries equal access to their domestic capital markets with home country borrowers and preferential access vis-à-vis other foreign borrowers. In particular, preferential access should involve relaxing of a number of constraints for developing country borrowers, except for those constraints necessary for the protection of domestic investors. Developing country borrowers should be given the same access to the issue calendar as home country borrowers. Ceilings on developing country issues should be removed where foreign exchange holdings permit, and other special requirements for developing countries should similarly be removed.

In view of the fact that potential developing country borrowers might find their access to industrialised country capital markets restricted because of their perceived high risk, borrowers and industrialised country governments should consider co-financing bonds for projects or programmes which involve the industrialised country's aid agency or development finance agency (DFA).

Co-financing can take different forms. It can consist of purchase by the investor from the DFA of participations in its investment in the project.[2] In such a case, the DFA virtually acts as trustee for the investor. Another form for co-financing would be investment in bonds issued by the project direct to the investor on the basis that the project has been appraised by the DFA which will also invest in it. Yet another possibility is parallel investment in a separate part of the borrower's programme, the entire programme having been appraised by the DFA which will invest in a different part of it.

1/ The World Bank has recognised the importance of Industrial Development Banks and Development Finance Companies as an important base for industrial financing.

2/ This arrangement is much favoured by the IFC. See IFC, Annual Report 1978, Washington D.C., 1978.

In addition, the market economy industrialised countries should agree on measures to extend the South's access to their bond markets, in particular by facilitating the issue and listing of bonds in their capital markets; consideration might be given to some relaxation of exchange control regulations in appropriate cases. It is recognised that all these suggestions regarding capital makret access, many of which were discussed in the Development Committee, would need to be promoted in several ways involving the education and the flow of information to both prospective borrowers and investors.[1/]

4.4 Improving DC Access to Commercial Bank Funds

(i) Borrowing countries can increase their borrowing by permitting a wider range of their financial institutions, generally commercial banks, to borrow from international banks and relend the funds to local borrowers who would not otherwise have access to external credit.[2/] The lack of diversity among local borrowers can hinder the ability of a country to draw on credit from the Eurocurrency market. Industrialised country laws and concepts of prudence limit a lender's willingness to lend a lot to any one borrower. The Borrowing requirements of separate developing country entities are low but scale is valuable: high thresholds for entry, such as the $ 10 million minimum often cited as necessary for syndication, restrict the access of the many local entities that are too small to use such large financing. Some device is required to aggregate otherwise credit-worthy borrowers so that they can achieve the minimum scale or reduce the cost of borrowing. Intermediation by domestic banks, mentioned above, is one such device. A country can expand its own channels to external credit by permitting local financial institutions to borrow internationally and relend the funds to local borrowers who do not otherwise have access to external credit. Such a proposal envisions the transfer of all risks (except the local borrower's default) from the intermediary bank to the borrower. If interest rates float, so does the local borrower's rate, and where exchange rates fluctuate, the local borrower bears the risk. Government authorities can decide whether local borrowers receive foreign or local currency, and indeed, they can manipulate cost, risk, and use, to accomplish various national policies. Technical assistance is required to facilitate this borrowing which could also be assisted by co-financing arrangements where appropriate. It is fully recognised that in this area the provision of technical assistance might well be necessary in order to provide an effective regulatory framework by national governments who adopt this strategy. Technical assistance in controlling bank borrowing etc. may be required.

1/ See Development Committee, Developing Country Access to Capital Markets, Washington, D.C., 1978.

2/ See Lessard and Wellons, op.cit.

(ii) The volume of developing country borrowing can be increased by encouraging a group of smaller, second-line OECD banks, who have not yet developed a tradition of developing country lending, to increase their lending to developing countries. This concept needs to be actively promoted among potential borrowers and lenders and in certain cases may need to be supported by co-financing from bilateral or multilateral agencies.

(iii) In order to avoid bad debt structures arising from international bank borrowing, borrowers and lenders should be encouraged to make greater use of two loan forms already in existence, flexible credit lines and tied deposits. Likewise conventional loan agreements could be modified so that flexiblity in repayment is incorporated. Other innovations suggested are bank lending linked to an index or to commodity prices and contingent product financing (i.e. involvement of banks in barter-linked investment). These innovations will need to be actively encouraged. In order to improve the maturities of bank credit in the context of a developing country's economic cycle, flexibility could be introduced into the repayment schedule. The cost of bank credit could be reduced by rationalising the fee and interest structure by eliminating special one-time payments that confuse the true costs in the eyes of other borrowers and lenders. Commercial banks should be willing to accept long-term deposits, from capital surplus developing countries, that are explicitly to be loaned on to capital-deficit developing countries. The tied deposit transfers from the depositor to the bank the risk of default by the borrower, which is normal in all such intermediating activities. The tied deposit also permits a flexible repayment schedule during the life of the loan since the depositor is known and committed to a long-term deposit. While such a scheme could be left to the vagaries of the international financial market, it would be more effective if a multilateral agency would initiate and co-ordinate the relation between banks and appropriate developing countries.

Within the range of maturities prevailing at any time, nothing other than convention prohibits banks and borrowers from negotiating a flexible repayment schedule at the outset. Balloon repayments are not alien to loan agreements now, so nothing requires repayment by regular and equal instalments. The novelty lies in asking banks to accept formally and in advance an arrangement that appears increasingly to be accepted in practice: the experience of the past several years demonstrates that if developing country borrowers encounter repayment problems, lenders will reschedule, formally or informally, rather than declare default. There are two main obstacles for making such arrangements explicit. Lenders prefer to retain the legal power to act if trouble threatens a borrower. The lender's real power lies in his ability to withhold net increases in credit in the future, a power that persists regardless of whether a default may be declared. Secondly, lenders see a contractual obligation to repay fixed amounts at certain times as imposing a discipline on a borrower: yet banks frequently use the open-ended line of credit or overdraft facility in corporate finance.

A flexible repayment procedure could be developed, which would embody a fixed repayment schedule subject to certain contingencies. For general purpose loans, these events could include commodity prices falling below a fixed amount or trade receipts falling short of a specified amount. For true project loans, even now one contingency is the project's success. If the contingency occurs, the agreement would permit delays in amortisation but require continuing payment of interest and, in all likelihood, payment of a premium for the additional administrative costs of the lenders. But because the event is within the terms of the contract, it constitutes neither a default nor a problem loan for the bank. Such a procedure recognises that borrowing countries differ profoundly from companies in that, despite debt problems, the countries will continue to exist while the companies may be liquidated. International banks know and act on this reality now, and OECD country regulators should also do so. To accomplish this requires co-ordinated action, which calls in turn for a recognition of this reality by an appropriate multilateral body.

(iv) Tax considerations may lead to commercial banks restricting loans to borrowers in countries where they cannot obtain tax credits for use against home country tax obligations. Double taxation agreements which contain tax sparing covenants to eliminate the impact of home country tax laws on the way in which banks allocate resources to developing countries need to be promoted and developed.

(v) The Central Bankers of some of the major OECD countries (the Group of Ten) have met formally and informally on a regular basis in recent years in order to discuss and to reach measures of agreement with respect to policies regarding international monetary issues, particularly the current regime of managed floating exchange rates and off-shore bank lending (i.e. activities in the Eurocurrency markets). Neither the capital-surplus nor capital-deficit developing countries have participated in these discussions, although one consequence of the notion of global interdependence is that such participation would be both useful and equitable; in addition, banking prudence does suggest that since certain Third World actors are major participants in the International Monetary System, as both lenders to and borrowers from the system, the concurrence of these actors should be sought.

It is therefore suggested that the Third World should become actively involved in the current debate on a regular basis in an appropriate forum, on issues concerning increased control and regulation of the Eurocurrency markets in order to protect its interests as the major borrower and to ensure that the industrialised countries do not agree on measures prejudicial to Third World interests. An important objective of these discussions would be to arrive at a series of agreed measures, incorporating perhaps an informal code of conduct, to which all the major participants and controllers of these markets (from the North and the South) could be asked to subscribe.

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FINANCIAL FLOWS: STATISTICAL BACKGROUND

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PART I: FLOWS OF FINANCE TO DEVELOPING COUNTRIES

a) Volume Flows

Annex 1 shows total net resource receipts of developing countries from all sources. Excluding Southern European countries, the total reached $57.1 billion in 1977, of which $3.5 billion went to "oil-producing"[1/] countries. The equivalent total for 1974 was $30.0 billion, and for 1972 $20.4 billion. In money terms, this represents an increase of about 23 per cent per year, about 9 per cent per year in real terms. While this may sound a substantial achievement, a further examination of the sources and terms of this finance will make it appear less so.

Between 1970 and 1977, total receipts of all developing countries, including Southern Europe, almost quadrupled from $16.70 billion to $63.93 billion. At the same time, ODA little more than doubled, from $8.04 billion to $19.54 billion, while non-concessional flows increased five-fold, from $8.66 billion to $44.39 billion. In real terms, however, ODA grew at less than 3 per cent per year over 1970-1977, and the vast majority of the growth was in non-concessional flows. In fact, the majority of the increases came from two sources, international bank lending and the "non-monetary" sector.

International bank lending comes mainly in the form of syndicated Eurocurrency loans. Apart from 1974, the expansion of such borrowing has been strong and regular. The downturn in 1974 followed upon rapid increases in 1972 and 1973, when the conditions of this cyclical market favoured the borrower. Expansion picked up again in 1975 and 1976, and 1977 and 1978 saw a return to very favourable borrowing conditions which market sources generally expect to continue during 1979. This market is now the single most important source of funds for developing countries. Past borrowings have an important bearing on the existing debt structure, and financial flows in the future will depend heavily on the long-term expansion of the market, its cyclical behaviours and its relationship with other financial sources.

Details of DAC country bilateral flows from the non-monetary sector are shown in Annex 2[2/]. From 1975 onwards, export credits have expanded very substantially and have become one of the major sources of external finance for developing countries. The increase in private direct investment hides the substantial amount of disinvestment that has taken place, especially during 1974. A particular feature here was the nationalisation of some oil company assets, especially in the OPEC countries. Bond issues remain a relatively minor source of finance, even though past expansion has been rapid.

1/ OPEC members, apart from Indonesia and Nigeria.

2/ The totals do not tally exactly with those in Annex 1 which is illustrative of the statistical problems encountered in this field.

Of the remaining sources, OPEC's concessional and non-concessional flows rose above $6 billion in 1975, but stagnated subsequently. However, since 1974, concessional assistance of OPEC has been over 2 per cent of GNP, whereas the comparable figure for DAC member countries has not risen above 0.35 per cent since 1974. However, substantial quantities of OPEC money have gone into the Eurocurrency market and have certainly played a substantial part in funding the expansion of international bank lending to developing countries. Aid from multinational agencies has expanded quite rapidly also, perhaps reflecting an inclination of some DAC members to channel increasing proportions of their aid budget through multinational agencies. Also, OPEC funds to multilateral agencies have increased quite rapidly.

The disappointing feature of financial flows has been the lack of expansion in funds from centrally-planned economies. Such flows as do occur represent an infinitesimal proportion of GNP, and there is no immediate prospect of any increase, unless it comes from a newly outward looking China.

The Distribution of Financial Flows

Since 1970 there has been some marked changes in the distribution of financial flows by income group, as illustrated in Annex 4. ODA has been increasingly committed to low income countries, in accordance with the stated policy of many aid agencies, to concentrate aid on the poorer people in the poorer countries. Low income and lower middle income countries have also increased their share of export credits at the expense of upper middle and higher income countries. (The OPEC share has remained fairly steady at just under 30 per cent.) However, Indonesia accounts for much of the export credits received by low income countries, and if it is omitted, this group received only 9 per cent of export/credits in 1975/1976.

Higher income and, perhaps surprisingly, low income countries, have both increased their share of private direct investment substantially, at the expense of lower middle income and upper middle income groups. However, in terms of investment per head of population, low income countries would easily come bottom of the list, and Indonesia alone accounts for the increase in this group. The other source of private capital, international bank lending, illustrates the most skewed distribution of all, with only 1 per cent going to low income countries in 1977. Because of the lack of statistical information, comparison with earlier years is difficult, but an examination of data on publicised syndicated bank lending indicates that the proportion was usually between 5 per cent and 10 per cent over 1972-1976. However, the proportions do not mean much, as Indonesia is the only consistent large borrower in this income group.

It is of interest, though, to look at the major sources of finance for each income group. On the basis of the data in Annex 4, low income group countries receive perhaps 80 per cent of their external funds through ODA. At the other end of the spectrum, upper middle and higher income groups receive only about 20 per cent of their funds through ODA, and about 50 per cent from international bank borrowing.

TABLE 1: Relative Importance of Sources of Funds to Non-Oil Developing Countries
(Per cent)

	Least developed countries	Low income	Lower middle income	Upper middle income	Higher income
ODA	95	81	47	18	22
Export credits	4	7	14	13	8
Private direct investment	1	9	9	21	19
International bank lending	-	3	30	48	51
Total	100	100	100	100	100

NOTE: Income groups follow OECD definitions. Figures are approximate only, as some data refer to 1975/1976, and other to 1977. Also items such as bond issues and private sector grants are omitted.

The relative stagnation of ODA is therefore likely to increase the relative deprivation of the least developed countries, and means need to be found to increase flows to the countries.

Within these income group breakdown, it is worth adding that in 1975/1976 private direct investment flows were divided as follows:

Asia and Oceania	42 per cent
Latin America	40 per cent
Africa	11 per cent
Europe	7 per cent.

In 1976, 9 countries (Brazil, Indonesia, Bermuda, Bahamas, Zaire, Argentina, Netherlands, Antilles, Peru and Philippines) accounted for 56 per cent private direct investment. The OECD Secretariat estimates that at the end of 1976 the stock of foreign private direct investment in developing countries amounted to $76 billion.

The number of developing countries which "addressed the market" for syndicated bank loans rose from 16 in 1971 to 54 in 1977, and developing countries' share in total syndicated bank lending is well over 50 per cent.1/ In 1977, 8 countries accounted for nearly 75 per cent of borrowing by non-oil, non-Southern European developing countries. The concentration is usually similar, although the composition of the dominant group varies from year to year. By and large, there is a relatively small group of countries with both adequate investment opportunities and a credit rating acceptable to lenders which dominates developing countries' international bank borrowing.

1/ See Annex 5.

(However, the relative dependency of small countries on the Eurocurrency markets may be as great as the larger ones, although their total borrowing is much smaller. For example, Brazil borrowed $93,500 per head of population over 1973-1977. This figure was exceeded by the Ivory Coast, Liberia, Nicaragua, Peru, Uruguay and Trinidad and Tobago, among others, none of which would be regarded as important borrowers. However, the market is important to them.)

A similar situation exists in the bond market, except the dominance of the few becomes even greater. By the end of 1977, 37 non-Southern European developing countries had issued foreign or international bonds. One or two more were added in 1978. In 1977, fewer than 20 countries tapped the market, and Mexico and Brazil placed nearly 80 per cent of the bonds issued. Apart from these two, Philippines, Algeria, Venezuela and Singapore, issues have always been small. The problem of perceived creditworthiness is even more acute in this market than in the syndicated loan market, as the bonds are traded on secondary markets. Given suitable conditions in the market, developing countries' bonds may be able to find increasing acceptance in the future. However, developing countries' bonds still account for under 10 per cent of the foreign and international bond market.[1/]

b) Terms of Financial Flows

Official Development Assistance

Annex 6 shows the terms on which ODA has been granted over recent years. The measure used to evaluate the package which constitutes aid terms is known as the grant element.[2/] The over-all grant element of ODA commitments by the DAC countries has varied between 86 per cent and 89 per cent over 1973-1977. The over-all interest rate has gone up from 2.4 per cent in 1973 to 217 per cent in 1977, and the maturity period fell below 30 years only in 1974. The grace period has also increased, from 8.4 years in 1973 to 10.8 years in 1977. The grant element of DAC loans has been around 60 per cent. The grant element of commitments to least developed countries has been over 90 per cent over 1973-1977. All these figures compare favourably with the standard set b the 1972 DAC Terms Recommendation, under which each donor committed itself to reach a minimum 84 per cent grant element in its ODA programme. In February 1978, the DAC adopted a recommendation that the figure be raised to 86 per cent.

However, it should be recalled that about one third of ODA goes to multilateral agencies rather than directly to recipient countries. To the extent that these agencies lend at harder terms the grant element figures quoted above are exaggerated, from the recipient countries' point of view.

1/ See Annex 5.

2/ There are different ways of measuring this, but following OECD it is done by estimating the present value of repayments discounted at 10 per cent, and expressing the PV as a percentage of the face value of the loan.

The other important aspect of ODA is the extent to which it is tied. For DAC countries as a whole the following data apply:

	1975 (per cent)	1976 (per cent)	1977 (per cent)
Tied assistance	49.8	39.2	39.0
Partly tied assistance	9.9	12.4	13.9
Untied assistance	40.3	48.3	47.1

Figures relate to gross disbursements.

SOURCE: OECD Development Co-operation Annual Reviews, 1976 and 1977.

The impact of tied aid often means that capital equipment has to be purchased at prices considerably above competitive international prices, which may erode any grant element very considerably. Numerous cases have been recorded of tied aid being less concessionary than untied commerical borrowing.

Multilateral Agencies

It is interesting to consider the lending performance of multinational agencies. In 1976 the figures were

	1970		1976	
	$ million	per cent	$ million	per cent
Concessional flows	445	20	2,312	31
Non-concessional flows	1,066	49	3,520	47
Grants	672	31	1,667	22
Total	2,183		7,499	

SOURCE: OECD Development Co-operation Annual Reviews.

Figures are for gross disbursements. The preponderance of non-concessional flows means that the grant element of this type of lending is rather lower than for bilateral aid. Again it is likely that the overwhelming majority of lending for manufacturing will be non-concessional by nature.

OPEC

Terms of OPEC funds are difficult to measure accurately. In recent years, concessional assistance has accounted for nearly 70 per cent of official disbursements of member countries. The following figures relate to concessional commitments only.

	1974 (percentage)	1975 (percentage)	1976 (percentage)
Percentage of grants in total commitments	64.6	48.2	62.9
Grant element of ODA loans	40.6	46.4	45.4
Over-all grant element	79.0	72.3	79.3

SOURCE: OECD Development Co-operation Annual Review 1977.

Thus terms tend to be harder than from DAC member countries. However, very little OPEC finance is tied (member produce very little equipment) which is a significant compensatory feature.

Centrally-planned Economies

The over-all grant elements of aid from USSR and China were:

	1975 (per cent)	1976 (per cent)
USSR	63.0	52.0
China	90.0	87.0

SOURCE: OECD Development Co-operation Annual Review 1977.

Eurocurrency Lending

Typically, this medium-term syndicated lending is made for perhaps 5 to 8 years, although recently 10 and even 12 years have not been uncommon, with a spread of anything from 0.5 per cent to 2.5 per cent over the three-month or six-month London Inter-Bank Offer Rate (LIBOR). The initial terms will depend fundamentally upon the state of the market, which fluctuates significantly. In 1972/1973 and again in 1977/1978, borrowing became very easy, and maturities lengthened and spreads narrowed. In 1978, a significant number of developing countries were able to borrow at spreads of 1 per cent or less which would have been inconceivable one or two years earlier. Grace periods of up to 4 years are sometimes available on repayment of principal and occasionally interest may be capitalised. Estimates of the true cost of borrowing on this market are very difficult to make precisely. First and foremost, LIBOR fluctuates considerably over time, as the data below shows.

Six-month Eurodollar Deposit Rates, London

(per cent per annum)

1973	1974	1975	1976	1977	1978 (6 months)	1978 (end)
9.24	11.19	7.60	6.13	6.23	8.10	12.0

SOURCE: World Financial Statistics (Morgan Guaranty Trust Company);
National Westminster Bank;
Financial Times.

In addition, variations arise in the basic spread agreed, changes in the spread agreed during the loan period (e.g. 1.5 per cent for the first 4 years, 1.25 per cent thereafter), agreed changes in the currency of denomination which may be made at certain intervals, renegotiation of terms on roll-over, the possibility of early repayment (with a penalty) so that a new loan may be taken out on more favourable terms, and the initial management fees.

Management fees will range from 1-4 per cent; for a prime borrower such as Norway up to 1 per cent of the loan amount. However, they really form a "package" with the spread, and the two cannot be considered independently. For example, Nigeria recently borrowed $ 1 billion with management fee of 1/16 per cent, but the spread was 1 per cent. Nigeria's second loan in 1978 has a management fee of 3/4 per cent, with a spread of 1 per cent for the first few years, and 1 1/8 per cent for the last few years, terms which are significantly harder. In addition, commitment fees of around 0.5 per cent may be charged, as may be participation fees to syndicate members taking a large share. The lead bank's expenses are usually paid also. Nor can the cost of borrowing (and its impact on debt servicing) be considered without reference to expected exchange rate fluctuations. Six-month Eurocurrency rates on DM and Swiss francs, for example, are notably lower than the rates on dollars or sterling, reflecting the markets' expectations of the relative movements of these exchange rates. Adverse movements in future can have a significant impact on the borrower's ability to service his debts.

Therefore, with such free market borrowing, a developing country does not know what the true cost will be until the loan is fully repaid. The increasing preponderance of Eurocurrency borrowings in the financial flows to developing countries means therefore that future debt servicing requirements become increasingly uncertain, and the problem of debt management that much greater. Therefore, it is likely that developing countries will run into debt servicing difficulties much more frequently, and that mechanisms may need to be found in the future to enable these problems to be solved more easily than at present.

Private Foreign Investment

The impact of PFI on a country's external financial flows lies in the repatriation of dividends and any local sale and repatriation of assets. Data on divident payments is neither comprehensive nor very recent, but the best available estimates are given below.

TABLE 2: Developing Country Stock of Foreign Investment and Dividend Payments ($ billion)

	1967	1971	1972	1973	1974	1975	1976
Foreign investment stock	32.8	43.3	n.a.	n.a.	n.a.	68.2	76.2
Dividend payments	4.44	5.99	7.60	9.80	16.4[a/]	n.a.	12.6[b/]

NOTE: a/ Preliminary.
b/ Unofficial OECD estimate (possibly an under-estimate).
UNCTC data covers 61 countries

SOURCES: 1967-1975: Transnational Corporations in World Development: A re-examination (UN Centre on Transnational Corporations, 1978);
1976: Development Co-operation (1978 Annual Review), OECD.

Conclusions are difficult to arrive at, but it appears that income payments on capital rose from about 12.5 per cent in 1967 to over 25 per cent in 1974 (in view of the 1975 capital stock). To some extent this reflects the financial depreciation of assets, but the rapid increase in both assets and income payments suggests that rates of return earned by DPFI have increased sharply in recent years. The data suggests that income payments may have been running at about $ 23 billion by 1976. Moreover, considered as only a source of funds, DPFI gives the impression of being significantly more expensive than borrowing on the Eurocurrency market.

Portfolio Investment

The majority of portfolio investment in developing countries is done through foreign or international bonds. These are denominated in various currencies, although about 70 per cent tends to be in dollars. The table below sets out representative rates for industrialised and developing countries and international agencies (e.g. IBRD, EEC, etc.).

Offer Yield of Publicly Offered Bonds
(per cent on dollar bonds)

Location of borrower	1975	1976	1977
Industrialised countries	8.95	8.63	8.48
Developing countries	9.60	8.88	9.22
International organisations	8.66	7.97	7.40

SOURCE: Estimates based on data in Borrowing in International Capital Markets, various issues (IBRD).

Even though the bond markets are effectively restricted to the higher income developing countries, they still have to pay a significant premium over industrialised countries, as they are less well established borrowers and regarded as "higher risk". International agencies, of which the IBRD is a substantial borrower, obtain the lowest yields, as they are backed with industrialised Government guarantees.

Other currency denominations have different interest rates. For example, representative Deutsch Mark bonds were issued in 1977 as follows:[1/]

Industrial country borrowers	5.93 per cent
Developing country borrowers	7.08 per cent.

Finally, a few floating rate bonds have been issued which carried an initial yield of 0.25 per cent above LIBOR in 1976.[1/]

Generally speaking, the interest rates on bonds are lower than on Eurocurrency loans, although maturities now tend to be shorter. However, there is not the facility available to renegotiate them if desired, as they are traded in secondary markets.

In this context it is interesting to note the Arab currency bonds mentioned earlier. These had coupons of between 8.0 per cent and 9.0 per cent generally, and maturities of up to 10 years.

Bonds have tended to be medium term for developing country issuers. In the first quarter of 1977, for example, over 50 per cent of developing country bonds were in the 5.01 to 7.0 year bracket, and only 15 per cent in the 7.01 to 10 years' bracket.[2/] However, in the second quarter of 1978, 40 per cent of international bonds issued by developed countries had a 7 to 15-year maturity, while 57 per cent of developing country bonds fell in this range.

1/ Borrowing in International Capital Markets, various issues.

2/ Borrowing in International Capital Markets, IBRD, June 1977.

Export Credits

The terms of export credits are generally determined by the Berne Convention of 1934. All signatures to the Convention agree to supply export credits on similar terms, which at present applies to credits up to 7 or 8 years at about 7.5 per cent interest. Sometimes these figures are shaved, but not by very much. In the last 2 years there has been an increased tendency for the signatories to become slightly more competitive, especially through the provision of special lines of tied credit to individual countries.[1/]

As capital goods manufacturing in developing countries grows, it will be necessary to support them with government-backed export credit schemes. Several developing countries have been slow to establish such schemes and have thereby placed their incipient capital goods industries at a disadvantage to the rest of the world's exporters. Such finance not only helps manufactured exports to the industrialised countries, but also to other Third World countries, thereby encouraging trade flows on a South-South basis.

The Impact of Inflation

Inflation helps to reduce the real cost of borrowing. However, this is true only if the borrower's currency does not deteriorate relative to the loan currency. Apparently low coupon loans in hard currencies can turn out to be very expensive.

Conclusion

Because of the greatly increased proportion of commercial money in the flows to developing countries, over-all terms of finance have definitely hardened during this decade. This will make future debt servicing more difficult, and suggests that mechanisms should be sought to soften the terms of commercial funds.

c) The Debt Service Burden of Developing Countries

The debt service burden is the other side of the coin to the volume and terms of financial flows to developing countries. Debt service consists of payments of principal and interest. Payments of principal have already been covered implicitly, in that the volume flows discussed earlier were net of repayments of principal (but not interest). Therefore one needs to consider the net flows plus interest payment requirements in future. Attention will therefore be given to interest payments more than principal.

1/ The OECD Group on Export Credits and Credit Guarantees agreed in 1978 to restrict the maximum repayment period to 5-10 years, and minimum interest rates to between 7.25 per cent and 8.0 per cent, both depending on the income group to which the recipient belongs.

Unfortunately the two major sources of data on debt, OECD and IBRD, are not compatible. The World Bank's Debtor Reporting System covers 84 countries, whereas the OECD/IBRD Expanded Reporting System covers some 140 developing countries. The two main sources of published data, IBRD's World Debt Tables and OECD's Development Co-operation: Annual Reviews, each follow their respective systems. Generally the method here has been to follow the more comprehensive OECD data, but the fuller analysis in IBRD's World Debt Tables make it desirable to refer to them from time to time. The OECD figures have the disadvantage of including developing European countries.

Annex 7 shows total debt of developing countries (disbursed) at year end during 1960-1977 by source of lending. OECD estimates of debt service are also shown in Annex 8. Both debt and debt service have grown at fast rates in recent years.

Debt Service: Debt Ratios (OECD data)

(per cent)

	1961	1965	1970	1971	1972	1973	1974	1975	1976	1977
Debt service: debt	14.5	15.1	14.0	14.5	15.5	17.1	17.6	19.0	18.5	17.2
Interest: debt	3.9	4.0	4.2	4.3	4.6	5.3	5.9	7.1	5.8	6.2

NOTE: Estimates are based on debt figures relating to the beginning of the year (i.e. end of previous year).

SOURCE: Derived from Annexes 7 and 8.

It is clear that the last five years have seen an increase in the debt service: debt ratio. This is to be expected and reflects the higher proportion of commercial money in developing country borrowing and the higher debt service obligations which it implies. Similarly, interest: debt has increased. Although the future ratios will depend upon the structure of borrowing, it is not likely to decline, given the now established importance of borrowing from commercial sources.

Details of debt and debt service by income group are shown in Annex 9. Again, it is clear that debt service falls most heavily on the middle income and oil producing developing countries which are the countries most dependent on commercial borrowing.

The vast majority of developing country debt is either incurred by or guaranteed by the public sector. The IBRD estimated that private sector debt without a government guarantee at the end of 1976 was "between $ 20 and $ 22 billion for non-oil developing countries other than those in the Mediterranean region".[1/] Such borrowing, of course,

1/ IBRD World Debt Tables, Vol.I (EC 167/77).

requires a strong, creditworthy private sector, capable of borrowing wi[illegible]out government guarantee, and only a handful of developing countries, such as Mexico, fall into that category.

Other ratios which may be significant to consider are debt to GNP and to exports.

Ratios of Public Debt[a] to GNP and Exports and of Debt Service to Exports 75 Non-Oil Developing Countries 1973-1976

(per cent)

	1973	1974	1975	1976[b]
Debt to GNP	11.9	1[illegible].9	13.4	15.0
Debt to exports	76.5	71.1	85.0	88.9
Debt service to exports	10.1	8.4	9.9	10.0

a/ Outstanding, disbursed only.

b/ Estimated.

SOURCE: IBRD World Debt Tables, Vol.I (EC 167/77).

The debt service ratio is perhaps useful only as an indicator of the extent to which a country's export earnings are spoken for. The above table accounts for over 60 per cent of all developing country debt service, so it is a useful indicator of magnitudes. Although none of the ratios above can be described as unduly high, they do tend to disguise differences which arise between countries. An examination of individual debt service ratios[1] also suggests that there is a good correlation between high debt service ratios and high income per head. Not only do the wealthier countries borrow more commercial money, they also borrow more in total, as they have the greater potential to invest the funds and obtain good rates of return. A number of countries have limited scope to increase their indebtedness beyond the rates of growth of their GNP and exports in that they are already up against their borrowing limits.

Debt and Economic Development

A high level of indebtedness is sometimes regarded as a constraint on a country's economic development, and the problem of the "debt burden" has from time to time been "solved" by writing off some of an individual country's debts (e.g. India and Pakistan). However, if debts in relation to balance of payments seem to be acting as a constraint on a country's development, it is likely that the appearance of a debt service burden is more of a sympton than a disease. OECD comments[2] "In relation to exports, (debt service) deteriorated markedly for most low income countries where official debt

1/ See World Debt Tables, Vol.I (World Bank EC 167/77).

2/ Development Co-operation, Annual Review 1977, page 29.

constitutes about one half of total debt and gives rise to about one third of total debt service. This was not so much the result of growth of debt, but of relatively weak export performance and disappointingly low external assistance". Thus increased trade becomes an important factor in enabling developing countries to take on and service more debt which makes the expansion of their trade an important consideration in obtaining future investment finance.

OECD also expresses concern that increasing indebtedness may discourage private capital flows. This may be an inaccurate reading of the situation, as some countries with high debt service ratios (e.g. Mexico) continue to receive substantial private capital flows, of which a significant amount is not guaranteed. It is likely, for example, that non-economic considerations such as political stability play a greater part in determining a country's creditworthiness, together with the availability of promising investment opportunities.

Profit Remission

Data on dividend payments were given in table 2. Compared with other debt servicing discussed above, of $19.8 billion in 1974, and $15.9 billion in 1973, the figures are substantial and represent a serious financial outflow. Nor do they include other outflows associated with direct private foreign investment, such as royalties and management fees. Any element of transfer pricing would also effectively increase the figures.

Total Interest Payments

Taking into account interest on debt and dividends on private foreign investment, the following results are obtained:

	1967	1971	1972	1973	1974	1976
			($ billion)			
Interest on debt	1.7	3.2	3.8	4.9	6.6	11.4
Income payments	4.4	6.0	7.6	9.8	16.4	12.6 a/
Total	6.1	9.2	11.4	14.7	23.0	24.0
Total: previous years' total net inflow (per cent)	n.a.	50	56	59	68	45 a/

a/ Possibly an under-estimate.

SOURCE: Derived from table 2 and Annex 8.

Thus payments of interest on debt and income on investments account for a high (and increasing) proportion of net financial flows. This implies that a relatively small proportion of net financial flows are used "productively", and suggests that the debt service burden in this sense is very heavy. But it should be recalled that net inflows exclude short-term loans of less than one year which might alter the picture somewhat. The Independent Commission on International Development Issues states that these amount to some $50 billion, mostly trade credits.

Conclusion

The increase in borrowing together with the increasing share on commercial finance has led to a rapid increase in debt and the debt service burden. The World Bank predicts an increasing current account deficit of non-oil developing countries[1/] which will increase the need for financial inflows and increased debt. Consequently, the debt management problems faced by individual countries are likely to increase in complexity, leading to an increased number of cases of "default", unless measures are introduced to alleviate the problem. The problem is made more difficult by the potential volatility of the world's financial markets, and the impact it may have on developing country debt service charges and new borrowing possibilities. Developing countries may need to be cushioned from this volatility.

The instances of debt crises have been relatively few, but when they do occur they illustrate the lack of any agreed procedure for handling them. Action is usually organised by the major creditors (often international banks), sometimes supported by IMF intervention. The latter tends to be unpopular and leads to a sense of heavy handed "economic imperialism" being exercised by the industrialised countries. There is a need for mechanisms which can perceive the possibility of debt crises well before they arise, and which can circumvent them. There is also a need for more sensitive and imaginative methods of handling them when they do arise. These methods should recognise the entitlement of developing countries to concessional assistance from the developed, and should ensure that the mass of population does not suffer a loss of welfare as a result of any measures which may be imposed. Above all, economic development should not be curtailed.

d) Recent Developments in Developing Country Financing

An interesting feature of international money and capital markets in recent years has been the establishment of markets in Third World countries. Arab finance houses, particularly in Kuwait, have been active in lead managing Eurobond issues since 1974, and an increasing number are participating in lead management groups. In addition, they have floated bonds denominated in Arab currencies, and a secondary market trading company has been established to create a market in such bonds. Both Arab currency bonds, and the participation of Arab finance institutes in syndicated Eurocurrency loans provide important mechanisms for the future mobilisation of Arab funds.

1/ World Development Report, 1978.

Developing countries have already been significant borrowers through Arab currency bonds. Of the 29 bonds issued in 1975, 1976 and the first quarter of 1977, 17 were issued by developing countries, 3 of which are obviously for industrial use.[1/] As Arab financial institutes gain further experience, their potential for lending Arab currency bond issues will increase. Already they have co-managed a significant number of Euro-currency loans. 32 of the 147 such loans made between 1974 and 1977 were raised by developing countries, totalling $607 million. Clearly such loans are potential sources of finance for industry.[1/]

Within Latin America, international capital flows have been growing since the mid 1960's, mainly from the higher income, larger market economies to the less developed countries of the region. The IDB reports that "the net annual flow of long-term official and private loans mobilised between these countries rose from just under $ 8 million in 1966-1967 to $ 80 million in 1969-1971 and more than $ 300 million in 1973-1974".[2/] These figures are based on financial obligations reported in the external public debt of the Latin American countries, and the report continues "Total capital flows, with and without public guarantee in the debtor countries, including direct and portfolio investment, no doubt exceed the figures mentioned above". The IDB considers the development of this capital market to be of "high importance for the region's development".

The other major regional market is based on Signapore. There is an established off-shore currency market, Asian currencies, along the line of Eurocurrencies, but, of course, much smaller.

The market is estimated to have had assets of $1,000 million in 1971 and $15,000 million by June 1976[3/]. (Further Eurocurrency centres exist in Nassau and Panama.) Economically, the importance of these markets is the extent to which they mobilise funds which otherwise would not have been mobilised. Apart from that, they merely handle funds which have been counted elsewhere.

The Singapore Asian currency market[4/] was first established in 1968 and has grown at a rate well beyond even the most optimistic expectations. There is a net flow of funds from Europe and America to Singapore, and Wellons estimates that "non-residents probably receive nine-tenths of all Asian Currency Unit (ACU) lending to non-banks". By the end of 1974, loans to non-banks accounted for 27 per cent of all ACU assets, which totalled around $ 10 billion. Therefore non-bank lending amounted to $2,700 million. Substantial borrowers are located in Indonesia, and formerly in the Philippines, until

1/ Euromoney, August 1977.

2/ Economic and Social Progress in Latin America (Annual Report 1975), IDB.

3/ P.A. Wellons, Borrowing by Developing Countries on the Eurocurrency market (OECD, 1977), quoting the monetary authority of Singapore.

4/ Much of the following is taken from P.A. Wellons, op.cit.

its Government decided that Manila should become a competing financial centre. Thailand and Malaysia each absorb a little. Japan and Hong Kong are substantial borrowers, and loans have been made to South Korea, Taiwan and Guam, and to Fiji and Tahiti. Very few Indian loans were recorded. Australia and New Zealand are both heavy borrowers. Loans have gone to developing countries in Africa and Europe (Greece and Yugoslavia). Borrowers are both public and private, with the former probably predominating.

Lenders prefer to provide project finance, and private sector borrowing is mainly for this purpose. Manufacturing, especially textiles, is preferred, while many shipping loans are made. Trade and mining take little, although property took a lot in the boom of 1972 and 1973, but is no longer a significant borrowing sector. Government borrowing tends to be for balance of payments or non-specific purposes. However, it is clear that the market is a major supplier of funds to industry in the private sector.

Medium and long-term lending tends to be conducted on terms similar to Eurocurrency lending, although Singapore has its own base rate, SIBOR, an equivalent to London's LIBOR. The two move very closely together.

The prospects for the continued expansion of the market appear favourable. It should therefore develop as a major supplier of commercial finance for industrial investment in the Far-East region. Moreover, the development of similar markets based in Panama and Nassau can provide similar industrial finance for the Latin American region. These regional markets are able to provide facilities to many borrowers in the area who, because of their relatively small size and lack of knowledge about them, would not be able to raise funds in the European centres. Therefore such regional markets can fill an important gap in the market for overseas finance for industrial investment and other uses.

Complementary Financing (Co-financing)

Initiated by the IBRD and IDB, co-financing is a procedure to marry multilateral agency finance to private capital finance, usually Eurocurrency. The agencies are willing to lend long, but have relatively low supplies of funds, whereas private banks lend medium term, but have ample funds. Therefore the combination of the two can provide the necessary volume of finance and a good debt repayment structure for the larger projects. The private banks get the benefit of the thorough project appraisal and management procedure of the multilateral agencies. The private banks may also feel that they benefit from "cross-default" clauses, in that if the borrower defaults on one loan, the other lender may terminate its loan agreement. It appears that with co-financing the private bank may be prepared to lend on easier terms.

Although the technique is still in its infancy, the World Bank supported eight co-financed projects in 1976-1977, putting in $ 340 million of Eurocurrency loans. Five of the projects were industrial, and one other was an industrial credit line to a national

development bank. It is clear that the industrial sector stands to gain from the development of co-financing. To what extent it will generate investment funds is unclear. However, at a time when bankers are having some doubts about the prudence of heavy lending to developing countries, it provides a method of Eurocurrency financing which banks can enter into with comparative confidence. It will also encourage a switch from "general purpose" lending to project lending.

Summary

The rapid increase in developing country borrowing requirements over the last decade has been largely met by the operation of the world's financial markets. The consequence is that the debt service burden of developing countries has increased sharply, and terms of commercial finance have made debt management more difficult. If the Lima target is to be approached, much more finance for industrial investment will be needed. The increase in aid, borrowing and direct investment, and the consequent increase in indebtedness, is likely to substantially increase the financial dependency of the South on the North, unless measures are found which reduce this dependency. Moreover, the South has become very exposed to the financial strength of the North through dependency on debt refinancing. The nature of much of the loan financing places almost all the risk on the developing country borrowers, and methods should also be sought which reduce this form of financial dependency. By now, any inability or unwillingness of North-based banks to refinance developing country debt could lead to numerous cases of "default", which in turn could lead to crises in the banking system. It is therefore essential that developing countries and the leading sources of finance should recognize their mutual interests, and develop relationships in a framework of co-operation and on a more equal footing than has been the case until now. The object of subsequent sections of this report is to propose mechanisms which will help to alleviate the problems touched upon in this section.

Total Net Resource Receipts of Developing Countries from all Sources

($ billion)

Net Disbursements	1970	1971	1972	1973	1974	1975	1976	1977
ODA	8.04	8.94	9.72	11.57	15.23	19.48	18.74	19.54
DAC bilateral	5.66	6.32	6.63	7.10	8.26	9.81	9.51	10.08
Multilateral agencies	1.10	1.33	1.39	2.00	2.85	3.84	3.87	(5.00)
OPEC bilateral	(0.50)	(0.50)	(0.60)	1.21	3.02	4.95	4.54	3.76
Centrally-planned economies	0.78	0.79	1.10	1.26	1.11	0.88	0.82	0.70
Non-concessional flows	8.66	9.92	11.90	18.42	17.73	31.70	34.20	44.39
DAC bilateral - non-bank sector	7.16	7.44	7.01	8.43	6.97	18.08	16.08	22.60
Multilateral agencies	0.69	0.90	1.00	1 28	1.80	2.58	2.73	(3.10)
OPEC bilateral	(0.10)	(0.10)	(0.10)	0.14	0.92	1.50	1.61	0.86
International bank lending a/	0.60	1.38	3.68	8.47	7.95	9.45	13.70	17.80
Centrally-planned economies	0.11	0.10	0.11	0.10	0.09	0.09	0.08	0.03
Total receipts	16.70	18.86	21.62	29.99	32.96	51.18	52.94	63.93
Less receipts of Southern European countries b/	n.a.	n.a.	1.20	1.40	3.00	2.60	3.60	5.80
Total receipts by "Lima Group" countries	n.a.	n.a.	20.42	28.59	29.96	48.58	49.34	57.13
Receipts of oil-producing developing countries c/	n.a.	n.a.	2.00	3.20	0.60	4.70	5.20	3.50
Memorandum items								
Private sector grants (grants by voluntary agencies)	0.86	0.91	1.04	1.37	1.22	1.34	1.35	1.49
Selected IMF facilities d/	-	0.08	0.33	0.14	1.26	2.76	3.08	0.42

Annex 1

Explanatory Notes to Table in Annex 1

a/ From banks in DAC countries and their affiliates in financial centres. Data for 1977 and 1976 are estimates of net new lending with a maturity of over one year, based on BIS figures. Data for earlier years are estimates, based on statistics of publicised syndicated bank credits, of the corresponding net flows.

b/ Cyprus, Gibraltar, Greece, Malta, Portugal, Spain, Yugoslavia.

c/ OPEC, less Indonesia and Nigeria.

d/ "Oil facility", "compensatory drawings" and "extended fund facility"; loans by the IMF Trust Fund of $ 175 million in 1977 are included under ODA flows from multilateral agencies.

NOTE: Figures concerning non-DAC member countries are based as far as possible on information released by donor countries and international organisations, and completed by OECD Secretariat estimates based on other published and unpublished sources. It has therefore not been possible fully to verify that they comply in all respects with the norms and criteria used by DAC members in their statistical reports made directly to the OECD Secretariat.

SOURCE: Development Co-operation (Annual Reviews 1976-1978), OECD.
See also Annex 2.

Annex 2

Non-Concessional Flows - DAC Bilateral - Non-Monetary Sector

($ billion)

	1970	1971	1972	1973	1974	1975	1976	1977
New official and private export credits	2.8	3.3	2.2	2.3	3.2	5.5	7.2	10.4
Net private direct investment	3.7	3.3	4.2	4.7	1.1	10.5	7.8	8.9
New foreign and international bond issues a/	0.3	0.4	1.0	1.3	0.9	0.9	2.2	4.2

a/ Excluding bonds issued by multilateral agencies.

NOTE: Southern European countries and Israel are included in the above totals. Totals do not exactly tally with the non-monetary sector in Annex 1.

SOURCES: Export credits and direct investment from Development Co-operation (various annual reviews), OECD;

Bond issues: Development Co-operation (1978 Annual Review) and IBRD (Borrowing in International Capital Markets).

Annex 3

Lending to Southern European Countries

In order to put the data on a comparable basis with the Lima projections, it is necessary to subtract the flows to Southern European countries. These are as follows:

Financial Flows to Southern European Countries[a/]

($ million)

	1972	1973	1974	1975	1976	1977
Official development assistance	53	147	92	95	172	229
Other official flows	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Official and private export credits	166	53	342	538	1,009	1,258
Grants by voluntary agencies	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Private direct investment	300[b/]	500[b/]	974	810	431	500[b/]
Portfolio investment[c/]	200[b/]	133	93	117	327	547
Total DAC countries	719	633	1,501	1,560	1,939	2,634
Centrally-planned economies d/	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
OPEC	n.a.	n.a.	137	74	220	40
International bank lending b/	500	800	1,400	1,000	1,400	4,222[e/]
Total net borrowing	1,219	1,433	3,038	2,634	3,559	6,796

a/ These are Spain, Greece, Yugoslavia, Cyprus, Malta, Portugal and Gibraltar.

b/ Author's estimate.

c/ Bonds only.

d/ Thought to be small.

e/ Development Co-operation (Annual Review 1978), OECD.

SOURCES: OECD data, IBRD, author's estimates.

Distribution of Funds by Recipient Income Group

ODA Commitments to Non-Oil Developing Countries 1970 and 1977

(geographically allocated amounts)

	Total				Of which ($ billion)					
					Bilateral					
	1970		1977		DAC		OPEC		Multilateral	
Group	$ billion	Percentage	$ billion	Percentage	1970	1977	1970	1977	1970	1977
Low income countries	3.9	53.4	15.5	62.3	3.0	7.7	0.2	2.5	0.7	5.3
(of which least developed countries)	(0.6)	(8.2)	(5.1)	(20.4)	(0.4)	(2.2)	a/	(1.2)	(0.2)	(1.7)
Low middle income	2.0	27.4	5.6	22.5	1.5	2.7	0.2	1.1	0.3	1.8
Upper middle income	1.1	15.1	2.1	8.4	0.8	1.6	-	0.1	0.3	0.3
Higher income	0.3	4.1	1.7	6.8	0.3	1.4	-	0.3	b/	b/
Total c/	7.3	100.0	24.9	100.0	5.6	13.4	0.4	4.0	1.3	7.5

a/ Less one half the smallest unit shown.

b/ Incomplete.

c/ Excluding geographically unallocated commitments and commitments from countries with centrally-planned economies.

SOURCE: Development Co-operation (Annual Review 1978), OECD.

Distribution of Certain Categories of Net Non-Concessional Flows to Non-Oil Developing Countries a/ Annual Averages or 1977, as stated

($ million and percentage of total)

	Export credit		Private direct investment		International bank lending b/
	1969/1971	1975/1976	1969/1971	1975/1976	1977
Low income	198 (9%)	1,075 (22%)	259 (14%)	1,324 (21%)	498 (1%)
of which least developed countries	32 (2%)	179 (4%)	14 c/	56 (1%)	4 c/
Lower middle income	671 (30%)	1,727 (36%)	416 (23%)	1,088 (17%)	3,572 (26%)
Upper middle income	959 (43%)	1,477 (30%)	904 (49%)	2,378 (38%)	5,570 (41%)
Higher income	384 (18%)	587 (12%)	256 (14%)	1,458 (24%)	3,982 (29%)
Total	2,213 (100%)	4,865 (100%)	1,836 (100%)	6,248 (100%)	13,622 (100%)
Memo: OPEC countries except Indonesia and Nigeria	660	1,384	301	114	4,153

a/ Geographically allocated amounts only.

b/ Secretariat estimates, based on BIS data of over one-year lending by DAC banks and their foreign affiliates, wherever located, to developing countries other than offshore financial centres.

c/ Incomplete.

SOURCE: Development Co-operation (Annual Review 1978), OECD.

Annex 5

Developing Countries' Shares of International Capital Markets

	1975	1976	1977
		($ billion)	
Total borrowing	43.3	63.0	69.0
of which developing country borrowing	13.2	19.6	24.7
Total publicised Eurocurrency credits	20.6	28.7	34.2
of which developing country borrowing	12.5	17.3	20.2
Foreign international bond issues	22.8	34.3	34.9
of which developing country borrowing	0.7	2.3	4.5
Developing countries' percentage of Eurocurrency borrowing	61	60	59
Developing countries' percentage of bond market	3	7	13

SOURCE: Data from Borrowing in International Capital Markets, IBRD, September 1977 and September 1978.

NOTE: Developing countries include developing European countries and Israel which account for the following:

	1975	1976	1977
		($ billion)	
Bond issues	0.4	0.6	0.9
Eurocurrency borrowing	1.0 a/	1.4 a/	4.2

a/ Estimates.

NOTE: IBRD and OECD figures do not always agree exactly.

SOURCE: Development Co-operation (Annual Review 1978), OECD.

Annex 6

General Summary of Terms of Performance

ODA Commitments of DAC Members

	1973	1974	1975	1976	1977
Total ODA commitments	12,930	15,126	16,562	19,418	21,392
Percentage of grants in total commitments	66.2	65.4	69.0	69.6	72.1
Over-all grant element of total ODA (percentage)	87.5	86.0	88.3	88.5	89.3
Grant element of ODA loans (percentage)	63.0	59.5	62.3	62.3	61.5
Grant element of commitments to least developed countries (percentage)	91.2	93.1	95.6	92.1	94.2
Maturity of loans (years)	32.0	28.9	32.6	32.8	32.2
Interest rate of loans (percentage)	2.4	2.6	2.5	2.6	2.7
Grace period (years)	8.4	7.7	9.1	9.0	10.8

SOURCE: Development Co-operation (various Annual Reviews), OECD.

Total Debt of Developing Countries[a/] (disbursed), at year end, during 1960-1976 by Source of Lending

($ billion)

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
DAC countries	14.3	16.3	18.6	21.8	25.5	29.3	33.5	38.6	44.6	51.0	57.9	64.9	69.5	77.5	90.2	110.4	124.7	137.9
ODA	5.0	6.0	7.0	8.7	10.3	12.0	13.7	15.9	18.0	20.3	22.6	24.0	25.2	27.5	30.2	33.5	36.0	38.4
Total export credits	6.9	7.4	8.1	9.1	10.5	12.0	13.7	15.7	18.5	21.0	23.8	27.5	28.5	31.0	34.0	43.4	50.2	57.5
Other (private) b/	2.4	2.9	3.5	4.0	4.7	5.3	6.1	7.0	8.1	9.7	11.5	13.4	15.8	19.0	26.0	33.5	38.5	42.0
International financial markets	-	-	-	-	-	-	-	-	-	0.3	0.5	1.9	5.0	12.0	17.5	24.2	37.8	47.3
International organisations	2.8	3.0	3.3	3.6	4.1	4.6	5.2	5.8	6.5	7.3	9.2	10.6	12.6	14.9	18.1	22.5	27.5	33.0
Centrally-planned economies	0.7	1.5	2.0	2.2	2.6	3.0	3.2	3.7	4.3	5.0	5.6	6.2	6.8	7.6	8.5	9.2	9.8	10.6
OPEC countries	-	-	-	-	-	-	-	-	-	-	-	-	0.1	0.9	3.5	6.0	7.9	10.0
Other developing countries	0.1	0.1	0.1	0.1	0.2	0.2	0.3	0.3	0.4	0.6	0.9	1.0	1.2	1.5	2.1	2.5	2.9	3.4
Other and adjustments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	0.5	1.5	1.8
Total	17.9	20.9	24.0	27.7	32.4	37.1	42.2	48.4	55.8	64.2	74.1	84.6	95.2	114.4	139.9	175.3	212.2	244.0
Annual increase in percentage	-	17	15	15	17	15	14	15	15	15	14	14	13	20	22	25	21	15

a/ Including intra developing country debt.

b/ Bank loans, foreign bonds, nationalisations and other.

c/ Eurocurrency credits, Eurobonds and other.

NOTE: In 1976, debt of developing European countries was $19.2 billion, included above (9 per cent of the total). Figures exclude debt to IMF, short-term debt and for most countries, military debt.

SOURCE: Development Co-operation (Annual Review), OECD.

Total Annual Debt Service of Developing Countries[a] during 1960/197 by Source of Lending

($ billion)

Source of Lending	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977
DAC countries	2.4	2.5	2.7	3.3	3.6	4.2	4.8	5.3	6.2	7.3	7.6	8.8	10.4	12.5	14.8	13.1	21.8	25.4
ODA	0.4	0.5	0.5	0.7	0.8	0.9	1.0	1.0	1.1	1.1	1.3	1.4	1.6	1.7	1.7	1.8	1.9	1.9
Total export credits	1.7	1.7	1.8	2.0	2.1	2.4	2.7	3.0	3.6	4.4	4.5	5.1	610	7.4	817	10.7	12.6	15.0
Other (private)	0.3	0.3	0.4	0.6	0.7	0.9	1.1	1.3	1.5	1.8	1.8	2.3	2.8	3.4	4.4	5.6	7.3	8.5
International financial markets	-	-	-	-	-	-	-	-	-	-	-	0.3	0.6	1.4	2.9	3.7	4.9	5.0
International organisations	0.2	0.3	0.3	0.4	0.4	0.5	0.5	0.6	0.6	0.7	0.8	0.9	1.1	1.2	1.4	1.7	2.1	2.5
Centrally-planned economies	-	0.1	0.1	0.1	0.2	0.2	0.2	0.3	0.3	0.4	0.5	0.5	0.6	0.7	0.8	0.8	0.9	1.0
OPEC countries	-	-	-	-	-	-	-	-	-	-	-	-	-	-	0.1	0.2	0.3	0.4
Other developing countries	-	-	-	-	-	-	-	-	-	-	0.1	0.1	0.2	0.2	0.3	0.4	0.5	0.6
Other and adjustments	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	0.4	0.7	0.7
Total	2.6	2.9	3.1	3.8	4.2	4.9	5.5	6.2	7.1	8.4	9.0	10.6	12.9	16.0	20.3	25.2	31.3	36.6
(Annual increase in percentage) of which:	-	(12)	(7)	(23)	(11)	(17)	(12)	(13)	(15)	(18)	(7)	(18)	(22)	(24)	(27)	(24)	(24)	(17)
Interest	0.6	0.7	0.8	0.9	1.1	1.3	1.5	1.7	1.9	2.4	2.7	3.2	3.8	4.9	6.6	9.1	11.4	13.2
Amortisation	2.0	2.2	2.3	2.9	3.1	3.6	4.0	4.5	5.2	6.0	6.3	7.4	9.1	11.1	13.7	16.1	19.9	23.4

a/ Including intra developing country debt service.

NOTE: In 1976, debt service of developing European countries was $[illegible].2 billion.

SOURCE: Development Co-operation (Annual Reviews), OECD.

Total Debt of Developing Countries (Disbursed) at Year End and Total Annual Debt Service during 1970-1977 by Group of Developing Countries

($ billion)

Group		1970	1971	1972	1973	1974	1975	1976	1977
Least developed countries	D	2.2	2.4	2.8	3.9	5.0	7.5	9.6	12.1
	DS	0.2	0.2	0.3	0.3	0.5	0.5	0.6	0.6
Most seriously affected countries	D	19.0	21.6	23.7	27.2	31.0	35.6	42.5	48.6
	DS	1.6	1.7	2.0	2.2	2.5	3.0	3.5	4.0
Poorer countries a/	D	15.1	16.9	18.7	21.3	23.9	27.9	33.3	38.9
	DS	1.0	1.1	1.3	1.4	1.7	2.0	2.0	2.2
Other non-oil developing countries	D	47.3	53.3	59.8	70.7	91.6	118.4	144.0	166.2
	DS	7.0	8.0	9.3	11.6	14.5	18.0	22.6	26.4
Total non-oil developing countries b/	D	62.4	70.1	78.5	92.0	115.5	146.3	177.3	205.1
	DS	8.0	9.1	10.6	13.0	16.2	20.0	24.6	28.6
OPEC countries c/	D	11.7	14.5	16.7	22.4	24.4	29.0	35.0	38.9
	DS	1.0	1.5	2.3	3.0	4.1	5.2	6.7	8.0
Total developing countries	D	74.1	84.6	95.2	114.4	139.9	175.3	212.2	244.0
	DS	9.0	10.6	12.9	16.0	20.3	25.2	31.3	36.6

a/ Countries with per capita GNP of $265 or less in 1975, not including Indonesia.

b/ Non-OPEC countries.

c/ Including Indonesia and Nigeria.

SOURCE: Development Co-operation (Annual Review 1978), OECD.

PART II: THE FLOW OF FINANCE TO INDUSTRY

The Investment Background

Before looking at external finance allocated to industry, it may be helpful to look at the overall pattern of investment in developing countries.

TABLE 1: Gross Domestic Investment
(current $ billion)

	1960	1967	1968	1969	1970	1971	1972	1973
Africa	3.64	6.90	8.07	8.88	11.24	14.44	15.24	15.98
Asia	11.33	17.47	19.37	21.68	24.35	27.44	27.75	36.74
Latin America	13.45	18.84	31.48	23.81	26.66	30.17	39.07	51.53
Developing Europe	5.13	13.05	14.47	16.83	18.13	19.64	23.74	31.23
Total	33.55	56.26	63.39	71.20	80.38	91.69	105.80	135.48

SOURCES: World Tables 1976 (World Bank); United Nations Monthly Bulletin of Statistics.

NOTE: Data on investment are not very satisfactorily compiled in many countries, and 1973 represents the latest year for which comprehensive data are available. In current terms, total investment has grown at about 11 per cent per year.

Manufacturing Investment

The data available on manufacturing investment in developing countries from the usual sources are incomplete, conflicting and in some cases, obviously incorrect. Therefore, it is not possible to present complete past data on manufacturing investment. This statistical shortcoming is unfortunate, and the subject may merit further research and enquiry. The approach adopted has been to take data from those countries for which it is available, and compare it with gross domestic investment in those countries. This has been done for 1972, the latest year for which substantial data are available. The results are as follows:

	Number of countries covered	Gross manufacturing investment as per cent of gross domestic investment
Africa	26	17.0
Asia and Middle East	16	13.5
Latin America	12	21.1
Developing Europe	7	19.7
Total	61	18.05

The coverage of 61 countries is reasonably comprehensive.

Data were compiled from the United Nations Monthly Bulletin of Statistics, and World Bank Tables (1976).

The percentages may be applied to figures of total gross domestic investment for each region to obtain estimates of manufacturing investment. However, these estimates should be regarded as orders of magnitude only.

	Gross domestic investment 1972 ($ billion)	Factor per cent	Estimated manufacturing investment ($ billion)
Africa	15.2	17.0	2.6
Asia and Middle East	27.8	13.5	3.7
Latin America	39.1	21.1	8.2
Developing Europe	23.7	19.7	4.7
Total	105.8		19.2
Excluding Developing Europe	82.1		14.5

Therefore, for the developing world manufacturing investment was about 18 per cent of domestic investment in 1972.

External Finance for Industry

At the outset, it should be emphasised that investible funds for industry are intimately connected with flows of funds for other purposes. For example, if available funds are fixed, investment in industry diverts funds from alternative uses in other sectors. Alternatively, the provision of additional finance for an industrial project may release funds already earmarked for that project so that they can be used in another project, perhaps in a quite different sector. This process of "fungibility" means that the provision of funds for industrial investment becomes blurred with the provision of

funds for other sectors, and in fact becomes part of the problem of generating flows of investible resources for all purposes.[1/] Part of the problem is then for countries to establish priorities for investment in the various sectors of the economy, and the problem is not just to increase finance for industry, but to give higher priority to industrial investment.

Notwithstanding the above argument, some sources of finance tend to provide funds for industry rather than other sectors. Typically, private sector finance, finance on commercial terms, and export credits tend to provide industrial finance, while there is an increasing tendency to use aid finance for projects which are non-productive or otherwise not commercially attractive. In recent years, several bilateral agencies and the World Bank have consciously directed funds towards rural development and basic needs in the poorer countries, which reduces the amount of aid available for industrial development. This tendency may be disguised in some of the aggregates which follow, but if the Lima target is to be achieved, it is essential that more aid funds be provided for industry, and that they be used more efficiently, probably in conjunction with private sector funds to provide a maximum gearing effect of the aid.

The second basic point concerns the underlying motive for financial flows to industry. A necessary condition is the availability of a project which is attractive either from a commercial or national point of view or both. Thus, the identification, preparation and promotion of good projects are essential pre-requisites for attracting funds to industrial investment (or into any other sector). As a generalisation, if a good project is available, finance can usually be found for it. For many countries the problem is not one of unavailability of investible resources, but of a shortage of good projects. Therefore, emphasis must be placed firmly on the importance of finding good projects.

Statistical Analysis

Ample data are available concerning the flow of foreign funds to developing countries, but little of this data breaks down the flow of funds by end use. Thus, it is sometimes not possible to specify whether funds are used for investment in industry, infrastructure, agriculture, etc., or for general balance of payments purposes. Similarly, information is available on local savings in developing countries from national accounts but again the extent to which this is used for industrial investment is not specified. Therefore, it is necessary to make the best possible estimates by type of flows, but it should be emphasised that these are sometimes crude, and merely a matter of judgement. The results are summarised in Table 4.

1/ The only source which is (relatively) free from fungibility is private foreign investment.

DAC Official Bilateral AID

OECD's Annual Reviews "Development Co-operation" break this down into sectors as far as possible, and the figures relate to finance for "industry, mining and construction". They include technical assistance flows.

Multinational Agencies and Sub-regional Banks

Most of the major agencies break down their disbursements by sector, which enables a summation to be made. However, these relate to gross disbursements, and it is necessary in each case to discount these by a factor to allow for repayments. In some cases, loans to development finance companies have been included, as these are largely on-lent to local industry.

Export Credits

No information about sectoral allocations is available, but clearly substantial amounts go to capital goods for manufacturing. A tentative proportion of 40 per cent has been taken.

Centrally Planned Economies

The major suppliers of finance are USSR and China. Both tend to favour finance for industry, with USSR aid being directed to large industrial and infrastructure projects, while Chinese aid tends to go towards small-scale, light industries, with labour-intensive technologies. A rough estimate is that about 50 per cent of aid from centrally planned economies goes to industry.

OPEC Bilateral Finance

Again, little systematic information is available about the sectoral distribution of such finance. OECD compiled details of some of the loans of lending agencies in Iran, Kuwait, Saudi Arabia and Abu Dhabi. Although these data do not cover all the commitments of these countries, it is interesting to consider them.

Industrial Lending Commitments by OPEC Countries, 1974 and 1975

	Number of loans to to industrial sector	Percent of value of total commitments
Iran	3	36
Kuwait	12	16
Saudi Arabia	3	22
Abu Dhabi	6	26

SOURCE: Data in Development Co-operation (Annual Review, 1976), OECD.

On the basis of the above data, it is estimated that perhaps 20-25 per cent of OPEC lending goes to industry.

Direct Private Foreign Investment

The best guide to the sectoral allocation of DPFI is some data collected by OECD. On the basis of the above, it is estimated that about one-third of DPFI goes into manufacturing.

TABLE 2: Sectoral Distribution of Private Direct Investment Flows from Japan, the United Kingdom and the United States in 1970 and 1976
(percentage)

Country	Year	Manufacturing	Petroleum	Other extractive	Other	Total
Japan	1970	30	7	55	7	100
	1976	30	35	11	24	100
United Kingdom	1970	48	20	2	30	100
	1976	47	15	6	32	100
United States	1970	28	39	1	32	100
	1976	31	15	6	48	100
Total	1970	31	33	7	29	100
	1976	33	22	8	37	100

NOTE: The three countries covered account for two-thirds of total DAC countries' private investment in developing countries.
SOURCE: Unpublished data from OECD.

Bilateral Portfolio Investment

Again, there is little reliable information on the proportion allocated to industry in LDC's. But the World Bank has divided all foreign and international bonds by type of borrower, and the following are the proportions taken by industrial borrowers.

1975	1976	1977	Total, 3 years
20.6	14.0	14.3	15.7

SOURCE: Borrowing in International Capital Markets, March 1978 (World Bank).

The extent to which these figures can be applied to LDC's is questionable. Significant sums are raised on the market by private sector industrial enterprises, virtually all of which are from OECD countries. The proportion of 15.7 per cent is likely to be at the top of the range going to LDC industry, and the true figure may be nearer 10 per cent.

International Bank Lending

The best available information is that collected by OCED, as follows:

TABLE 3: Syndicated Bank Credits to Developing Countries by Purpose
(as percent of total)

	1974	1975
Governments	45.1	55.2
Public utilities	13.3	6.9
Private financial institutions	2.2	1.0
Transport	17.5	8.2
Fuels	8.1	13.1
Other industry	13.2	15.1
Unallocated	0.6	0.5
Total	100.0	100.0

SOURCE: Development Co-operation (1976 Annual Review), OECD.

The figures roughly coincide with the World Bank's allocations of all Euro-currency credits to industrial borrowers, which are:

1975	1976	1977	Total, 3 years
	(percentage)		
17.0	14.9	12.4	14.4

SOURCE: Borrowing in International Capital Markets, March 1978 (World Bank).

Therefore 15 per cent of total net borrowing of Euro-currencies by LDC's have been attributed to industrial borrowing.

Summary

The results of the above estimates have been summarised in Table 4. In 1977, nearly $14 billion of foreign flows were allocated to industry, about 22 per cent of the total of $64 billion. In 1973, total foreign flows accounted for 21 per cent of total investment, and the estimates suggest that in 1972 foreign flows accounted for about 30 per cent of total industrial investment in LDC's. Of all foreign flows to LDC's, about 22 per cent went to industry in 1977, a slight increase since 1974.

TABLE 4: Estimated Net Flows of External Resources for Industry
(in million dollars)

	1974	1975	1976	1977
DAC official bilateral aid (includes mining and construction)	960	800	820	1,080
Multinational agencies and sub-regional banks (including OPEC)	900	1,000	1,100	1,100
Export credits[a/]	1,300	2,200	2,900	4,200
Centrally planned economies[b/]	550	400	300	350
OPEC bilateral finance[c/]	900	1,500	1,500	1,200
Direct private foreign investment[d/]	360	3,500	2,600	3,000
Bilateral portfolio investment[e/]	100	100	220	420
International bank lending[f/]	1,200	1,400	2,100	2,700
Other[g/]	100	100	100	100
Total	6,370	11,000	11,640	13,800
Percent of total flows (including Southern Europe)	19	21	22	22

a/ 40 per cent of total.
b/ 50 per cent of total.
c/ Rough estimate (20-25 per cent to total lending).
d/ 33 per cent of total.
e/ 10 per cent of total.
f/ 15 per cent of total net lending.
g/ Other countries, regional capital markets, voluntary agencies.

Concluding Remarks

The volume of available finance cannot be considered without reference to the terms on which finance is available. Indeed, the two are closely related, and investible finance available to industry is perhaps governed much more by the terms and operations of international capital markets than is finance for other sectors such as agriculture and infrastructure. This arises because of the relatively high degree of involvement of the private sector in industrial development, an involvement brought about in part by the dominance of the private sector in manufacturing in developed countries, and also by the tendency of many third world governments (and aid agencies) to leave manufacturing in the hands of the private sector to a considerable extent. Finance for industry tends to come on harder terms than finance for other sectors.

The desirability of leaving the development of manufacturing industry in the hands of the private sector, and particularly in the hands of private foreign investment, may be briefly considered here. Several third world governments have strong reservations about accepting private foreign investment (PFI), and would prefer to see the manufacturing sector developing under indigenous ownership and using indigenous technology. They

also see the dominance of FFI as establishing a new form of "economic colonialism", which deprives the country of control of its own economic development. Whatever the standpoints of particular governments, this argument serves as a reminder that the development of indigenously owned industry should not be neglected. Immediately this focuses attention on the importance of mobilising finance for such industry, both domestic and foreign finance. Moreover, a developing country which has a long-term policy of establishing an indigenously owned manufacturing sector will have to recognise the importance of small businesses, as these provide the basis for the development of large businesses in the future. In terms of financing, it may be necessary to distinguish between small and large "international type" industries, and to establish new mechanisms for financing small businesses.

Two lessons arise from this argument. First is the importance of diverting domestic savings from investment in such sectors as service industries, property development and land speculation, and shifting it towards manufacturing industry. Second is the importance of making finance available for the development of small manufacturing businesses, a problem which should be of concern not only to developing country governments but also to multilateral and bilateral aid agencies. Lending to small businesses is traditionally associated with high risk and much inconvenience. Therefore it is unattractive to commercially-minded lenders, and the availability of finance to such borrowers tends to be in short supply and at high cost.

There appears to be a gap in the money market here, which could be filled by aid donors or voluntary agencies. The United Kingdom Ministry of Overseas Development is now trying to channel funds to small businesses through U.K. voluntary agencies, under a scheme whereby it matches the voluntary funds pound for pound. In this way it hopes to circumvent the costly bureaucratic problems which it would otherwise face in getting its funds to small businesses.

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THE DEVELOPMENT AND EXPANSION OF SOUTH-BASED FINANCIAL ARRANGEMENTS AND INSTITUTIONS

by

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Introduction

One of the basic guiding principles of the study on international financial flows was to study methods of alleviating the financial dependence of the South on the North, a dependency which pursuit of the Lima target is likely to increase. In the long run, it will be desirable for the South to build up financial markets, mechanisms and institutions comparable to those in the North. Only in this way will the South achieve parity in financial development. The process of developing such financial strength is likely to last well beyond the year 2000, but it is desirable that steps should be taken to move towards parity with the North as soon as possible. Essentially, this process is the creation of the New International Financial Order (NIFO).

The essential requirement is that financial institutions should be developed which are owned, financed and managed by the developing countries, and are located among them. Such institutions may be national or multinational, private sector, public sector, or mixed. They should include banks, insurance companies, pension funds; organised money and capital markets capable of mobilising funds swiftly and efficiently; supra-national institutions for central bank settlements and balance of payments assistance; and payments unions, monetary unions, and other institutions for co-operation, for example, in trade finance. It should be recognised that for developing countries to establish such institutions will take considerable time, and probably involve many teething troubles. It may also require the rejection of "North dominated" proposals which may work better in the short and medium term, in favour of "South dominated" proposals which may take off more slowly, but which may be more satisfactory in the long run.

This study is not concerned with the establishment of national financial arrangements and institutions, but rather international institutions, which involve some degree of international co-operation. Individual nations are, of course, entirely free to establish their own institutions as and when they please, but international institutions and arrangements require that they should co-operate, and frequently comprise, with other nations. The study is also restricted mainly to consideration of financial institutions and mechanisms which pertain to aspects of industrial development, which limits the range of proposals to be made.

Nevertheless, it should be emphasised that the strengthening of financial institutions at the national level in developing countries as well as the international level has a significant part to play in expanding international co-operation in industrial financing. Increased intermediation capacity, both at a national and international level, will enable a developing country to increase its participation in international financial markets. This "financial deepening" can be achieved by improved local banking, the establishment of offshore bank branches, growing insurance, pensions and housing finance corporations, and the establishment of sound stock markets.

A. Proposals for medium-term export credit arrangements between developing countries

One of the features of developing country exporting arrangements is the absence of medium-term export credits and insurance schemes to support capital goods exports, even in those countries which have relatively mature capital goods industries. While all OECD countries are members of the Berne Union, only a few developing countries are members. In order to meet the Lima target, developing country production of capital goods is likely to increase substantially over the next 20 years, and their wish to export to industrialised and to other developing countries is also likely to grow. In order to fulfil this wish, developing country exporters of capital goods will need to be able to compete with industrialised countries, both in industrialised country markets and in developing country markets. One of the most important aids to exporting will be the ability to offer export credits, backed up by credit insurance facilities available to the exporter.

Possible arrangements to assist exports of capital goods from the South to the North are discussed elsewhere, but it is likely that trading relationships with the North will constrain exporters to adhere to the terms of the Berne Union. This is not necessarily the case with South/South trade, and developing countries may feel free to arrange terms for trade among themselves which can compete very favourably with terms offered by Northern exporters. By so doing, developing countries will in effect be giving themselves preferential access to each others' markets, thereby encouraging trade among themselves. In view of the danger of increased protectionism in industrialised countries, such a move may help to offset the detrimental effects of such protectionism, and maintain developing country trade. (This principle applies to all trade, not just to trade in capital goods.)

A few developing countries have export insurance schemes for capital goods, but there is very little subsidised export credit available. Indeed, documentation exists which suggests that capital goods manufacturers in developing countries (e.g. Mexico) have lost orders through being unable to offer medium-term credit on competitive terms. The apparent shortage of available finance suggests that the prospects for establishing national schemes along the lines of those existing in industrialised countries may not be very favourable. Therefore there is a need to look for alternative schemes, and some are examined below.

Existing systems

Several developing countries have their own export credit insurance systems, sometimes operated by the Government in conjunction with private sector insurance companies. Cases in point are countries such as Mexico, India, Peru, Jamaica, Pakistan, Korea, Argentina, Brazil, Colombia, Uruguay, Iran, Malaysia, and Philippines.[1/] However,

1/ See UNCTAD, TD/B/C.2/158, Suppl. 1 (1976), op.cit. for accounts of the systems in these countries.

it appears that very few national export credit schemes exist, and exporters who want credit generally have to obtain it from the banking system at commercial rates.

Export credit finance systems tend to be more limited in number[1/], although they do exist in Brazil, Argentina, Mexico, Korea, Malaysia and Singapore. Kebschull comments that they are inadequate in volume and in application. The following general observations can be made:

- (re)financing opportunities are strictly limited;
- credit costs, though below market level, are much higher than in the competing industrialised countries;
- the administrative machinery for individual applications and examination procedure is slow and lacks flexibility;
- special regulations for certain sectors tend to be exceptional:
- the often desired promotion of small and medium-sized enterprises "falls through" the net of these measures.

Various regional payments clearing systems exist which provide short-term export credit systems, and LAFTA has organised a "Latin American Bankers' Acceptance" trade paper which can be accepted on the New York money market. Of more interest is a scheme operated by the Inter-American Development Bank. This scheme essentially provides refinancing for export credits provided by national institutions. At the end of 1977, sums available for the medium-term credit programme amounted to $ 60 million in a revolving fund.[2/] However, the exporter is still likely to receive credit on market terms.

Alternative proposals

1. An Export Credit Guarantee Facility (ECGF)

The basic principle behind the proposal is to enable developing country export credit to be obtained from national or international financial markets, presumably in industrialised countries. The scheme requires the importer to issue promissory notes to the exporter (or to his Government), who passes them on to the Multilateral Export Credit Guarantee Facility, which then discounts them on the world's financial markets. The promissory notes would carry the guarantee of the importing country Government, the exporting country Government and the ECGF. The ECGF would also be backed by the World Bank, either with finance or with guarantees, so that the money markets should have confidence in its paper. The proposal in its original form was made to the Annual Meeting of the Board of Governors of the World Bank by the Governor of the Bank of Israel in 1972.

1/ This paragraph draws on a draft paper prepared for UNIDO by Dietrich Kebschull entitled Export Credits and Guarantee Systems, January 1979.

2/ See Kebschull, op. cit.

It has subsequently been discussed extensively, by the UNCTAD Trade and Development Board[1], and by Kearns International in a more detailed report prepared for UNCTAD[2].

There are two major shortcomings to the ECGF:

(a) The credit is provided at market terms, and unless exporting country governments can provide an interest rate subsidy to the exporter, the object of providing competitive terms to industrialised country exporters will not be met. The survey conducted for UNCTAD by Kearns International suggested that most financial institutions would require (in 1977) a yield of 1.5 to 2.0 per cent over LIBOR for discounting the promissory notes. At the time, most developing country Eurocredits were arranged on finer terms than this, suggesting that it would be as cheap for a developing country to obtain export credit finance by borrowing on the Eurocurrency market, with probably longer maturities, and the possibility of renewing the credit. While an ECGF guarantee would enable countries which did not normally have access to the market to raise export credit finance, this advantage is likely to be of use to only a few developing countries. Those who export manufactures (and capital goods) to any extent usually have access to the market. If such access is restricted by a country's perceived creditworthiness, the ECGF may not wish to guarantee very much of its paper anyway. (A further problem is that the ECGF, as proposed, would be backed by a World Bank guarantee. The World Bank is required by its articles to back one dollar of guarantee with one dollar of reserves, so its ability to lend would be reduced by the size of its guarantee.)

(b) The proposal contains no provision for insurance of the exporters risks, whether commercial or non-commercial. While it is not essential for the ECGF itself to provide it, insurance is essential for the exporters and is essential to a comprehensive export credit scheme. As the proposal stands, it would be necessary for the exporter to obtain insurance cover from his own Government or from the commercial market.

2. An Export Credit Fund

The major alternative proposal made here is to set up a multilateral Export Credit Fund (ECF) for exports between developing countries, with provision to extend its operations to providing credit for developing country exports to industrialised countries. The ECF should be financed initially by capital grants or long-term loans from ODA; subsequently it would be able to supplement its funds by borrowing on the world's financial markets. Developing country governments would then be able to draw upon the fund's reserves to an agreed amount, and would then pass on the funds to an exporter. Drawing would be conditional on the presentation of a promissory note from the importer, with an

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1/ See export credits as a means of promoting exports from developing countries, UNCTAD, TD/B/494, 1974.

2/ Export credits as a means of promoting exports from developing countries: report concerning a proposal for an export credit guarantee facility, TD/B/665/Add. 2, TD/B/C.3/139/Add. 2, 1977.

insurance policy taken out by the exporter. The fund would make a service charge to cover its costs, and, when it starts to borrow, an interest charge. However, the revolving of the initial capital would enable the fund to charge interest at well below its cost of borrowing and should provide credit at well below market rates, and probably below the rates offered by industrialised country export credits. This would enable developing country exports to other developing countries to be conducted at terms which are very competitive with Berne Union rates. However, it may be politic for developing country exports to industrialised countries which are financed by the ECF to be conducted on Berne Union terms.

The ECF might be part of an International Industrial Finance Agency (discussed elsewhere), where it would be owned and managed by the developing countries acting together, and thereby become a South-based financial institution. In order to borrow on the international markets, some loan guarantees are then likely to be required; these could be provided by an existing international financial institution, or, perhaps preferably, on an ad hoc basis by a variety of institutions, e.g. IBRD, EIB, bilateral aid agencies, etc. Should the fund be run so that it makes a profit, it may be able to borrow without guarantees once it has an established trade record.

The problems would be:

(a) arranging the ownership, management and objectives of such an institution;

(b) obtaining the initial financing; and

(c) arranging export insurance alongside the credit.

In so far as ODA provides the initial finance, it would involve obtaining funds from donor countries on a one-off basis. So that this does not merely divert funds from other aid uses, a special appeal should be launched for donor countries in OECD, OPEC and the centrally-planned economies to make special donations above their normal aid budgets; ideally they would be made in the form of grants. Should funds have to be provided out of aid budgets, a case would have to be made for the priority of the ECF. This could be convincingly argued on the basis of the importance of giving developing country exports parity with industrialised country exports on world markets, at least in terms of financing. It could also be made on the basis of the importance of establishing developing country-owned and managed financial institutions. It is recommended as a worthy case for aid money.

The possibility of the ECF providing insurance, or obtaining insurance, also arises. It seems an undesirable risk for the ECF to provide insurance itself. However, it may be in a good position to place the risk on the international insurance market, and pass on the cost to the borrowing country. However, it may be preferable for exporting countries to make their own export credit insurance arrangements, either through a government agency or on the local insurance market. The ECF may then merely restrict

itself to arrange insurance where adequate local facilities do not exist, or where their use is not economic. However, exporting countries should be encouraged to develop their own insurance facilities, as they may be used for products for which export credits would not be available.[1/]

The proposal as described so far would assist the wealthier developing countries which have significant capital goods industries. In order to assist the least developed countries also, it may be necessary to build some modifications into the proposal. For example, it may be reasonable to expect higher income developing countries to provide some or all of the subsidy element themselves, which may be done by charging them higher interest for their credit than other developing countries. It may also be desirable to impose borrowing limits on the larger, wealthier countries. In order to directly assist those countries which do not have a capital goods industry, it may be possible to extend credit for the export of consumer manufactures, such as processed foods and minerals, textiles and electrical goods.

3. Regional credit systems

The existence of several regional payments clearing systems may provide vehicles for regional export credit systems. These payments already arrange for short-term credits between members, and could be readily adapted to provide medium-term credits. However, funding would still be needed, and if the member countries were unwilling or unable to provide it, it would have to come from outside, as with the Export Credit Fund. Moreover, such an arrangement would only provide credits for trade within the region, rather than between regions, and so the use of credit would be restricted. At best, it would be a partial, second best solution, much inferior to the Export Credit Fund outlined above.

Another possible regional credit system is to extend the refinancing scheme of the Inter-American Development Bank to other regional development banks. But many countries in Africa and Asia suffer the initial lack of local export credit, and the system does nothing to provide finance on concessionary terms. However, it might be quite feasible to use the regional development banks instead of setting up a new ECF, with the aid loans and grants being invested in special revolving funds set up by the regional banks. This would ensure that export credits are available on subsidised terms. However, different approaches to managing the funds may lead to regional differences in the availability of credits and terms, and would lead to some developing countries being able to offer better credit terms than others, which is an argument in favour of an ECF.

4. Conclusion

There is a need for improved medium-term export credit and insurance schemes for developing countries, which will become increasingly apparent as manufacturing output increases over the next 20 years. The preferred system is an Export Credit Fund, but failing that, a system based on the existing regional development banks. Whatever system is to be adopted, there seems to be a strong case for the injection of some concessional

aid to assist developing country manufactured exports. Credit insurance should largely be left to individual country schemes, or to the commercial insurance market.

The case for aid assistance for export credit finance is particularly strong, in cases where developing country exports of capital goods go to industrialised countries. Were no aid available, then the developing countries would have to provide subsidised credit to industrialised countries which:

(a) is quite contrary to the spirit of aid for developing countries;

(b) is illogical when the exporting country is (probably) receiving aid from industrialised countries.

However, the provision of aid for developing country exports of capital goods to industrialised countries would need to be carefully handled so as to be acceptable to manufacturers and unions in industrialised countries, who may fear that their own governments were providing subsidies for imports. It would have to be provided in the framework of a global agreement of terms for capital goods trade, perhaps an expansion of the present Berne Union agreement to cover all nations, to ensure that developing countries and industrialised countries offered each other comparable terms.

B. Proposals for Approaching Indebtedness and Debt Reorganisation

The absolute level of developing country indebtedness is not particularly high at present compared with some periods in the past. But the debt structure, based heavily on medium-term export credits and eurocurrency loans, together with uncontrollable fluctuations in some countries' export earnings, is giving rise to a number of debt rescheduling problems. There are two distinct problems here with implications for the future:

(a) Finding a more satisfactory approach to debt rescheduling;

(b) Evolving financial mechanisms and borrowing possibilities to improve the future structure of developing country debt.

The second problem is a theme running through this report, and attention here will be concentrated on the problem of debt rescheduling.

The Conference on International Economic Co-operation (CIEC) stated the following:

"Integral to the creation of a NIEO is the necessity of giving a new orientation to procedures of the reorganisation of developing countries' debt owed to developed countries towards a development approach. To this

end, there is an obvious need to redesign and reorient operations such as those of the aid consortia and the creditor clubs in the context of international co-operation for development".[1/]

Before looking at possible new approaches to debt rescheduling and balance of payments problems, it is worth examining why the balance of payments problems arise. Two classes of reasons can be identified:

(a) Problems arising from "economic mismanagement" in the debtor country. The nature of such "mismanagement" might be quite varied, but range from inappropriate development policies to "over-borrowing" on international markets (although the organisations which "over-lend" should share responsibility in such cases). However, "mismanagement" is a subjective term, and should be borne in mind that relatively few economies are well-managed consistently, and judgements of "mismanagement" should be made with care. It is arguable that many countries achieve their economic growth in spite of their economic management, rather than because of it.

(b) Problems arising externally, over which the government has little or no control. It is perhaps this category of problem which are of most concern to developing countries, as it includes sudden (and perhaps prolonged) falls in prices of exports commodities, technological changes which reduce the volume of exports, trade and financial regulations in industrialised countries which affect developing country exports, price adjustments in essential imports (e.g. oil), or other factors which led to deterioration in the terms of trade. In fact it is sometimes changes in this category which expose alleged deficiencies in economic management, and leads to debt rescheduling conditions concentrating on the latter, rather than on the more fundamental cause of disequilibrium. A case in point may be the fall in copper prices in recent years. Other "exogenous" problems may arise through wars and natural disasters, perhaps not directly involving the debtor country, but which affect its trading position. Even well managed economies are usually helpless in the face of such changes.

The nature of such externally imposed problems is that they tend to be medium or long term, rather than short term. Long run (Kondratiev) cycles tend to be of 10-20 year duration, and Kuznets cycles of 3-5 years. It is the latter type of cycle which may be of most relevance, as it appears that it may be a reasonable measure of the length of time between successive commodity price peaks. The duration of these trade cycles needs to be recognised, as it needs to be recognised that certain developing countries which are commodity export dependent are very vulnerable to them. While commodity price stabilisation funds may help to smooth the fluctuations, some countries from time to time are still likely to find their external payments in unexpected disequilibrium. When debt rescheduling does arise for such reasons, it is desirable that financial mechanisms should exist which take into account the nature and the likely duration of the problem.

1/ Report of the Conference on International Economic Co-operation, Addendum, p. 68 (A/31/478/Add.1).

Existing systems for debt rescheduling

In recent years, attention has been focussed on the role to be played by commercial leaders' associations, and the IMF where a debtor country has found itself unable to meet its debt obligations. There is a general tendency for the IMF to make credits available on a short term basis, subject to certain economic measures being taken by the debtor country, which are usually deflationary in nature and which usually involve exchange rate devaluation. Subject to these measures being accepted publicly by the debtor country the commercial banks will then agree on a debt restructuring exercise. The weakness of this approach is that the IMF measures may be quite unrelated to the causes, if these are externally imposed. Moreover, the short term finance it provides is not appropriate to solving a problem which may be of 3-5 year duration. The provision of short term funds by the IMF has the impact of making a 3-5 year crisis appear as a succession of 1 year crises, and both fails to understand, and to solve, the real problem. Finally, the IMF "assistance" may be distasteful to developing country recipients, as it is seen as a "North-based" financial institution. It is fashionable to say that the IMF has lost its role in the industrialised countries, as the Group of Ten negotiate exchange rate changes and Central Bank Swap Arrangements among themselves, but one wonders about the adequacy of its measures for solving developing countries' debt problems and balance of payments problems.

The magnitude of the IMF's financing, in itself, is small relative to total developing country borrowing. For example, in 1978 purchases and repayments of currencies and SDRs from the IMF in the year ending 30 April 1978 were:

(Million SDRs)	Purchases	Repayments	Net Borrowing
All Countries	2503	4485	-1982
Of which developing countries	753	1137	- 384

Source: IMF Annual Report, 1978

1978 was unusual in that net repayments were made. The total outstanding purchases for all countries fell from about SDRs 16 billion to SDRs 14 billion during 1978. It is not easy to check on the proportion of this held by developing countries, but it is obviously very small relative to total indebtedness of developing countries which amounted to $ 244 billion at the end of 1977. The IMF may be a lender of last resort, but it is obviously not an important source of finance to developing countries. The IMF 1978 Annual Report comments "Nevertheless, the considerable net reduction in the outstanding use of the Fund's resources can be partly attributed to an improvement in member external financial positions and the greater availability of funds from the international money and capital markets" (page 63). The Financial Times stated on 13 February 1979:

"The long drawn out problems of Turkey - to give a topical example - are a reminder of the way in which Eurocurrency loans have overwhelmed official loans in financing the aspirations of developing countries. Mr. Harold Lever, Britain's Chancellor of the Duchy of Lancaster, pointed out recently that from 1974 to 1977 the net foreign currency finance provided by banks in the Group of Ten amounted to $ 230 billion while the IMF provided $ 16 billion in the same period."

Nevertheless, arguably the most important role of the IMF is to impose conditions on borrowing countries, thereby engendering confidence in commercial lenders to re-negotiate existing loans, and to provide new ones.

Alternative arrangements for handling balance of payments and debt crises

Five groups of developing countries have established mutual assistance arrangements to provide each other with balance of payments credits. Usually referred to as "Credit Agreements"; these are mechanisms to provide multilateral balance of payments support to individual members who find themselves in difficulties. As such, they may be considered as alternatives or supplements to the existing IMF facilities. Five such groups exist of which two, the Central American Monetary Stabilisation Fund and LAFTA's Financial Assistance Agreement, operate in parallel to those regions' payments clearing arrangements. The agreements are listed in table 1, and cover a total 47 countries. According to Gonzalez del Valle, "..... a common denominator appears to be the intention to supplement the balance of payments financing provided by the IMF in order to avoid restrictions on convertibility and/or exchange rate instability. Except in the case of the ASEAN Swap Arrangement, the existing credit agreements explicitly link such balance of payments support to the broader economic integration and free trade expansion objectives of the subregional groups formed by the participants".1/

Members have some automatic drawing rights (related to subscriptions) after which any further borrowings are subject to conditions laid down by other members. In so far as this form of assistance avoids the imposition of import restrictions and competitive devaluations, it supports the clearing arrangements by avoiding restrictions on regional trade.

An interesting example is provided by the Central American Stabilisation Fund, which is financed 40% by members subscriptions, and 60% by foreign borrowing. This Fund will provide loans up to 1 year maturity for short term problems, loans up to 5 years for cyclical problems, crop failures, disasters, etc., and up to 8 years to allow for structural adjustments in cases of persistent balance of payments disequilibrium. The Articles of Agreement of the Arab Monetary Fund also provide for "short and medium term

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1/ Preliminary report on the feasibility of global payments arrangements among developing countries, UNCTAD Nov. 1978 (TD/B/C.7/26).

loans to members for a period not exceeding 7 years" (Article 19). Such flexibility can be contrasted favourably with the short term lending and deflationary policies of the IMF, which appear to be adhered to regardless of the nature of the problem faced by the country.

The five existing agreements provide balance of payments credits amounting to US $ 1,700 million. These may be small in relation to the value of trade and reserves of the members, but for individual countries they may provide significant additions to, or alternatives to, IMF credits.[1/] They also have a significant political role to play in that they enable conditions to be imposed by other neighbouring developing countries rather than the IMF which is dominated by the industrialised countries. Within the agreements there may be scope for expanding the volume of credits available to members, while there may also be scope for expanding the groups, and co-operation between, or merging of, groups. As the financial strength of developing countries increases, one can envisage the possibility of the developing nations establishing their own equivalents of the IMF and the BIS. If the present political and economic relationships in the world tend to remain much as at present, the developing countries may find the establishment of their own supra-national organisations to be an attractive alternative to existing relationships.

The establishment of a new Third World Monetary Fund could be approached by merging the existing arrangements, or by setting up a new institution. If the former were the case, the leading role would probably fall on the Arab Monetary Fund, as the largest and wealthiest group. If a new institution is to be established from scratch, then it is likely to be very dependent financially on subscriptions from the capital surplus oil exporting countries. Either way, the final result is likely to be similar.

In order to be a lender which can provide substantial funds over 3-5 years, a TWMF would require substantially greater funds than are available at present from the IMF. Sir Arthur Lewis stated that "to fully ride a Kuznets depression would require access to reserves equivalent to 75% of a year's exports. Oil importing country exports last year (1976) amounted to $ 118 billion. If the DCs kept three months reserves on their own, they need stand-by facilities of, say, $ 60 billion over 4 years. Now the original quotas of the oil importing DCs amounted to less than $ 7 billion, carrying a right to borrow of only $ 13 billion. The quotas are about to be increased, and one must also add SDRs, the IMF buffer stock scheme, and funds available under the export compensation schemes, both of the IMF and the EEC."[2/] However, a Fund could certainly be started on a much smaller scale than $ 60 billion over 4 years.

1/ Nicaragua took the financial establishment by surprise in late 1978 when it demonstrated some independence by borrowing $ 20 million from the Central American Monetary Stabilisation Fund, after experiencing some difficulties with the IMF.

2/ The less developed countries and stable exchange rates. 1977 Per Jacobsson Foundation lectures reprinted in Third World Quarterly, January 1979, Vol. 1, No. 1.

The case is argued elsewhere for a mechanism to provide a long-term (10-20 years) finance which is not tied to projects. Such a mechanism could be associated with a TWMF so that it provides not only medium term (3-5 years) financial assistance, but also long-term assistance providing member countries with medium-term finance to ride the trade cycle, and also long-term finance to enable its debt to be fully restructured. There is currently no mechanism for this function. The long-term finance is likely to come from the Eurocurrency market by borrowing medium and lending long, or perhaps from OPEC. The TWMF would require very sound financial backing and guarantees, probably from OPEC, so that it would have the confidence of international commercial banks, as does the IMF. It may be that the proceeds of an OPEC bond (see elsewhere) could be channelled through such an institution, supported by whatever DAC aid may be needed to provide the interest rate subsidy. It would be an opportunity for OPEC to increase its solidarity with the rest of the Third World.

The alternative to the above scheme would be to reform the IMF so that it could provide medium and long-term finance, in much greater volume than at present, and in the spirit of a development finance institution. In view of the apparent difficulties of achieving these ends within the existing IMF developing countries might prefer to establish their own institution.

Table 1: Credit arrangements among developing countries as of July 1978

Type of arrangement	Official name of entity and date of establishment		Participating Countries
Credit	1. Arab Monetary Fund (1977)	(20)	Algeria, Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libyan Arab Jamahiriya, Mauritania, Morocco, Oman, People's Democratic Republic of Yemen, Qatar, Saudi Arabia, Somalia, Sudan, Syrian Arab Republic, Tunisia, United Arab Emirates and Yemen Arab Republic.
	2. Andean Reserve Fund (1976)	(5)	Bolivia, Colombia, Ecuador, Peru and Venezuela.
	3. ASEAN Swap Arrangement (1977?)	(5)	Indonesia, Malaysia, Philippines, Singapore and Thailand.
	4. Central American Monetary Stabilisation Fund (1974)	(5)	Costa Rica, El Salvador, Guatemala, Honduras and Nicaragua.
	5. Latin American Free Trade Association's Financial Assistance Agreement (1969)	(12)	Argentina, Bolivia, Brazil, Colombia, Chile, Dominican Republic, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela.

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FINANCING DEVELOPMENT: INNOVATION AND PRIVATE CAPITAL MARKETS

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1. INTRODUCTION AND STATEMENT OF ISSUES

1.0. INTRODUCTION

The Joint Study on International Industrial Cooperation obliges UNIDO to identify financing mechanisms that help shift control of production and technology to developing countries without increasing their financial dependence on the North. To that end, this paper examines private sources of funds. Our goal is to propose constructive innovations,* ranging from marginal to systemic, in international capital markets and in the domestic markets of the North.

The paper has three major sections, of which this introduction is the first. The second reviews the determinants of national policy in this sphere. Finance has certain functions that define what one can hope to accomplish through innovation. That the finance is external constrains DC policy makers because of the needs of the other players, governmental and private; we outline the major constraints. A government's financial policy must also fit the national development strategy and the wide range of strategies for an equally broad array of financial policies. From these intrinsic functions, external constraints, and national goals we derive certain principles to guide the policy maker in the developing country.

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* UNIDO has already analysed capital flows in general, a subject this paper therefore does not address.

In our analysis, we distinguish between policies for financing at the aggregate or national level and those at the enterprise level.* For both lenders and borrowers, issues of risk and impact vary according to the level of the borrower. Given UNIDO's special competence in industrial policy and projects, principles governing policy toward finance at the enterprise level carry special importance. They also provide the opportunity for links between this paper on finance and other parts of the Joint Study.

The third major section of this paper addresses the scope for innovation and presents our proposals. Because today commercial banks are both the major source of funds and among the least susceptible to fundamental change, we distinguish between proposals to improve the use of bank finance and proposals to reduce reliance on banks. While diversification may appropriately run to other medium-term or even short-term sources, depending upon the needs of the country, we focus primarily on long-term alternatives.

1.1. ISSUES: THE CONTEXT OF INTERNATIONAL FINANCE

1.1.1. Overall, the debt and debt service burden of developing countries (DCs) is large and is growing rapidly. The volume of debt has increased in part as a result of the downturn in world economic activity and rising energy costs, in part because of the rapid pace of industrial development by key borrowers, and in part to improve the standard of living in borrowing countries. The debt service burden has grown even more rapidly than the overall volume of debt because of a trend toward shorter maturities, higher nominal interest

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*The national level encompasses all government debt, whether or not for specific projects, all public enterprise debt, and all private sector debt guaranteed by the government.

rates, and a decline in the relative importance of concessional finance.

1.1.2. The policies of industrialized countries towards their own domestic financial markets often have serious repercussions on the availability and terms of finance for DCs. Industrialized countries (IC) governments often resort to credit allocation and queues, interest rate ceilings, controls on international capital flows, and other interventions in financial markets for domestic policy purposes. Most of these interventions are prejudicial to the international financing of DCs. Many ICs are unaware of these effects or, in cases where they are aware, give them little weight in their choice of policies.

1.1.3. There is little prospect for increased concessional resource transfers for industrial development. Concessional transfers are increasingly targeted towards the poorest countries, towards basic needs, etc., and, as a result, are less available for industrial development. A large portion of concessional finance available for industrial development remains tied to capital goods purchases. Therefore its value is reduced and distortions are introduced into development programs. Further, of greater significance for the joint study, concessionary finance tied to capital goods imports from the north hinders a shift towards new patterns of investment and production, continuing to favor north-south flows of capital goods over domestic sources or newly emerging DC suppliers of capital goods and technology.

1.1.4. There is increasing reliance on commercial banks as sources of finance. This reliance has come about because of the relative ease of access to these institutions and their substantial flexibility. However, it has negative aspects as well. It has increased the market power of commercial banks and, more importantly, has exposed DC borrowers to risks with regard to refinancing. This refinancing risk is the possibility that commercial banks

will be either unable or unwilling to continue to extend credit as they have in the past and, as a result, will either shorten maturities or reduce the total volume of lending. A variety of reasons may cause this to happen: changes in the banks' own economic fortunes; changes in bank policy; or, perhaps the greatest threat, changes in the policies of IC governments towards their own banks' foreign lending activities. Still another effect of the increased reliance on commercial bank sources is that it reinforces DCs' almost exclusive reliance on debt instruments at the national level in contrast to financing at the enterprise level. One result of this shift towards national debt financing is that DC borrowers bear the bulk of the risks associated with their industrialization policy. Another is that, by failing to link foreign sources of finance with specific projects for enterprises, it thereby dilutes foreigners' stakes in the outcomes of these projects. This, in many cases, has had negative impacts on the incentives for performance by foreign suppliers of capital goods, technology or management advice.

1.1.5. Developing countries' ability to service debt and to carry out development plans is vulnerable to fluctuations in net external revenues which may result from a variety of factors beyond their control, including declines in international economic activity, changes in commodity prices, and changes in the conditions of international trade. In addition, developing countries embarking on ambitious industrialization programs face risks associated with the proper selection of industrialization strategies as well as the proper management of industrial concerns.

1.1.6. International financial mechanisms which have evolved appear to be more favorable to large borrowers than to smaller entities both because of the greater sophistication of the large borrowers and the greater interest of

the international financial community in these large borrowers. This affects not only the relative ability of large and small countries to tap international markets for development purposes, but also the relative ability of large and small firms within a country. Existing international financial relationships may concentrate economic power in key countries and within key groups in given countries.

1.1.7. A large number of developing countries explicitly or implicitly limit international financial linkages at the level of specific enterprises or firms. Further, as an increasing number of DCs reserve key sectors of the economy for development by public and mixed enterprise, the ability to distinguish between the enterprise and the state is clouded. As a result, it often is hard to distinguish between international finance on the aggregate, national level and international finance on the enterprise level. This presents no problem for those countries which have evolved sophisticated systems for allocating capital and controlling the performance of public enterprises, but there are few which have attained this status. Increasing difficulties with the management of large-scale externally oriented enterprises, especially when these include the involvement of TNCs as owners or by contract, suggest that there is a major need to find new mechanisms which will allow some international financial linkages at the enterprise level even in those economies where direct access by foreign private lenders or investors is either infeasible or deemed undesirable.

These seven observations describe the system within which we must work. The next section of this paper reviews the role of external finance in order to derive principles that could guide policy in this field.

2. GOALS AND GUIDING PRINCIPLES

2.0. THE GOALS OF EXTERNAL FINANCE

The goals of external financing by developing countries may be several. Possible goals are: 1) to enhance the potential national income over time by investing in profitable projects that could not be financed with domestic resources, 2) to accelerate or delay domestic consumption* relative to the income stream anticipated from natural resources, 3) to smooth domestic consumption in response to sharp fluctuations in either income or required outlays, and 4) to shift risks associated with particular development strategies or particular economic ventures to foreign investors or governments. Further, if there are outstanding external financial claims, part or all of new external financing may be used to refinance these existing claims and hence maintain a desired level of national consumption and investment.** Finally, when concessional sources are involved, a major element of external finance is the transfer of resources from one set of countries to another.

The first goal, to <u>enhance potential income over time</u>, is the major focus of most discussions of development finance. The notion is that countries benefit from external finance if it enables them to undertake real investments whose social return is in excess of the cost of funds borrowed and that could not have been financed out of domestic resources

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*Strictly speaking, the reference should be to absorption--the combination of consumption and investment.

**Formally, these separate goals can be modelled as maximizing the utility of national consumption over time where the utility of consumption at any one point in time depends not only on its absolute level, but also on its level relative to previous and planned levels of consumption to capture the effects of growing absorptive capacity over time as well as the adjustment of expectations. Since the country is treated as a unit, distributional considerations are ignored.

alone. This benefit of external finance is illustrated in Figure 1A. The solid line represents the anticipated income path with only self-finance, the dotted line the income attainable through expanded investment financed externally, and the shaded area the cost of financing or "debt service." The area between the solid line and the shaded area is the gain in net national income resulting from external finance. The decision rule associated with this goal of enhancing income over time is to borrow abroad up to that point where the marginal cost of finance--the interest rate if one abstracts from uncertainty--is just equal to the marginal yield or return expected from the project or program being financed.

The second goal, to alter the time path of national absorption, is a major element in the external financing programs of resource-rich programs, although it seldom is acknowledged directly. Countries whose current income outstrips their "absorptive capacity" and threatens to disrupt their economy or society or that face an imminent decline in external revenues as resources often delay expenditures by accumulating external financial claims, thus trading reduced present expenditures for increased potential future expenditures. Alternatively, countries that expect high future incomes from proven resource positions, often borrow abroad to accelerate expenditures in anticipation of these revenues. In either case, external finance allows a country to uncouple current expenditures from current income and shift expenditures to those years where they are most valuable. This shifting of expenditures is illustrated in Figure 1B for a country seeking to delay consumption and in Figure 1C for a country spending in anticipation of future revenues.

The decision rule associated with this goal of shifting income over time to enhance the value of national expenditures is to borrow (lend) to

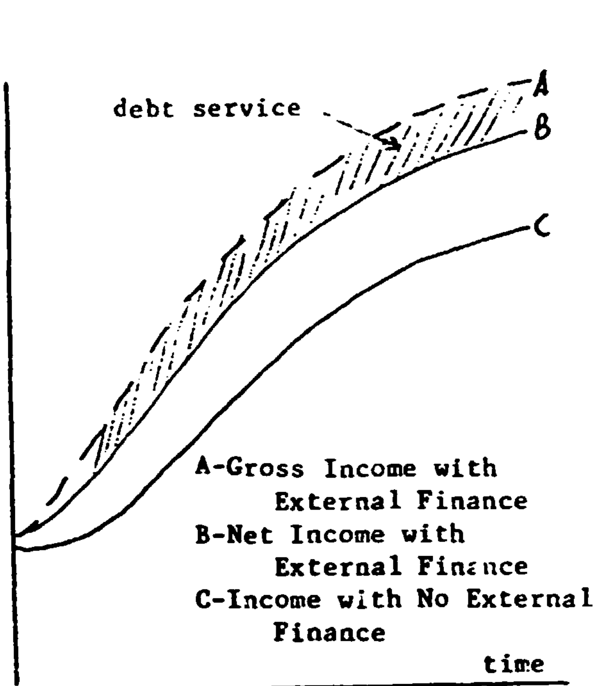

Figure 1A
External Finance to Enhance Potential Income Over Time

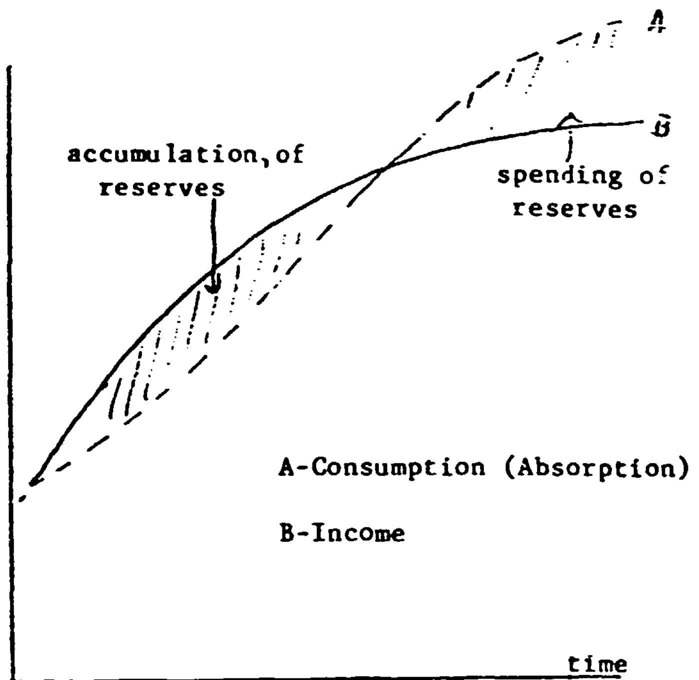

Figure 1B
External Finance to Postpone Consumption Relative to Pattern of Income

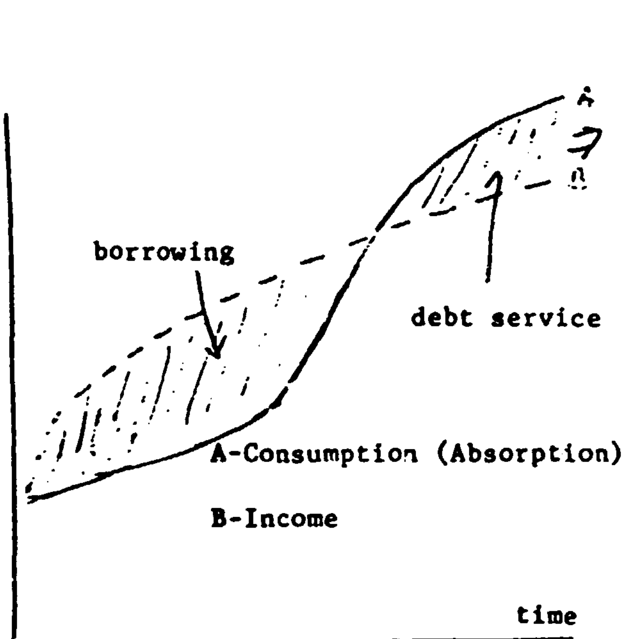

Figure 1C
External Finance to Accelerate Consumption Relative to Pattern of Income

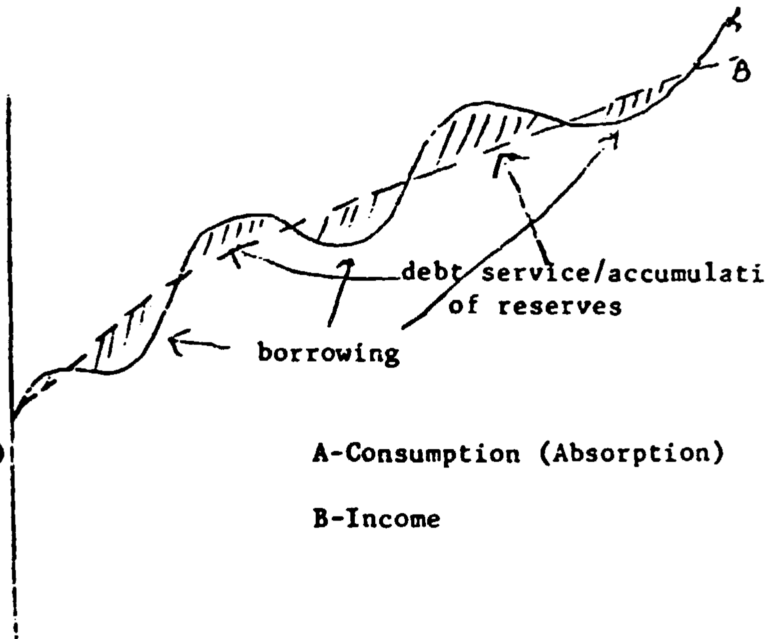

Figure 1D
External Finance to Smooth Consumption

Figure I

<u>Patterns of External Finance</u>

that point where the marginal cost (expected return) of external finance is equal to the country's marginal rate of time preference for expenditures.

The third goal of external finance, to smooth the path of national expenditures over time, is the force behind much of the so-called "balance of payments" financing by DCs. External finance is obtained to maintain national absorption in the face of shortfalls in export revenues that result from downturns in the world economy, shifts in the terms of trade, or domestic economic problems, or sudden increases in desired or required expenditures resulting from external or domestic pressures.* In contrast to financing taken on to enhance income which might be termed "true development finance," balance of payments financing often is viewed as something that should be avoided. It is true that the need for such finance often is the result of economic mismanagement, but this fact should not obscure the major benefit that can be obtained from short-term "de-coupling" of income and expenditure flows.** Figure 1D illustrates how balance of payments financing can smooth expenditures over time. The solid line represents national income in the absence of any short-term financing, the dotted line "smoothed" income, and the shaded area debt service associated with the short-term financing.

The decision rule associated with short-term finance to smooth expenditure is simple to state but hard to implement: borrow in the short-term to offset temporary declines in net resource flows and use short-term surges

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*Short-term borrowing is a substitute for drawing down national reserves. Therefore, reserves and "borrowing capacity" serve similar functions.

**A more serious difficulty is that, in practice, it is very difficult to distinguish between short-term fluctuations in income and long-term shifts in income. As a result, what was thought to be short-term financing to deal with a temporary shortfall might be financing to accelerate consumption in face of declining future income prospects!

for the repayment of balance of payments debt or the accumulation of reserves. The difficulty lies in distinguishing short-term from basic changes in a country's economic circumstances.

There are two basic mechanisms for maintaining relatively smooth expenditure flows in the face of uncertain, fluctuating revenue streams. The first is to maintain borrowing capacity or reserves that can be drawn down to offset temporary revenue shortfalls. The second is to explicitly shift some or all of the risks associated with certain economic activities to external investors or governments, thus exchanging a claim against a risky revenue stream for a more stable, and in most cases, smaller revenue stream. Financial mechanisms that perform this function include futures, contracts, equity interests in specific ventures, and bonds or other contracts indexed to variables whose future value is not known with certainty.

When there are uncertainties regarding either financing costs or future returns, financing decisions must take into account not only the (expected) marginal cost of financing and the (expected) marginal return of the investment in question, but must consider as well the impact on the country's well-being of the resulting allocation of risk. Two principles are at work in this case. The first is related to the relative willingness of the borrower or lender to accomodate risk, the second to the relative ability of one party or the other to limit or modify the risks.

Both the borrowing country and the lender prefer to avoid risks. As a result, the borrower would be willing to pay a premium, i.e. a higher expected cost, to shift the risk to the lender, whereas the lender would demand a premium for taking on the risk. To the extent that the lender, either because of the ability to diversify risks or a greater tolerance

for bearing risk, demands a smaller premium than the maximum the borrower is willing to pay, both parties are better off by transferring risk.

The resulting decision rule is for a country to shift risk via financial mechanisms up to the point where the marginal risk premium demanded by external investors or financial institutions is just equal to the cost (in real resources) of reducing these risks by adopting alternative development strategies or to the premium that the country is willing to pay to eliminate these uncertainties.*

At any point in time, a country's financing requirements and options are determined to a large extent by existing repayment obligations resulting from past financing choices. In deciding on external finance to enhance income or to shift or smooth the pattern of expenditures, these claims against current income must be taken into account. A country may have sufficient gross income to finance all attractive development projects, but repayment obligations may bring net income below the required level. Thus, in order to maintain the desired investment pattern it will have to "roll over" the existing financing. Similarly, a country's growing gross current income may be sufficient to cover the desired current level of consumption, but repayment obligations may bring net income below the desired level and rolling over will be desirable. Finally, the existence of fixed external obligations will exacerbate the impact of sudden revenue shortfalls since the absolute decrease will represent a larger proportionate decrease of net revenues than of gross revenues.

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* A rigorous statement of this decision rule requires an explicit specification of the national "utility function" with respect to the expected level and uncertainty of anticipated future income. Practical illustrations of the rule are provided in section 3.3.

The flexibility of the timing of repayments, thus, will be a major factor in determining a country's gross external financing requirements. This will be true whether the flexibility takes the form of allowing the deferral of repayments as a function of some set of external events or actually changing the amount due, as is the case with contingent, risk-shifting financial contracts.

Most financial transfers involve the exchange of current real resources for claims (often uncertain and occassionally explicitly contingent on future events) against future income. Concessional transfers of resources arise when current resources are transferred without a (full) corresponding transfer of financial claims. Clearly, DCs will try to maximize the concessional element in finance since it directly increases their current potential level of expenditures without offsetting claims against future loans.

2.1. THE FUNCTIONS OF FINANCE

There are three essential functions of external finance, to shift resources over time, to shift risks, and to transfer resources on a concessional basis. The function of transferring resources over time corresponds to the first three goals outlined above--to enhance potential income, to shift the long-term path of expenditures, and to smooth income in the short run. The function of transferring risk serves to smooth income without requiring a transfer over time of resources. Concessional transfers, by directly increasing wealth and hence increasing financial flexibility may serve any one of these goals or a combination of them. To illustrate these concepts, Figure 2 identifies particular financing contracts that perform various combinations of these functions.

FIGURE 2

Financial Mechanisms: A Three Dimensional Typology

Mechanism	Extent to Which Transfers Resources Over Time			Extent to Which Shifts Risks			Extent to Which Involves Concessional Resource Transfer		
	Not at all	Short Term	Long Term	Little	Moderately	To large extent	Little	Moderately	To large extent
Commercial Bank Loan		X		X			X		
Long Term Bond			X	X			X		
World Bank Loan			X	X				X	
IDA Term Loan			X		X				X
IMF Compensatory Finance		X			X				X
Commodity Futures Contract	X					X	X		
Commodity Price Linked Bond			X			X	X		
Equity Investment			X			X	X		

These three functions often are described with the terms credit or debt capital, risk capital, and grant or subsidy capital. Financial claims with (substantially) fixed repayment requirements that provide a time transfer of resources are termed debt capital. Claims whose repayment is contingent on specified future outcomes are considered to be risk capital. Unrequitted transfers of resources in the form of grants, subsidies, guarantees, or concessional interests rates are subsidy capital.

An additional function of external finance that comes into play only if obligations are linked to the outcomes of specific projects or undertakings, as opposed to being backed by the general credit of the borrowing country, is to provide foreign lenders or investors with a specific stake in the success of the project, program, or enterprise in question. To the extent that lendersor investors have some control over variables crucial to a project's success, this linkage may lead to improved performance and reduced risk. For example, if part or all of a project-specific obligation is tied to performance criteria for the project being financed, the vendor will have a greater interest in seeing that the project design is appropriate and its management is satisfactory. Similarly, if global obligations of a specific borrowing country are linked to that country's volume of manufactured exports, lenders will have an interest in seeing that exports are not hampered by IC protectionism. The other side of the coin, of course, is that as the investor's stake in a particular project or programme grows, the lender will demand greater control. Equity investment, whether of a direct or portfolio nature, represents the extreme case of shifting risk and consequently in the degree of control required by the investor.

Debt involving fixed repayment obligations regardless of specific investment outcomes, even if nominally linked to a specific project or enterprise, is unlikely to fulfill this function since it probably will be viewed as a general obligation of the borrowing country. Only in the case where the project is financed on a stand-alone basis and the government will not bail it out under any circumstances will so-called project financing provide this link.

2.2. ISSUES IN EXTERNAL FINANCING STRATEGIES

Each government sets its policy toward external finance in the light of its own perceived needs. For valid reasons, many countries do not seek maximum use of their external financing options. Others do. External financial policies must be viewed as a means to an end defined in terms of the broader goals of governments and their societies. However, all governments must consider certain basic issues. These are discussed first, then they are related to the broader goals of various countries.

Most counties will seek to maximize the concessional element in finance. This is logical since it relaxes current financing constraints and softens the burden of subsequent debt service. However, given that concessional resources are insufficient to meet most countries' requirements, they must view these as scarce resources to be utilized in the most efficient manner and they must decide the volume and nature of non-concessional financing they will undertake.

Implicit in all policies toward external finance are common issues of substance and process. Substantive issues concern the total volume of external finance; diversification of sources, and matching of required repayments with expected future revenues in terms of timing, currency or other denominator,

degree of flexibility in the timing of repayment, and the extent to which the amount to be repaid is contingent on future events. Process issues concern the procedure for deciding issues of substance.

Substantive issues: The total volume of external finance is a major issue for both the DC and the lender. The first measure any lender takes of a country is the total volume of its external debt, and its consequent servicing costs, in relation to its projected sources and uses of foreign exchange. Most commonly, the debt service ratio expresses this relation. The government must concern itself with this issue not only because of the lender's concern, but also because the decision about the total volume of external finance involves a crucial trade-off between the additional resources it makes available for current consumption or investment and the claims it represents against future resources. For this reason, the debt service ratio taken alone provides an extremely simplistic view of a country's financial situation and may be misleading to borrower and lender alike. More relevant measures focus on the relationship between debt service and resources available to meet it under particular sets of future circumstances. Choices regarding the mix of debt and risk capital, diversification of sources, and matching of sources and expected future revenues along various dimensions are central in this regard.

Diversification of sources is a second issue. Dependence on a single source exposes a country to the risk that refinancing will not be available in the future as a result of a shift in the fortunes or attitudes of the lending institution or the market or a shift in the industrialized country (IC) government's controls on the lender. Diversification can have a major impact on a country's ability to take on a particular level of financial commitments.

The matching of the terms of financing to anticipated future revenues presents the most complex, yet potentially most important policy tool. It is now widely recognized that in order to minimize debt problems and, more importantly, to maximize the likelihood of success of the development programs themselves, borrowers should match the maturities of their external obligations to the length of pay-off on investment programs and that they should avoid the bunching of required repayments at any point in time. The choice of currencies or indexes which determine the required repayment on foreign debt must take into account the currency and commodity composition of the borrower's net foreign exchange receipts. The greater the extent to which required repayments are denominated in the same units as anticipated foreign revenues, the less the difficulty of repayment and hence the risk of financial crisis.

Similarly, given that the time pattern of revenues is not known with certainty, flexible repayment terms can decrease the risk of serious financial difficulties with the widespread use of floating interest rate instruments, and the linkages of required cash payments to the current interest rate, repayment flexibility becomes even more important. Not only is there uncertainty with regard to the pattern of revenues available for debt service, but of the debt service itself. In the same vein, to the extent that financial obligations themselves are linked to the DC's success with particular investments, serious problems can be minimized and as a result, total external financing and the investment it supports can be increased. For example, debt instruments linked to prices or commodities produced by the borrowing country can mitigate the impact of a fall in prices on revenues since there will be a corresponding fall in financial obligations and debt service requirements.

Process issues: The process issue all governments face concerns who will decide the substantive issues. Will decisions be made by a single government

unit, by decentralized public enterprises, by large-scale, local, private businesses with access to external markets, or by foreign financial institutions operating in local markets? The decision on this issue is extremely important in defining the range of options facing a specific country and in determining to what extent financing will occur at the national level or the enterprise.

2.3. FINANCING DECISIONS AND NATIONAL POLICIES

A government's decisions about the major issues of substance and process are closely linked with the goals a DC sets for itself in designing a national strategy. National strategies are the purposive response of a government to numerous forces acting on it and the country. They evolve from the government's decisions about three types of goals: growth of productive capacity, welfare of the populace, and power or autonomy--sometimes called control, sometimes integration--in the international system. These three goals are implicit in the three models of industrialization strategies considered by the Joint Study: international division of labor, nationalistic industrialization, and human-centered development. The relative importance of the three types of goals varies and the trade-offs among them lead to different development strategies, which in turn prompt different policies toward external finance.

Financial policies to implement the development and financing goals must meet two requirements. First, they must be consistent with the goals; where goals conflict, the policies must be a compromise. Second, policies must be realistic. They must reflect the constraints in the environment: one cannot, for example, adopt a policy of mineral exploitation in order to implement a goal of rapid growth if no minerals exist. Stated thus, these

precepts are self-evident. But for several reasons they become critical when one focuses on policies toward external finance. Most important is the fact that decisions about the goals actually help to shape feasible financing strategies, although in a more subtle way than is generally imagined. In terms of access to credit, the strategic choices about growth, welfare, and integration themselves encourage or discourage private lenders. Their willingness to lend in turn shapes the options for external debt. A government's strategy thus emerges as significant to external financing policy for two reasons: development goals shape a government's desire for external finance, but it also shapes the options open to it.

In setting policy toward volume, sources, and terms of external finance, a government has already by its major goals helped to shape the non-concessionary credit environment and therefore the options available to it. For example, data suggest that banks or investors are most favorably disposed to countries with a strategy for fast growth, low emphasis on welfare, and a high degree of international integration.* They are somewhat less receptive but still open to countries with goals of fast growth but also high welfare and low international integration. Thus even a mineral-rich country with a goal of high welfare or a country with a large, highly-protected domestic market will discover fewer options for private external finance. Even more limited are the options open to a country that emphasizes welfare or economic independence and accepts slow growth.

Similarly, national strategies will also define the volume and nature of concessional finance. Concessional finance often is politically

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*Assuming, of course, that the government has a reasonable chance to succeed in its strategy.

motivated and, as a result, depend on the extent to which the strategy chosen is favored by the countries granting the concessions. Further, the concessions often will reflect particular economic interests and, as a result, will be conditional on specific commercial transactions, such as the purchase of capital goods from the countries granting the concessions.

The gist of this argument is that government decisions on the fundamental development goals play an important role in shaping its options for external financing. Those decisions about strategy reflect the factors others have associated with external financial flows, such as the level of industrialization or the extent of natural resource wealth. But no simple technical factor explains the behavior of the lenders. Their strategic decisions also reflect social and political factors and sophisticated creditors or investors also consider these factors. In addition to limiting the options open to it, a government's goals also shape the type of financial obligations it will accept.

2.4. THE FINANCING REQUIREMENTS OF PARTICULAR DEVELOPMENT STRATEGIES

DCs following rapid growth strategies will require substantial long-term external financing, spanning the period required to reach a self-sustaining level of growth. DCs with uncertain future foreign revenues will require access to shorter term "balance of payments" financing to enable them to maintain an efficient, stable investment program or a level of consumption in line with their welfare objectives. This same uncertainty regarding future revenues may call for greater flexibility in longer term financial arrangements, since fixed debt service requirements will exacerbate the effect of volatile revenues on net resource flows available for investment and consumption.

A country's growth strategy may hinge on a major gamble on one or more key internationally integrated sectors with uncertain payoffs, suchh as manufactured exports that are vulnerable to IC protectionism or primary commodities which are exposed to price swings. Under these circumstances, the uncertainty of the future returns from these activities will require flexibility in long-term financing as well as short-term financial flexibility to smooth net revenues in terms of cyclical or other stress.

Finally, if the development plan calls for substantial expenditures on human services which will not lead to directly appropriable payoffs, then concessional resource transfers will be an essential component of any external financing programs.

2.5. GUIDING PRINCIPLES

For purposes of convenience, guiding principles are divided into two groups: those associated with aggregate finance at the national level and those more closely associated with the financing of specific enterprises or of specific patterns of international trade or technology flows.

2.5.1. Guiding Principles for Non-Concessional Finance at the National Level: Traditionally, the emphasis in discussions of international finance of development has been on finding ways to increase the volume of finance. This in large part has reflected the fact that much international finance has been of a concessional nature. However, with the increasing reliance on commercial finance, maximizing the volume of external financial flows is no longer a valid guiding principle. It implicitly assumes that external constraints on financing are binding and that DCs would borrow more if they could. The decision regarding the magnitude of external finance involves a crucial trade-off between the additional resources it makes available for

consumption or investment and the claims against future resources it represents. Further, the "cost" or "burden" implied by the future claims depends not only on the total magnitude of external claims but on the relationship between debt service requirements and resources available for debt service under particular sets of future circumstances. Thus there must be a close interaction between decisions relating to sources of financing, terms of financing and the volume of financing. As a result, a more compex set of specific guiding principles emerge.

Innovations or increased cooperation should be sought to:

1) relax external constraints on the volume of finance;

2) stabilize and guard against sudden interruptions in the flow of external finance;

3) increase the choice of DCs in terms of both sources and terms of finance to allow better matching of debt service requirements and revenues;

4) allow greater flexibility of repayment in order to reduce the chance of financial crises resulting from unanticipated revenue shortfalls; and

5) allow DCs to shift certain risks associated with development strategies to foreign lenders or investors on improved terms.

These guiding principles have the objective of increasing the range of choice available to DCs and insulating them from external events which at present limit their financial flexibility. This greater flexibility will allow DCs to tailor external financing so as to minimize the debt "burden" and hence increase their ability to make use of external finance in pursuit of their development goals. These guiding principles call for a variety of specific innovations in terms of the volume of finance, sources of finance, and the terms of finance. These specific innovations are discussed at length in part 3.

In addition to increasing the range of financing options open to DCs, hence enabling them to make better use of external finance, steps must be taken to deal with the problems of countries currently in a state of financial crisis. Much of the public debate over DC borrowing has focused on the "after the fact" aspect, at times at the expense of discussions of improving financing conditions "before the fact." An important guiding principle is that the two issues should not be allowed to cloud each other, since quite different steps are required. The primary focus should be placed on structuring external finance so as to minimize the chance of crisis. However, a realistic appraisal of DC prospects suggests that even with major improvements in the terms and structure of external financing, financial crises will occur. Thus, any "new world financial order" must include mechanisms which minimize the economic and human costs of financial crises.

<u>2.5.2. Guiding Principles for Finance at the Enterprise or Project Level</u>: At the enterprise or project level, innovations should be sought to facilitate flows of trade, technology and investment initiated by the South. Today, many financial mechanisms are linked to specific North-initiated trade patterns. To reduce their real dependence on the North, DCs must seek mechanisms which will provide financial support for the new steps in the areas of trade, technology, and investment. But an equally important principle requires DCs to structure North-South financial flows at the enterprise level so as to increase the likelihood of success of industrial investments by increasing the stake of the participant from the North. DCs should incorporate, where feasible, incentives for Northern participation in the design, performance, and management of the projects being financed.

This suggests some "rebundling" of finance with technology, capital goods or management flows and at first glance may appear to conflict with the overall goal of reducing the South's dependence. However, the absence of specific international financial links at the enterprise level strains the domestic financing and control system of most DCs. It appears likely, therefore, that DCs will increase rather than decrease their links at a subnational level. The experience of socialist countries in this regard is instructive.

2.5.3. Guiding Principles for Related Concessional Finance: With regard to finance both at the aggregate national level and at the enterprise or project level, concessional finance will continue to play an important role. Granted, the scope for expanded concessional flows appears limited given the political climate in the North. This does not suggest, however, that there are no new areas for international cooperation in this regard. Concessional transfers increasingly must be viewed as a scarce resource with a social opportunity cost that must be applied to the best possible use by developing countries. This suggests the need to identify clearly at either level, aggregate or enterprise, financing requirements which cannot readily be met through private markets but which could be supplemented by public support. The resulting guiding principle is to apply concessionary transfers in a way that maximizes their leverage in attaining development goals and not waste them in those areas or programs where properly designed finance on commercial terms is sufficient.

3. PROPOSALS TO IMPROVE NON-CONCESSIONAL FINANCE

3.0 INTRODUCTION

There is little reason to believe that the dominant mechanisms and instruments of finance are best suited for all DCs regardless of their particular policies or situations. These mechanisms have evolved in response to the requirements of industrialized countries and IC-based enterprises. DCs will often have substantially different needs and, further, the financing options acceptable to them will be constrained by their own goals and policies, especially those aimed at limiting foreign control of their economies.

In considering financial innovations, however, several cautions are in order. First, financial transactions inherently depend on confidence and as a result financial markets and institutions tend to be extremely conservative with regard to change. Second, financial markets are characterized by substantial economies of scale in terms of gathering information, providing liquidity, and diversifying risks. As a result, the cost of creating new markets, new institutions, or new financial instruments may be much greater than the direct outlays required. Finally, given the conservatism of financial markets in general and their concentration in industrialized countries, transactions with DCs are often perceived as being more risky than they actually are. If this general skepticism is compounded by the fact that a DC is using new, untested financing mechanisms, the likely result is outright rejection by world capital markets.

These cautions suggest the need for a realistic view of financial innovations which recognize the conservative nature of financial markets and institutions. Non-traditional features should be avoided unless they provide a clear

advantage to DCs over available instruments. The motivation for innovations must rest on the requirements and "comparative advantage" of the DC borrower, not simply on the likelihood that some new feature will attract investor interest. For example, many observers have suggested that DCs should issue index-linked bonds of one type or another, but most proposals give little weight to why a particular index should be attractive to a particular DC.

Financial "gimmickry" should be avoided, since it is likely to reduce the credibility of DC borrowers and mask the seriousness of the issues being dealt with. Similarly, innovations that appear to offer something for nothing are best avoided. In general, they either are not economically logical or they involve some hidden concessional element that is unlikely to be the best way to employ these admittedly scarce resources.*

Organization of Proposals

There are a variety of types of innovations relating to the volume, sources, and terms of finance that increase either the options available to DCs or their sophistication in using these options. Further, these options can be ordered along many dimensions including the problems they address, the type of financial instrument or institution involved, and the likely degree of difficulty or cost involved, and the actors (private firms, DC governments, IC governments, and multi-lateral institutions) involved.

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*A case in point is the proposed "premium bond," a bond coupled with a lottery prize. Such an instrument would be of interest only to individual investors who lack the sophistication required to properly evaluate DC securities and hence is likely to run afoul of IC investor protection regulations. It also includes a subsidy in the form of the "right" to operate a lottery, a right that has a definite opportunity cost to the IC granting it since it will be sought by hospitals, charities, and state or municipal authorities. Finally, it places DC finance in the "joke" category and does nothing to enhance DC credibility.

Of necessity, our presentation is organized in terms of a mix of these various dimensions. Because of the major role played by commercial banks in DC external finance, we begin in Section 3.1 with a series of proposals relating to commercial bank finance. Given the nature of bank finance, these proposals relate to credit transactions and, in general, to finance at an aggregate national level. This is followed by a somewhat parallel analysis in Section 3.2 of mechanisms to improve non-bank credit mechanisms. In section 3.3, we then turn to an analysis of various mechanisms to increase and improve the flow of risk capital, both at a national and a project level. In each case, we conclude with a brief discussion of proposals that require concessional resources in combination with non-concessional ones. Proposals considered in each case are further broken down into four groups, by the type of action and the nature of actors involved. These categories are:

1. Innovations in DC practices aimed at increasing their utilization of existing external financing alternatives;
2. Innovations in IC practices and policies directed toward increasing DC access to existing financial markets and instruments;
3. Innovations in financial instruments aimed at matching terms of external financing to DC requirements;
4. Innovations in financial institutions and market structure to facilitate points 1 through 3 above.

Since most of the proposals for new institutions address a variety of issues simultaneously, there is a separate, more comprehensive discussion of institutional innovations in Section 3.4. Figure 3 which follows provides a schematic overview of the various proposals that are presented and evaluated.

FIGURE 3

Potential Innovations in International Mechanisms
for Financing Development

Degree of Difficulty: MIN = minimal, MOD = moderate, MAX = extremely difficult.

Object of Innovation	Proposed Innovation	Actors Involved
Reduce bottlenecks to absorptive capacity	Greater use of local financial institutions to diversify sources	DC governments (MIN)
Increase medium-term credit flows	Greater use of local financial institutions to diversify sources	DC governments (MIN)
	Tax sparing agreements for withholding taxes on debt	DC/IC governments (MOD)
	Improved distribution of data about borrowers	DC/IC governments, multinational institutions (MOD)
Diversify among commercial banks	Increased use of other than standard lead banks to tap smaller banks	IC governments, IC financial institutions, and multilateral institutions (MOD)
	Increased DC presence in financial centers	DC governments, multinational institutions (MI
Diversify away from banks	Greater access to existing domestic capital markets/ other financial institution of ICs through relaxation of restrictive laws & regulations	IC governments either bilaterally or multilaterally (MIN to MOD)
Increase available range of maturities - reduce bunching	Improved debt management by DCs (timing procedures, marketing, information, coordination)	DC governments and multinational institutions (MI
	Greater access to existing markets/institutions	IC governments (MIN to MO

Figure 3 cont.

Object of Innovation	Proposed Innovation	Actors Involved
Increase repayment flexibility of credits (non-concessionary basis)	Flexible line of credit	IC financial institutions (MOD)
	Tie deposits to credit	IC banks and governments of sources and users (MAX)
Increase repayment flexibility of credit (concessionary basis)	Lines of credit with "compensatory" repayment guarantee	IC financial institutions, governments (MAX)
Improve real time pattern of repayments	Modified repayment patterns	IC financial institutions, (MOD)
Shift risk of commodity price fluctuations	Commodity-linked debt	IC financial institutions (MOD)
Shift risk of project technology, management	Contingent project financing	IC financial institutions, contractors, possibly multilateral agencies (MOD to MAX)
Shift risk of world income fluctuations/ protectionism	"Compensatory" global long-term financing	Multilateral agreements among IC governments (MAX)

3.1. NEW MECHANISMS FOR NON-CONCESSIONAL BANK FINANCE

3.1.1. Matching maturity repayment terms to revenue projects

The problem. The long pay-off on many development projects argues for long-term financing if a country is to match debt repayments to prospective revenues. But the trend in many DCs toward greater reliance on credit from banks works against such matching and exacerbates the maturity gap. Certainly the most obvious and striking difference between concessional and non-concessional loans is that lenders extend the latter at much shorter maturities.* Yet due to differences in government policy and market decision, any discussion of or remedy for the maturity gap must distinguish between at least two types of developing countries, often simplistically called middle and low income countries. Those with the most access to bank credit, generally middle income countries, find a slightly narrowing gap between the maturities of commercial and concessional loans (see Table 2). Coupled with the relative advantages of bank finance and the dynamic of the international banking system, this narrower gap makes for a closer trade-off between commercial and concessional credit. Quite the opposite is true in the case of the poorest countries, for which much would have to be done to alleviate the impact of the maturity gap in bank finance.

For countries now most able to borrow from banks, their debt seems onerous at first glance. Table 1 ranks the top twenty borrowing countries: eleven must repay over half their debt within less than one year; only five report maturities beyond a mere two years on half or more of their debt. But if one removes the short-term credit, used mainly for self-

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*In contrast, the interest costs of concessional and commercial loans are often close, particularly when foreign exchange costs are included.

Table 1

Liabilities of Major Developing Country Borrowers

to International Banks

(end September, 1978 -- U.S. $ billions)

Top 20 DC Borrowing Countries	Liabilities to BIS Banks 9/78		Maturity Structure (12/77) - Due:	
	Total Assets	Net Assets	Under 12 Months	Over 24 Months
Brazil	$29.8bn	$20.5	32%	55%
Mexico	22.4	16.5	41	45
Venezuela	10.9	3.3	61	31
Iran*	6.6	0.2	51	40
Korea,S.	6.3	3.6	55	33
Argentina	5.8	0.9	57	28
Algeria	4.9	3.1	23	64
Indonesia	4.4	2.0	45	43
Philippines	3.9	1.7	54	37
Peru	3.2	2.6	48	40
Turkey	3.1	2.2	79	11
Thailand	2.4	1.1	81	13
Chile	2.3	1.1	61	23
Ecuador	2.1	1.5		
Columbia	1.9	0.1	59	29
Morocco	1.8	1.0	24	61
Cuba	1.7	1.5	66	26
Nigeria	1.4	0.7	83	6
Zaire	1.2	0.7	35	53
Ivory Coast	1.1	0.4	24	61

Subtotal $117.2bn

Total Liabilities of DCs
(Asia, Africa, Mid-East[non-oil], Latin America) $165.5bn

Total Liabilities, Global $801.8bn

*As of end of 1977

Source: Bank for International Settlements.

Table 2

External Public Debt of the Twenty Major DC Borrowers from International Banks:

Trends in Debt Service Ratios, Interest, and Maturity

(1970 - 1976)

Top 20 DC Borrowing Countries	Debt Service on External Public Debt as a percentage of: Exports (goods & services)			GNP			Average Interest **				Average Maturity **			
							1971-73		1974-76		1971-73		1974-76	
	1970	1972	1976	1970	1972	1976	Official	Private	Official	Private	Official	Private	Official	Private
Brazil	14.1	15.9	14.8	1.0		1.3	6.4	8.6	7.7	7.8	21.0	9.0	18.7	9.3
Mexico	23.6	22.8	32.3	2.1		2.1	6.8	7.4	7.6	8.1	17.9	10.3	18.9	5.9
Venezuela	2.9	6.1	3.9	0.8		1.3	6.3	7.0	8.0	6.4	14.4	9.8	10.8	6.6
Iran*	12.2	20.0	4.3	3.0		1.5	5.2	6.8	5.7	7.9	13.1	6.9	16.8	8.5
Korea, S.	18.9	17.4	8.9	3.7		3.8	4.7	7.7	7.1	8.4	28.4	9.9	20.2	9.6
Argentina	21.4	20.4	18.3	1.9		0.9	7.3	8.8	6.3	8.3	18.0	6.7	14.0	8.0
Algeria	3.2	11.8	14.1	0.9		5.7	5.0	8.2	6.9	7.9	17.9	11.5	15.0	10.1
Indonesia	6.4	6.9	11.2	0.9		2.3	2.2	9.1	6.1	8.6	35.7	7.8	22.5	9.0
Philippines	7.6	10.1	6.6	3.2		2.4	5.3	7.9	6.1	8.5	20.7	6.0	21.8	9.7
Peru	13.6	18.3	21.6	2.8	2.4	3.5	5.7	8.8	6.7	9.5	15.1	10.1	15.2	7.6
Turkey	16.3	11.3	7.1	1.3		0.7	4.6	6.9	6.2	8.6	25.1	8.9	18.5	7.4
Thailand	3.3	2.7	2.4	0.6		0.6	5.6	7.2	6.7	8.7	28.0	11.8	23.9	7.2
Chile	18.9	9.9	32.9	2.8		8.4	4.7	7.1	6.4	7.2	13.3	9.7	16.7	8.6
Ecuador	9.0	10.2	5.8	1.5		1.7	3.4	7.8	6.4	7.7	30.7	9.2	21.2	7.1
Columbia	11.6	12.4	9.4	1.7		1.8	5.7	8.7	6.2	8.0	26.1	10.0	21.5	8.1
Morocco	7.7	9.3	8.2	1.8		2.5	4.8	5.8	4.9	7.9	23.2	9.1	22.4	9.1
Cuba														
Nigeria	4.1	2.7	2.3	0.7	0.6	0.9	5.3	5.1	6.7		25.7	7.4	20.7	
Zaire	4.4	8.0	11.7	2.2		1.6	2.4	8.0	5.8	7.7	27.5	9.4	20.2	10.2
Ivory Coast	6.7	8.2	9.1	2.7	3.3	4.0	5.0	8.3	6.6	8.0	21.1	10.1	18.4	9.3

*As of end of 1977.

**On loans from official and private lenders.

Source: IBRD, World Debt Tables

liquidating trade finance, the average maturity of debt to private lenders was 8.4 years between 1974 and 1976 (public sector borrowers only). While this falls far short of the ideal development loan, it is far better than the popular stereotype. The bankable countries find, moreover, that donors advance concessionary credit at maturities that are shorter now than during the early 1970s. For these countries, because concessional loans are both more difficult to obtain and more costly than before, the maturity gap carries declining operational importance. Because the dynamic of the international banking system encourages roll-overs (see below), one can exagerate the commonly perceived danger that banks will declare defaults and prevent a borrower from restructuring its debt. The significance of the maturity gap for these richer countries lies more in its impact on net financial inflows. Bunching may discourage net increments in bank credit.

On the other hand, the difference between the maturities of concessional and commercial credit carries enormous weight for countries with low per capita income and few exportable resources. These countries remain eligible for cheap foreign aid at very long term. They believe that recourse to substantial commercial credit would jeopardize concessional flows because they fear that donors would disapprove of the higher servicing costs of bank loans. Governments in these countries therefore foreclose significant bank credit. But even if the governmets wanted such credit, the banks are reluctant to lend. According to one large U.S. bank, Citicorp, its loans to these poorer countries are mainly short-term (as well as primarily in local currency and at a higher interest rate). In short, these countries would require a dramatic lengthening of commercial maturities before bank loans reach a threshhold of attractiveness.

Proposals. The different problems call for different solutions in any effort to lengthen the time transfer in commercial bank lending. In both cases, many countries used attention at home to the quality of their own debt management. This alone would allow individual DCs to take advantage of market opportunities by rescheduling, for exmaple, as liquidity and demand conditions permit. As noted above, opportunities are greater for middle income countries.

For several years, analysts have underscored the value of an effective, comprehensive system of debt management as a means of improving the terms of bank credit. But the process by which a country achieves it is often arduous and long. It requires sophisticated judgments and coordinated action in training, marketing, pricing, and the use of information generally. Here is an opportunity for South-South cooperation between countries with substantial experience and those with little. At first blush, cooperation would appear simple and straightforward. But enormous differences exist between sophisticated countries, such as Brazil or the Philippines, and those who could gain from the others' experience, such as Kenya or Indonesia. Language is only one problem. Legal systems diverge, as do administrative systems, domestic credit institutions, parastatal functions, and, of course, national strategies. Under such circumstances, the exchange of information and control procedures cannot be left unattended. Some multi-lateral institution, such as UNIDO, will have to act as a coordinator in the process of training and technical assistance. The International Monetary Fund does have the means to provide some of these coordinating services; its contacts--primarily with central banks--would be useful to exploit becuase most often the debt management function rests in the central bank.

This proposal would push further, however. For example, development banks are in a position to match finance and revenues on individual projects. Brazil's Banco Nacional de Desenvolvimento Economico, for one, could act as a useful training ground for appropriate staff of development banks elsewhere. Given the high foreign lending to public corporations, particularly the parastatal sector must be attuned to the exigencies of well-managed debt.

At the enterprise level, observers several years ago expected the so-called true project loans to provide the opportunity to match maturities to revenues (and also to transfer risk). Experience proved these opportunities much less significant. All lenders, concessional as well as commercial, compete for the very limited number of bankable projects. The donors, to assist DCs in this matter, would have to be willing to shift their lending from projects to general programs. Such a moderate move would free projects for commercial financing. Because home regulators accept more favorable terms on project-linked loans than on balance of payments financing, the effect of a change in donor policy would be to reduce the cost and extend the maturities of bank credit. For other reasons, DCs have urged donors to shift to program credit for years; the overall effect on financing <u>costs</u> would be salutory despite the fact that in macro terms no change occurs in the country's ability to earn foreign exchange.

For low income countries to narrow the maturity gap when they tap bank credit, donors and banks must change their policies. Official donors would need first to accept a higher share of commercial credit with larger gross servicing charges, and the banks must then be induced to extend maturities (and lower costs). Since the logic and practice of the

international banking system may be more tenuous with respect to low income countries,* roll-overs may appear less automatic. The minimal action possible in the home countries of the major international banks is to reduce the hysteria about lending to DCs that one finds among bank regulators and even stock analysts. A campaign to educate them would be useful because now they view such lending entirely from the perspective of the domestic financial system.

The first step toward better education would be to include regulators, if not analysts, in multinational conferences on the subject of LDC finance, something rarely done. An information campaign could focus on regulators in surplus countries, such as Germany and Japan. If uninformed perceptions of riskiness can adjust, then banks could be allowed to extend their maturities. Once this happens, the market itself could include longer term loans. If regulators' perceptions do not change, other measures will be fruitless.

3.1.2. Better use of existing markets.

The problem. Few will argue that DC borrowers from international banks possess perfect information about the market. On the contrary, this global market, in which banks are highly centralized** and in frequent communication, confronts many developing countries with serious operational problems. How does a finance ministry or central bank located 5000 miles from a major financial center stay current about trends and market innovations if it makes but occasional use of the euro-markets? Ignorance of alternatives can be expensive.

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*Zaire is a case in point.

**The administrative tension between the centralizing tendency of a bank's headquarters and the parochial interests of its field operations should not be ignored. But compared to the geographic constraints on individual DCs, the global networks of major banks are overwhelming.

One must, however, take care to distinguish among at least three groups of DCs. As shown in Table 1, the five largest DC borrowers--Brazil, Mexico, Venezuela, Iran, and South Korea--alone account for 46% of all bank assets in the developing countries of Africa, Asia, the Mid-East, and Latin America. These five countries, constantly in the market, require no assistance in recognizing alternatives.* Among the next fifteen, which account for 25% of all bank assets in DCs, the range of market sophistication is immense. All have a history of experience in the market, but their ability to use it to advantage varies widely. Some would clearly benefit from better information about the market. Of the remaining 50 or more DCs that raised eurocredits on occasion between 1971 and 1977,** most would benefit from better information. Even if one excludes the financial centers, which tend to have sophisticated policy makers, and the oil exporters of the Middle East, which hire the best financial advisors available, some 40 to 50 countries are infrequent or unsophisticated users of the eurocredit market. They represent a substantial market for a good information system.

Development priorities and the distrust of foreign private advisers, coupled with the high overhead costs of such a system, make it economically infeasible as a private sector venture. One finds some DCs turning to investment or merchant banks for advice, if they seek advice at all. This often raises conflict of interest problems even when ideology is

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*Indeed, many bankers might benefit from help in dealing with highly sophisticated officials of these five countries, but that assistance exceeds the scope of this Joint Study.

**See Tables 3 and 4. This figure excludes the more advanced Mediterranean economies.

no barrier to imaginative advice.

The Proposal: An Industrial Finance Information and Negotiation Network. Organizing the experience of countries in the South and coordinated by a multi-lateral agency, would attack this problem. This section examines the scope of appropriate services, which include both information (about markets, lenders and borrowers) and negotiation, and the appropriate organization. The clientele are identified above.

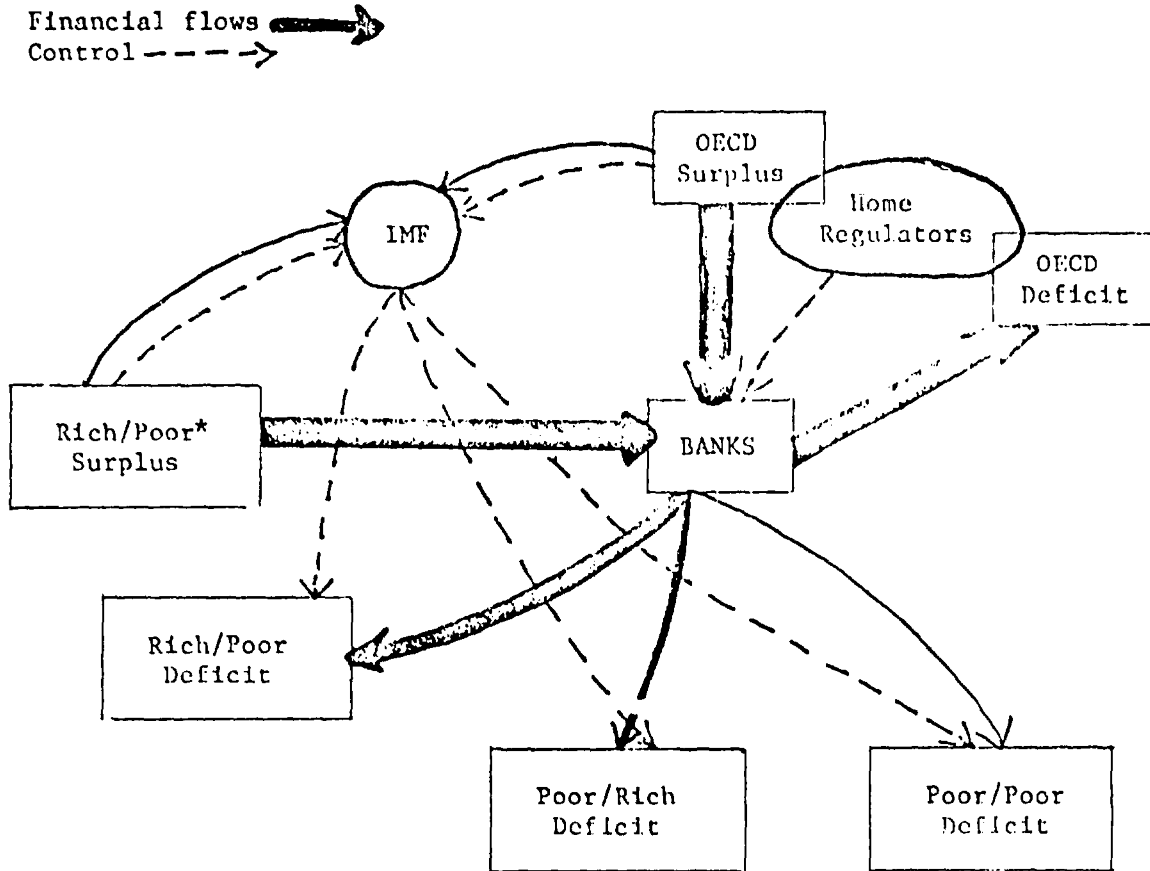
The Network would provide two basic services needed to permit DCs to use international banks more effectively. First, it would provide operationally useful information about three related topics: markets, lenders, and borrowers. Prospective borrowers need to know several things. At the most basic level, they are concerned with trends in specific terms (margins, maturities, fees) as well as more general trends (international liquidity or the competing demand for loans from transnational corporations or OECD governments). Data from the World Bank and the IMF do not fill the needs of unsophisticated borrowers. More and faster analysis is necessary. In planning financing policies, moreover, DC governments are well advised to anticipate changes in the context, such as proposed or actual regulation either of international banking activities in general or of lending to developing countries specifically. Finally, borrowers should keep abreast of innovations in the markets. In dealing with lenders, it is extremely useful to be able to point to a precedent for a proposed change in the standard form of contract.

Borrowers also need to know about differences among lenders. Figure 4 1 models the international banking system as it tends to be described, in terms of the resources of the major players. Banks are treated as an

Figure 4

INTERNATIONAL BANKING SYSTEM

RESOURCE MODEL: FLOW OF FUNDS AND CONTROL



* Rich/poor in terms of resources: natural/human. Deficit or surplus in balance of payments.

undifferentiated mass. The Joint Study takes a further step, disaggregating DCs in terms of their development strategies. Any useful information and negotiation system must go yet another step and differentiate among the banks to the extent that differences have operation consequences for borrowers. Preliminary research suggests that differences in the corporate strategies of the major international banks make some banks more responsive to DCs. Definable groups of banks allocate and price their resources differently among DCs. If one classifies strategies according to specialization and risk/yield policies, one discovers variations in pricing and allocation according to whether in a strategic sense DC business is integral to the bank, an important constituent of the bank's operations, or merely derivative of another market segment, such as multinational corporations. For a borrower, financing needs vary. There are times when it is important to tap or avoid one or another of these types of banks. But unsophisticated borrowers, thousands of miles from a financial center, are hard pressed to identify differences among banks. Contacts with the central banks of OECD countries could prove counter-productive: the Bundesbank may recommend a German bank to an inquiring DC because the bank's margins on DC loans are above average and so the bank is judged safe. A borrower seeks just the opposite. The Network must therefore provide information about banks' reputations and services in a way that enables a prospective borrower to identify what it means to use one major international bank instead of another.

The clear need for cross-fertilization prompts the recommendation that the Network provide information about borrowers that goes beyond simple terms on loan agreements. One finds among DCs a wide range of

instruments and institutions that serve as mechanisms for access to finance from international banks. One example is Brazil's Resolution 63, which controls the access of domestic banks to external credit, providing a useful way for local industry to draw on foreign savings at optimal times. While some other countries use different devices, most have nothing analogous. The Network should provide not merely general data about these mechanisms, but an indication of their advantages and costs to the country. One way to do this is for the coordinator of the Network to provide training assistance directly or as an intermediary.

The second major function of the Network is to assist in negotiations of loan agreements. This is an extremely difficult function to perform, since it demands highly skilled, mobile negotiators who bring a good sense of the needs and capabilities of the specific country. Assuming that the personnel requirements can be met, the negotiators must prove their worth. This requires institutional credibility in the organization responsible for this Network.

Several existing multi-lateral institutions are sensible forums for the Network. UNIDO itself is a logical choice, because of its central location, its expertise in similar services for industrial negotiations, and its efforts in assembling data--albeit weak on private financing--about finance for industrial development. The UN Center on Transnational Corporations has begun similar networks in related subject matter under its jurisdiction. Because many of the proposed information services resemble those provided for industrialized countries by the Capital Markets Unit of the OECD, another possible forum is the UN Conference on Technical Cooperation among Developing Countries (TCDC). But several agencies now directly

involved in international finance are not appropriate vehicles. The IMF and IBRD, as actors themselves, would have to overcome too many presumed conflicts of interest to manage the Network successfully.

3.1.3. Better access to bank credit.

The problem. The problem of access to international bank credit has two dimensions. First, all DCs as a group account for only 21% of the foreign assets of all international banks (see Table 1). This overstates the DC share by excluding assets in the BIS countries. At the firm level the disparity is even more pronounced. Among five of the largest U.S. international banks, as Table 5 shows, non-oil producing DCs receive at most 15% of a bank's assets (Citicorp), and as little as 5% (Morgan Guaranty). Second, as Tables 1, 3, 4, and 5 demonstrate, the distribution among DCs is skewed. If one removes oil producing countries, the bulk goes to high and upper middle income DCs.* Only a small fraction reaches middle income NODCs: the range is from 2.6% to 0.4% in Table 5. The share of low income countries, which account for 24% of the world's population, is miniscule: 0.5% to 0.01%.

The problem, therefore, is to increase the access of the DCs as a group and, to the extent that they choose to draw commercial funds, to increase the access of the middle and low income DCs as well. This must be done in the face of indications that trends in bank lending are against DCs. Shifts in lending strategies, even by banks for which DC loans are integral to overall operations, are moving the banks away from DCs. The big U.S. banks have begun to target the U.S. national personal and wholesale markets as the

*Note that this classification differs from the more general one of low income, middle income, and industrialized countries used in the 1978 World Bank Report and referred to earlier.

Table 3

Published Eurocurrency Credits to Developing Countries[1]

(by income category and region contrasted with others in group)

1971-1977

(U.S. $ millions)

	INCOME CATEGORY					
	Oil Exporters	Higher Income	Upper Middle Income	Middle Income	Lower Middle Income	Lower Income
AFRICA	$3,640 (5%)	—	—	$728 (1%)	$2,797 (4%)	$551 (1%)
	Algeria ($3,280) Gabon ($ 355) Nigeria ($ 25)			Ivory Coast ($ 583) Tunisia ($ 145)	Morocco ($1,289) Egypt ($ 593) Zambia ($ 335) Sudan ($ 292) Senegal ($ 102) Cameroon ($ 95) Liberia ($ 30) Congo ($ 25) (9 countries)[4]	Zaire ($446) Guinea ($ 40) Malawi ($ 20) Niger ($ 15) (9 countries)[5]
ASIA	$2,873 (4%)	$28 (*)	$30 (*)	$4,239 (5%)	$4,418 (6%)	$239 (*)
	Indonesia ($2,873)	Brunei ($28)	Singapore ($ 30)	Korea, Rep. ($2,392) Malaysia ($ 971) Hong Kong ($ 866) Fiji ($ 10)	Philippines ($2,916) China, Rep. ($1,050) Thailand ($ 265) Korea (Dem. Rep.) ($ 137) Papua, New Guinea ($ 25)	Vietnam ($112) India ($ 63) Burma ($ 55) Pakistan ($ 9) (6 countries)[6]
MIDDLE EAST	$7,133 (9%)	—	$15 (*)	$308 (*)	$201 (*)	—
	Iran ($4,338) U.A.E. ($1,682) Iraq ($ 500) Oman ($ 350) Qatar ($ 113) Saudi Arabia ($ 92) Kuwait ($ 52)		Bahrain ($ 15)	Lebanon ($ 298) Israel ($ 10)	Jordan ($ 201) (Yemen A. Rep., Yemen, P.D.R.)	
LATIN AMERICA & THE CARIBBEAN	$4,013 (5%)	$6 (*)	$271 (*)	$28,344 (39%)	$536 (1%)	—
	Venezuela ($3,445) Ecuador ($ 568)	Bermuda ($ 6)	Trinidad & Tobago ($204) Bahamas	Brazil ($12,107) Mexico ($10,224) Argentina ($ 2,605) Panama ($ 720) Colombia ($ 563) Cuba ($ 561) Chile ($ 452) Nicaragua ($ 303) Jamaica ($ 281) Uruguay ($ 272) Costa Rica ($ 161) Guyana ($ 36) Dominican Republic ($ 24) Guatemala ($ 15) (Barbados, Paraguay)	Bolivia ($408) El Salvador ($102) Honduras ($ 26) (Grenada)	(Haiti)
TOTAL	$17,659 (23%)	$34 (*)	$316 (*)	$33,619 (45%)	$7,952 (11%)	$790 (1%)

[1] IBRD Eurocredit Summary, various issues. These are only the African, Asian, Middle Eastern, and Latin American members of the IBRD. Countries parenthetical; noted did not announce Eurocredits during this period.

[2] Higher income countries have more than $5,000 per capita; upper middle income countries, $2,000-$4,999; middle income, $500-$1,999; lower middle income, $200-$499; lower income, less than $200.

[3] Percentage in parentheses is the portion the total for the category bears to all published L.D.C. Eurocredits, $73,342 million, during this period. This, of course, exceeds the total borrowing by these IBRD members. (*) is less than 0.5%.

[4] Angola, Botswana, Central African Empire, Comoros, Equatorial Guinea, Madagascar, Mozambique, Togo, Uganda.

[5] Burundi, Chad, Gambia, Lesotho, Rwanda, Somalia, Sierra Leone, Tanzania, Upper Volta.

[6] Afganistan, Bangladesh, Bhutan, Nepal, Sri Lanka, Western Samoa.

Table 4

[illegible]

COUNTRY	ANNUAL EUROCREDITS 1971	1972	1973	1974	1975	1976	1977	Country Total as % of Grand Total	TOTALS 1971-1977 IBRD MEMBERS Oil	High	Middle	Low	Non-Members	GNP 1975 Market Prices	Per Capita Income
BRAZIL	212	577	822	1,605	2,120	3,269	3,432	16%		12,107				107,970	1,010
MEXICO	140	490	1,278	1,478	2,156	2,140	2,632	14%		10,224				71,170	1,190
SPAIN	422	233	455	1,109	2,015	2,024	1,725	9%		7,002				95,63[illegible]	2,700
IRAN	224	335	727	115	245	931	1,733	4%	4,338					48,820	1,440
VENEZUELA	78	259	129	-	200	1,129	1,653	5%	3,445					26,670	2,200
ALGERIA	120	257	1,302	-	500	663	438	4%	3,280					12,290	780
PHILIPPINES	-	52	170	313	253	873	557	4%			2,916			15,730	370
INDONESIA	-	98	292	348	1,603	517	53	4%	2,873					24,180	180
ARGENTINA	50	242	87	476	34	895	818	4%		2,605				39,810	1,590
KOREA (REP.)	40	30	48	300	326	1,024	624	3%		2,392				18,650	550
GREECE	50	230	510	438	239	324	182	3%		2,083				21,500	2,360
PERU	-	147	625	342	433	350	91	3%		2,011				12,520	810
UAE	-	15	323	151	6	187	1,000	2%	1,682					6,870	10,480
YUGOSLAVIA	10	255	273	549	73	84	306	2%		1,550				31,640	1,480
MOROCCO	-	-	-	-	200	408	683	2%			1,289			7,890	470
CHINA (REP.)	-	-	170	205	163	178	533	1%		1,080				14,210	890
MALAYSIA	-	76	-	140	425	200	130	1%		971				8,690	720
HONG KONG	-	20	124	81	533	100	5	1%					866	7,520	1,720
PANAMA	16	40	191	58	115	151	147	1%		720				1,770	1,060
EGYPT	-	-	-	230	-	118	250	1%			598			23,080	310
IVORY COAST	22	-	74	63	50	148	226	1%		583				3,350	500
ECUADOR	-	-	8	-	55	88	417	1%	568					3,890	550
COLOMBIA	-	90	170	8	117	135	43	1%		563				13,170	550
CUBA	-	23	30	120	237	140	11	1%					561	7,430	800
TURKEY	-	-	20	-	170	170	150	1%		510				34,590	860
IRAQ	-	-	-	-	500	-	-	1%	500			466		14,260	1,280
ZAIRE	55	90	223	71	27	-	-	1%						3,740	150
CHILE	-	-	-	-	-	125	327	1%		452				8,050	760
BOLIVIA	-	-	5	52	90	161	100	1%			408			1,770	320
QUATAR	-	-	-	-	-	-	350	*	350					1,680	8,320
PORTUGAL	-	-	10	165	34	50	67	*		346				15,040	1,610
ZAMBIA	-	25	150	-	160	-	-	*		335				2,650	540
GABON	10	25	64	67	30	119	20	*	335					1,200	2,240
NICARAGUA	10	15	92	91	55	-	40	*		303				1,510	720
LEBANON	-	-	20	99	23	-	150	*					298	3,290[4]	1,070
SUDAN	-	-	-	220	53	19	-	*			292			4,510	290
JAMAICA	-	-	36	95	101	15	32	*		281				2,630	1,290
URUGUAY	-	-	-	-	130	82	60	*		272				3,670	1,330
THAILAND	-	-	-	10	5	100	150	*		265				14,540	350
TRINIDAD & TABAGO	-	-	10	19	5	-	150	*		204				2,050	1,900
JORDAN	-	-	-	-	5	196	-	*			201			1,240	460
COSTA RICA	-	-	11	10	46	40	54	*		161				1,790	910
TUNISIA	-	-	-	-	-	-	145	*		145				4,230	760
KOREA (DEM.REP.)	-	-	65	67	-	-	-	*			132			6,790	430
OMAN	-	-	15	14	64	-	-	*		113				1,660	2,070
VIETNAM (DEM.REP.)	-	-	-	-	38	-	74	*					112	7,100	160
EL SALVADOR	-	-	-	50	45	7	-	*			102			1,820	450
SENEGAL	-	-	65	-	20	-	10	*			102			1,850	370
CAMEROON	-	-	-	10	-	67	15	*			95			1,940	270
SAUDI ARABIA	-	-	5	-	-	-	68	*	92					24,960	3,010
BAHAMAS	-	-	17	40	-	-	10	*		67				530	2,600
INDIA	-	-	10	-	-	-	50	*				60		91,810	150
KUWAIT	-	-	-	-	24	20	38	*	58					11,280	11,510
GUYANA	-	-	13	15		4	-	*		56				450	560
GUINEA	-	40	-			-	-	*				40		710	130
BURMA	-	-	-	-		-	39	*				39		1,390	110
MALAWI	-	-	5	-		25	-	*				30		760	150
SINGAPORE	-	-	-	-		30	-	*		30				5,640	2,510
CYPRUS	-	-	-	-		30	-	*		30				740	1,180
LIBERIA	-	-	-	-	-	30	-	*			30		28	630	410
BRUNEI	-	28	-	-	-	-	-	*						N.A.	N.A.
HONDURAS	-	-	-	-	-	10	16	*			26			1,010	350
NIGERIA	-	-	-	-	25	-	-	*	25					23,080	310
YEMEN, REP. OF	-	-	-	-	-	-	25	*						N.A.	N.A.
PAPAU NEW GUINEA	-	-	-	-	-	-	25	*			25			1,220	450
CONGO PPO	-	-	-	-	-	-	25	*						660	500
DOMINICAN REP.	-	4	-	20	-	-	-	*		25				3,380	720
KENYA	-	15	5	-	-	-	-	*		24				2,900	220
BAHRAIN	-	-	15	-	-	-	-	*		15				630	2,440
NIGER	-	-	-	-	15	-	-	*				15		600	130
GUATEMALA	-	-	-	-	-	15	-	*			15			3,530	650
ISRAEL	-	10	-	-	-	-	-	*		10				12,400	3,580
FIJI	-	-	-	-	-	-	10	*		10				520	920
MAURITANIA	8	-	-	-	-	-	-	*			8			410	310
PAKISTAN	-	-	-	-	8	-	-	*				8		9,830	140
BERMUDA	-	-	6	-	-	-	-	*					6	230[4]	4,190
SWAZILAND	-	3	-	-	-	-	-	*			3			230	470
TOTAL	1,475	3,888	8,350	9,854	12,766	17,414	20,095		17,546	47,545	6,262	658	1,871		
GRAND TOTAL								73,842							
% OF GRAND TOTAL	2%	5%	11%	13%	17%	24%	27%		24%	64%	8%	1%	3%		

[1] IBRD Eurocredit Summary, various issues.

[2] World Bank Atlas, 1976.

[3] Higher-income countries have more than $500 per capita; middle-income, $200-499; and low-income, less than $200.

[4] 1974 data used.

*Less than 0.5%

Table 5

Distribution of Loans Among Developed and Developing Countries

December 31, 1977

Countries by Per Capita Income	Loans as a Share of Total Assets				
	Bank of America*	Chase Manhattan Bank	Citicorp	First Chicago Corp.	Morgan Guaranty
Industrial - USA	44.4%	32.8%	20.2%	36.5%	20.5%
Industrial - Non-USA	10.5	18.2	19.8	12.5 (Industrial - Non-USA and Centrally planned combined)	23.1 (Industrial - Non-USA and Centrally planned combined)
Centrally planned	0.7	0.9	0.6		
OPEC members	1.7	2.9	3.8	***	2.0
Non-Oil developing:	6.0	10.6	14.5	7.4	5.1
High income	3.4	9.6 (High income and Upper middle combined)	11.4 (High income and Upper middle combined)	6.5 (High income and Upper middle combined)	1.2
Upper middle	1.3				3.5
Middle income	1.0	0.9	2.6	0.9	0.4
Lower income	0.3	0.1	0.5	0.01	0.02
Total non-US loans	19.0	32.3	38.7	19.9	30.2
Total loans	63.4	66.1	58.9	56.4	50.7
Total assets (=100%) ($ bns)	$81.99	$53.18	$77.11	$22.61	$31.66

Source: Bank Annual Reports.

Classification and data are not stictly comparable because of different reporting systems.

*All figures in Bank of America column are for loans and securities.

new areas with potential for rapid growth. The logical next step for banks is to target the other industrial countries; DCs do not offer these markets. The result, despite the cyclical swing now in progress toward DCs as borrowers, is that banks with all three types of strategies say they are mapping new growth markets that do not include DCs. This confirms the forecasts of the last several years that much bank lending to DCs will simply refund outstanding debt and that the net increases in such loans will be small compared to the 1973-75 period.

[a] Proposals for OECD Country Action. What accounts for this global distribution of bank assets? The obvious answer, conventional notions of creditworthiness, does not carry the analysis very far. The concept is self-defining and circular: those who get loans are creditworthy and those who are creditworthy get loans. Because conventions change, a dynamic notion of creditworthiness is essential, particularly when one seeks to guide the change. Bank strategies are important, as mentioned above. In a concentrated market such as this,* the shifting credit assessments by the market leaders is important to the numerous followers. But leadership itself is shifting. If the major United States banks and a few in Europe held the lead in the mid-1970s, now major German and Japanese banks have a new dominance. In the United States, certain regional banks now compete more directly with the leaders. The implications for the Joint Study are several. Direct efforts to modify notions of creditworthiness must target not only established leaders but also emerging leaders and the regulators of both groups.

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*The U.S. Federal Reserve Board reported that in 1974 the six largest U.S. banks accounted for most outstanding loans to developing countries.

Since 1974, bank regulators in the home countries of the international banks have voiced increasing concern about the growth of bank assets in DCs. Initially uninformed and sporadic, these concerns gradually took shape. Unlike the general debate about regulating the euromarkets, the specific proposals that emerge could actually be implemented by one home government without the cooperation of other governments. In the United States, the Federal Reserve Board of Comptroller of the Currency could, for example, unilaterally limit lending by U.S. banks to some or all DCs.

In fact, the regulators' concern helps to account for the shift in banks' strategies. Their actions have since 1974/75 restricted the banks' exposure to DCs. Restraints include country limits, procedures for problem loans, rules requiring balance in foreign exchange exposure, and ceilings on overseas expansion. Despite the high growth opportunities in many DCs, banks become increasingly reluctant or unable to establish local facilities in DCs or to make cross-border loans. Supplementing the governmental restrictions is the concern of shareholders who are relatively uninformed about DC borrowers individually or as a class.

The more general proposals still under debate reveal two basic themes. Regulators are concerned about the soundness of individual borrowing countries (country risk) and about undue concentration of any one bank's loans in even the best borrower. Over the last five years, banks and regulators studying country risk analysis concluded that its complexity requires considerable sophistication and even first hand knowledge of the specific country. In the absence of a respected country rating authority, logic leads regulators to examine not merely the portfolio of a bank but the process by which it decides to lend. This favors the oligopolists and

hurts efforts by newcomers and smaller banks lacking a global network to break into the credit market for DCs. The alternative to such limitations is a respected authority to rate countries; the IMF is frequently cited. From a borrower's point of view, this also leads to undue concentration of decision-making, further politicizing the IMF.

These proposals would further concentrate market power in existing lending institutions. But, granting that the concerns about sound borrowers are valid, there are alternatives. One could <u>increase the information about countries available to smaller banks</u>. Instead of focusing authority in the IMF, one could permit the banks to seek advice from a wider, more decentralized group of country analysts. They exist already in other multilateral and government agencies and are beginning to appear in the private sector of several OECD countries. Instead of reducing the use of syndication as a powerful tool for diversifying among lenders and adding depth to the market, regulators could demand stricter analytical procedures only when a bank reaches a high point of concentration of its lending to one country. At that point, the bank's investment in the country would justify the expenditure for thorough country analysis.

The voices of restraint do not speak for all the interests of these home countries. Set against them are government agencies concerned with the country's exports and its foreign policy; at least in the United States policy debate, they tend to support lending unrestricted by domestic monetary or financial considerations. That neither side dominates reflects the conflicting national interests. In this debate, the constituency for unrestricted lending resembles that for foreign assistance but with a crucial difference: it includes a group deriving substantial economic

benefit from the DCs, the banks themselves. But despite the benefits, these banks hesitate to increase the share of lending to DCs in part because of regulators. It therefore becomes in the interest of DCs to have the regulators as well as shareholders capable of informed judgments about borrowing countries. This argues for improved information flows to regulators and better public relations efforts with shareholders.

The second concern of regulators is undue concentration. The proposals to counter this problem could reduce financial flows to the most frequent borrowing countries. Not only do they know of the proposals, but they are lobbying to prevent adoption. In view of the sophistication and power of these few countries, no special action by the Joint Study is necessary.

Even if regulators can be encouraged to refrain from increasing the market power of established banks to the detriment of DC borrowers, it remains for the borrowers to reach the new and smaller entrants, the second-tier of banks with international operations. In the United States, this means greater access to the regional banks, smaller banks with some international operations. The existing structure of international bank networks favors the first-tier or transnational banks in terms of access to borrowers and to information about borrowers, but many of the second-tier banks, established since the beginning of this decade, now have accumulated experience in international lending which enables them to exercise considerable judgment independent of the transnationals. Nevertheless, as seen above, their less extensive networks will require them to draw on outside help in evaluating DC borrowers. As structural changes now throw them into greater competition with the transnationals in other markets, the

traditional vehicle of syndication may well come under pressure in the future. This means that co-financing, which has proved relatively unsuccessful in joining the big banks and multilateral lenders like the World Bank, may require renewed support as the major alternative means of leading the second-tier banks. So far the World Bank has not been willing to commit the resources needed to make co-financing work. Whether or not it does so in the future, the smaller banks must be educated to the opportunities of lending to DCs. This requires a coordinated effort.

As the relative importance of German and Japanese banks grows, special attention to the controls of their home country regulators is necessary. In view of the earlier practices of these banks, it is likely that much of their lending is still trade related. To the extent that this reflects the conservativeness of regulators, it is important to draw their attention to the drawbacks of tied lending of any sort for borrowers in developing countries.

There remain, finally, the numerous indirect ways in which the government authorities of home countries affect the flow of funds to DCs. Demand management, particularly through monetary policy, and foreign exchange controls are prime examples. Significant as they are to the pricing and flow of funds, however, it is unlikely that OECD countries can be induced to take into account the needs of DCs as they frame their policies. Some small educational effort might have a marginal impact.

One small structural change could have incremental value: Greater contact between home country regulators and developing country borrowers. A precedent exists. After foreign exchange crises crippled several international banks in 1974, the staffs of central banks in G-10 countries began

joint consultations; until then, they did not even know the names of their counterparts in other central banks. Regulators who examine banks' exposure in DCs could profit from a more intimate knowledge of those DCs, of the nature of financial flows to the DCs, and of the international system within which the banks operate. As mentioned earlier, these very regulators are often absent from the multilateral forums where such issues arise. The model for this proposed change is organic rather than legal. The proposed connections could lead eventually to a recognized Code of Conduct adhered to bay all important players in the international banking system. But formal or informal, the institutional links must be forged if spokesmen for competing interests are to accomodate one another.

[b] Proposals for Action by the South. DCs themselves can act to improve their access to bank credit. In addition to better debt management and a coordinated public relations effort, DCs can eliminate some of the bottlenecks to their own absorptive capacity and they can diversify among the sources, reaching a larger number of banks.

We are long familiar with the argument that for structural reasons developing countries sometimes cannot productively use greater infusions of external finance, but in the main this paper assumes that absorptive capacity exists. There is, however, one institutional bottleneck so directly related to this study that it deserves attention. The lack of diversity and sophistication among local borrowers can hinder the ability of a country to draw on credit from international banks. Home country laws and concepts of prudence limit a lender's willingness to lend a lot to any one borrower. Limitations on staff size and organizational purpose may restrain the borrowing of any local entity. Particularly in the

syndicated credit market, scale is valuable. High thresholds for entry, such as the $10 million minimum often cited as necessary for syndication, restrict the access of the many local entities that are too small to use such large financing. Some device is required to aggregate otherwise creditworthy borrowers so that they can achieve the minimum scale or reduce the cost of borrowing.

Intermediation by domestic banks, mentioned above, is one such device. A country can expand its own channels to external credit by permitting local financial institutions--generally commercial banks--to borrow from international banks and relend the funds to local borrowers who do not otherwise have access to external credit. Such a proposal envisions the transfer of all risks (except the local borrower's default) from the intermediary bank to the borrower. If interest rates float, so does the local borrower's rate. If exchange rates may fluctuate, the local borrower bears the risk. The local authorities can decide whether local borrowers receive foreign or local currency. Indeed, they can manipulate cost, risk, and use to accomplish various national policies.

Just as a general regime of debt management is essential to the productive use of external credit, so does this proposal require careful government regulation. But if local banks have adequate financial skills it is possible for the regulators to delegate many decisions to the banks. This decentralization speeds up the process. It also permits the use of long term loans for working capital or investments with a faster return, because banks can lend on for shorter terms, but such a reversal of maturities is not essential. The opportunity for South-South cooperation rests in the need for effective management at all levels: regulatory

agency, intermediating bank, and local borrower. A few DCs have acquired skill in intermediation--Brazil, Philippines, and South Korea, for example --which they could share with others.

Intermediation appeals to international banks. Some, such as Morgan Guaranty Trust Company, consider themselves as bankers to banks now and lend a high portion of their assets to smaller banks. This expertise would carry over into international lending. Others, such as Bank of America, have in place throughout the world a network of local banks and financieras which they could use for intermediation. In order to assure that the funds reach local industry rather than subsidiaries of transnational corporations, regulators could specify certain uses or borrowers.

Diversification of sources is another technique by which a DC may increase access to bank credit. Several routes are described above. In the United States, DCs need more direct contact with other regional banks. DCs must also consciously draw on non-traditional banking partners, such as those from Germany and Japan. In both cases, the assistance of the Network recommended above is essential for most countries to make a coordinated effort to diversify.

An alternative would be to by-pass banks entirely. As the market in commercial paper grows, particularly in the United States, foreign issuers have begun to draw upon it. At first, only the major public corporations from DCs could expect to sell their own paper, but this may change as the market expands and DC borrowers become better known. Now even the longest terms are relatively short. As a result the market has limited usefulness in addressing the maturity gap, but it may allow

flexibility in smoothing resource flows. Moreover, it would be necessary to hire an investment bank to manage the issue. At this stage, DCs can only begin to tap the market, but the opportunity for evolution exists. If DCs do so, however, they cannot expect the semi-automatic roll-overs found in the international banking system.

3.1.4. New means of bank financing

The problem. For a country with continued access to bank credit, it is not clear--at one level of analysis--that the terms of commercial credit are harsh. Interest rates float above 10% but world inflation is high at the same time. As Table 2 shows, the frequent borrowers report relatively little difference in the interest paid on loans from official creditors and those from private. Maturities are a moderate 5 to 8 years on average, but if lenders do roll loans over as they become due then whether the roll-over occurs in 5 or 10 years is not important. Although legal risk rests with the debtor, in practice major lenders and borrowers are mutual hostages of a system in which no party declares default.* If borrowers can thus count on borrowing to service outstanding debt, does this mean they need not concern themselves with the terms of new debt? Certainly not. Various factors independent of the parties to the loan agreement constrain gross flows and, thereby, the net flows as well. External debt should finance development, not merely service debt, so a country has every incentive to hold down the cost of its debt and stretch amortization as far as forecast resource flows permit. The problem therefore persists, to reduce costs and lengthen maturities.

*Note that this interdependence does not exist in all credit relationships. In highly diversified credit markets, the individual stakes can be too small and the problems of coordination too large to permit the mutual accommodation one finds in bank lending to public sector borrowers in DCs.

Proposals. Several actions will encourage better terms on credit from banks. Because of the role of the market in allocating resources, the Information and Negotiation Network proposed earlier will serve an important function in helping DCs improve the terms of loans in the direct negotiations with lenders. In order to improve the maturities of bank credit in the context of the economic cycle, one could introduce flexibility into the repayment schedule. In order to reduce the cost of bank credit, one could rationalize the fee and interest structure by eliminating special one-time payments that obfuscate the true costs in the eyes of other borrowers and lenders. One could fix some interest rates in order to obviate the violent swings inherent in floating rate loans.

In opposition to these proposals are convention, the regulators' concern, and the basic mechanism by which short-term deposits are translated into floating rate, longer term loans. Reason and experience may persuade the first two centers of opposition to relent, but the third is structural and likely to impede any substantial change that is not itself structural. This argues for incremental change.

Banks should be willing to accept long-term deposits, from resource-rich countries of the South, that are explicitly to be loaned on to deficit countries of the South. The tied deposit transfers from the depositor to the bank the risk of default by the borrower. This is normal in all such intermediating activities and should appeal to low capital absorbers in OPEC, for example. The tied deposit also permits, however, a flexible repayment schedule during the life of the loan since the depositor is known and committed to a long-term deposit. While such a scheme could be left to the vagaries of the market, it would be more effective if a multilateral agency such as UNIDO would initiate and coordinate the relation between banks and surplus depositors from the South.

Within the range of maturities prevailing at the time, nothing other than convention prohibits banks and borrowers from negotiating a flexible repayment schedule at the outset. Certainly balloon repayments are not alien to loan agreements now, so nothing requires regular and equal installments. The novelty lies in asking banks to accept formally and in advance an arrangement that appears increasingly to be accepted in practice. The experience of the last several years demonstrates that if public sector borrowers encounter repayment problems, lenders will reschedule, formally or informally, rather than declare default. Why not be explicit? There are two reasons. Lenders prefer to retain the legal power to act if trouble threatens a borrower, but this is something of a sham. The lenders' real power lies in their ability to withhold net increases in credit in the future, a power that persists regardless of whether a default may be declared. Secondly, lenders see a contractual obligation to repay fixed amounts at certain times as imposing a discipline on a borrower. Yet banks frequently use the open-ended line of credit or overdraft facility in corporate finance.

The solution would be to develop a flexible repayment procedure that would embody a fixed repayment schedule subject to certain contingencies. For general purpose loans, these events could include commodity prices falling below a fixed amount or trade receipts falling short of a specified amount. For true project loans, even now one contingency is the project's success. In either case, the events must be outside the borrower's control. If the contingency occurs, the agreement would permit delays in amortization but require continuing payment of interest and, in all likelihood payment of a premium for the additional administrative costs of the lenders. But because the event is within the terms of the contract, it constitutes neither

a default nor a problem loan for the bank. Such a procedure recognizes that borrowing countries differ profoundly from companies in that, despite debt problems, the countries will continue to exist while the companies may be liquidated. International banks know and act on this reality now. Home country regulators should also do so. To accomplish this requires coordinated action, which calls in turn for some multilateral body.

Recognition of this simple principle could have a profound effect in that it would serve as a precedent for counter-cyclical lending by private creditors. For several reasons, DC borrowers are seen as marginal to banks. The notion is simply that banks lend more to them as demand falls from traditional borrowers such as multinational corporations. Proof is aduced from the events of the early 1970s, when DC lending began, and from the distribution of credit in 1974, when demand from industrial countries reduced the share of loans to DCs. This being the case, it is argued, DC borrowers are most vulnerable to swings in world economic cycles. As growth picks up in industrial countries so too does loan demand, and banks would prefer to lend to these prime customers. But the argument has its weaknesses. It ignores strategic and structural factors; bank strategy generally calls for diversification, while the institutional presence of banks in many DCs creates a bureaucratic dynamic to lend. Major corporations, with direct access to capital, can now by-pass the banks. Nevertheless, the argument retains a certain power. At a broader level of analysis it asserts that, particularly for those DCs tied to a few commodity exports, recessions in their foreign markets can lead to diminished credit inflows as the export earnings drop.

Counter-cyclical lending would be part of the solution. Some of the larger, more experienced banks now lend to DC borrowers in anticipation of

cyclical swings in world or regional economies. That they did not do so in the early 1970s shows increasing sophistication; that many other banks still do not do so reveals the disparity within the industry. Part of the solution is the education of new lenders, part the example of the leaders in the industry. To move the process faster toward counter-cyclical lending requires official action: carefully administered compensatory financing, coupled with a more enlightened posture by home country regulators.

3.1.5. Improved allocation of specific risk

The problem. As the international banking system now works, banks themselves accept very few risks except the risk of default by the borrower. Experience suggests that outright default is unlikely and that countries with debt problems pay premiums for delay, so one may question the seriousness of even this risk. As a matter of course, banks pass to the borrower the risk that interest rates will fluctuate. They reserve the right to recall the loan if they are unable to fund it in the short-term interbank market; if new funding techniques become necessary, banks can pass on any additional costs to the borrower. The borrower that wants to switch currencies bears all exchange risks. These are risks other types of lenders often accept. Borrowers from banks also bear the more standard risks of changes in their terms of trade or in the receptivity of export markets to their goals.

Proposals. In all likelihood, little can be done to induce banks to accept a wider range of risk under the circumstances prevailing now. If regulators and shareholders see DC lending as imprudent by its very nature today, they will be unreceptive to increased risk-taking by the banks. The

solution is either to shift from the banks some of the few risks they normally accept or to reduce the uncertainty in the risks they shift to borrowers by fixing some of the provisions. Despite the hostile environment, there is a remote possibility that a few major banks could be induced to join in small or pilot schemes to shift more types of risk from the borrower to the lender. Any such proposal should be very carefully presented.

[a] Risk of default: an international insurance fund. Some observers have proposed a fund, charging commercial rates and managed either privately or by the World Bank, that would insure banks against loss by default. Given the dynamic of the international banking system, such a proposal seems superfluous. This is the one risk banks now accept.

[b] Risk of currency fluctuations: currency cocktails and forward markets. Borrowers confront a potentially serious problem in the increasing availability of credit in currencies other than those they earn. The yen- and DM-credits are examples. While in theory interest rates should reflect the prospect of currency realignments, in practice this may not always be the case. Even if the market is correct before the fact, after the fact the cost of borrowing in different currencies will differ. Countries may therefore wish to match the currency of their debt with that of their export revenues.

This suggests that further experiments with currency cocktails may be in order for DC borrowers that face access mainly to strong currency credit. The purpose is to reduce the impact of revaluation (or an upward float) on the borrower whose primary markets are, for example, in dollar areas. The ideal solution is for banks to open credit lines in currencies that reflect the borrowing country's needs; the banks could then simply balance the composition of their own overall assets and liabilities. While this solution

seems unlikely, it is preferable to the solution of the World Bank, which passes on to the borrower the impact of changes in the lender's liabilities. Recent efforts by banks to institute SDR deposit accounts proved unsuccessful, however, so the banking community's receptivity to a loan cocktail proposal is likely to be muted at best.

Under certain circumstances banks will lend across borders in local currency but fund the loan in international markets. This removes the risk of currency fluctuation from the borrower. But interviews suggest that a serious impediment to lending in the domestic currency of a DC is the absence of any forward market in that currency. In the few instances where the development of such a market is possible, it would improve the DC's access to credit from international banks.

[c] Risk of interest rate fluctuations: fixed rate loans. Over their life, the expected cost of floating rate loans should approximate the cost of fixed rate loans in an open market. It is therefore not clear before the fact that a borrower benefits materially from fixed rate loans. The gain presumed by many DCs to exist is more in the certainty afforded by those forecasting the nominal future servicing obligations of the borrowing country; one could urge fixed rate loans for this convenience. The linked, long-term deposits from surplus countries in the South, a proposal outlined above, could be one means to achieve a fixed rate. But an alternative is to accept floating rates and seek either a subsidy if rates exceed a fixed amount or, alternatively, an agreement allowing the borrower to pay no interest above a certain level but pay a higher margin when rates fall below an agreed floor. These points lead to a discussion of concessional assistance for commercial debt.

3.1.6. Subsidies for commercial bank financing

Opinions diverge about the advisability of merging concessional and commercial finance by subsidizing private lending in a direct or indirect manner. In favor of such a marriage is the view that it will increase the impact of the concessional flows, leveraging them. The contrary view holds that by interfering with markets one undermines their efficiency and misallocates resources. Private banks, for example, and OECD governments act in response to different needs and pressures; they should hold apart. The divergence of opinion, existing in both public and private sectors, will impede any proposal to subsidize commercial financing. Subject to this caveat, we propose the following, arranged in ascending order of difficulty.

[a] Tax concessions. The leading transnational banks exploit differences in tax laws in a most sophisticated manner. Newer and smaller banks try to do the same, but with less skill. The effect is institutional, since branches appear in tax havens, and operational, since banks allocate their resources in response to tax considerations. Interviews suggest that the goal of using all tax credits available in a given year can effectively foreclose financial flows to a DC. The following is a simple illustration.

> Assume Bank A, domiciled in the USA, lends money to a borrower in Mexico, a country that imposes a withholding tax on interest paid. Bank A will book the loan through its office in a country such as Belgium whose tax laws and treaties permit Bank A to credit the Mexican tax payment against Belgian income and also apply the credit against U.S. taxes, up to a ceiling. Bank A would therefore book loans to Mexico through Belgium until the amount of the tax credit reached the ceiling, which in this case would be Bank A's income attributable to Belgium. Beyond that point, Bank A could not use the Mexican withholding tax as a credit and the effective cost of the bank's lending in Mexico would rise. Unless the bank was prepared to absorb this cost, it would have to stop lending in Mexico if other banks with the credit could price their loans lower than Bank A.

For the bank, several courses of action are open in the face of this apparent impasse. It could wait for other banks to fill their own books and then all would raise the price of their Mexican loans, but this is risky since the timing is uncertain and lost clients might not return. It could carry the credit forward three or four tax years, but this is unsatisfactory because income flows over time are uncertain. The bank could increase its income attributable to Belgium by booking through the country what are called stateless loans, such as those for which there is no local Bank A installation or for which the local entity, perhaps a subsidiary in a high risk country, is not judged a safe port for an asset. Finally, Bank A could use the tax credit against loans it writes off in Mexico. These last two options may generate administrative problems. Booking stateless loans through Belgium will generate discontent if they are not truly stateless and the local manager sees his profit threatened. Setting write-offs against credits could lead a local manager to riskier loans, since he has a cushion for error. The bank must resolve these potential troubles; often they lead to increasing headquarters' control. High international profits now prompt many banks to devote more attention and personnel to the tax element in all transactions.

Consequences exist for the borrowing countries. Governments of borrowing countries confront a system of resource allocation bent by the vagaries of international tax treaties and foreign tax laws, where banks search not for a single use of the credit for withholding tax but a double use, in the booking station as well as in the home country. Despite the considerable attention devoted to tax agreements between developed and developing countries, little work has been done on their implications for resource allocation by

transnational banks and more detailed analysis would be useful considering the enormous volume of such loans. The goal should be to include in double taxation agreements certain tax sparing covenants to eliminate or reduce the impact of home country tax laws on the way in which banks allocate resources to DCs. Such a covenant would be the equivalent of an indirect subsidy.

[b] Subsidies to reduce the cost of private credit. Given the variety of payments a DC borrower makes on its loans, including not only interest but fees for participants, managers, agents and the like, there are numerous points where financially rich countries of the North and South could modify the pricing of a loan. Few are likely to gain a donor's acceptance. One possibility is a fund that would pay interest due* on a floating rate loan above a certain rate, such as 10%. The fund could be self-liquidating or could be replenished by countries that draw on it if the rates fall below a floor rate, such as 7%. Users would presumably be restricted to the low income, mineral poor nations that now lack effective access to international bank credit. Given the liquidity of the euromarkets, an increase in their demand is unlikely to reduce funds available to the higher income DCs. If the fund were to be replenished, its size need not be excessive. If the Information and Negotiation Network managed such a fund, the Network would have access to the loan agreements and discussions for those funded loans, which would in turn increase the usefulness of the Network to all DCs in the market.

[c] Guarantees. In a few instances, A-OPEC states have guaranteed borrowing by DCs from private banks. The major examples are Sudan and Egypt; in the latter case, four countries established the Gulf Organization for the

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*See paragraph 3.1.5 [c] above. page 190.

Development of Egypt (GODE) to act as guarantor, but because GODE lacked substantial assets United States banks declined to lend. The lesson is that any guarantor must be substantial, preferably a State or major multinational agency. But precisely because OPEC countries use the international banking system to shift the risk of default to the banks, these States are not keen to guarantee loans by those banks. Experience has proved the same of OECD governments. Guarantees, when they are provided, will be judged case by case by a guarantor concerned primarily with strategic issues rather than development. The Network would assist DCs in making their case

3.2. NEW MECHANISMS AND PROPOSALS FOR NON-BANK CREDIT

3.2.1. Means to Improve DC Use of Non-Bank Credit

The Problem. The financing problems of many DCs are to some extent the result of inadequate utilization of existiing financial markets and instruments. The relative ease of access to Euro-credit and Euro-bond markets, for example, may have led certain countries to concentrate on these markets at the expense of alternative markets, especially domestic IC capital markets, which they had used in the past. Similarly, apparent cost advantages of borrowing in particular currencies for particular maturities may have outweighed considerations of matching repayment requirements with anticipated future funds available for repayment.

Proposal-Information and Negotiation Network. Cl[illegible]ly, a greatly increased sophistication is called for in the current era of volatile exchange rates, rapidly changing interest rates, and generally unsettled financial market conditions. For competitive reasons as well as outright conflicts of interest, commercial banks are not ideal sources of the requisite information and even multilateral agencies such as the IMF and the World Bank, because of their specific focuses, cannot be expected to provide the necessary sophistication. Fortunately, a number of major DCs themselves have gained the necessary sophistication through experience. The diffusion of this sophistication through an information and negotiating network as outlined in 3.1.1. appears to be the most attractive mechanism available. There is little conflict of interest among DCs since, in contrast to vying for DFI or competitive supremacy in a particular industry, tapping world financial markets is not a zero-sum game. In fact, given the small size of DC requirements compared to total world financial flows, it might actually improve terms for all DCs through increased sharing of information.

The aim of increasing DC financial sophistication applies not only to obtaining better terms in external financial markets, but to determining DCs' own targets with regard to volume, sources, and terms. External financial strategies must be devised which not only provide the necessary funds for development strategies, but also minimize the potential for future financial crises which could force drastic changes in those strategies.

Since much external financing is done in conjunction with specific industrial programs or projects, a logical innovation in this regard is for UNIDO itself to give greater emphasis to financing along with project evaluation in its publications, training, advising and information exchange functions.

3.2.2. Means to Increase Access to Existing IC Domestic Capital Markets

The Problem. There are two major reasons for seeking greater access to major IC domestic non-bank financial markets in addition to the international markets, largely bank related, to which DCs have free access. The first is to diversify sources in order to reduce the vulnerability to changes in off-shore markets. The second is to seek a wider array of terms than is available in these markets and, in particular, to increase the available range of maturities.

In recent years, there have been few, if any, limitations on the capacity of international capital markets to supply the volume of funds required by DCs on a commercial basis. However, there has been substantial variation in the terms, particularly the maturity, on which Euro-financing has been available. More importantly, there are a number of factors which could drastically reduce the capacity of these markets in the future. These include changes in the regulation by IC governments of financial institutions operating in these

markets, possible direct controls over these markets, or changes in policies of key institutions operating in these markets. While the probability of drastic changes is low, it is of sufficient magnitude to discourage exclusive reliance on international markèts and, in particular, on banks from major ICs operating offshore.

Domestic capital markets in ICs far overshadow international markets in size and include a much larger number and variety of institutional participants. Total assets of international markets - eurocurrency deposits and international bonds - are roughly ten percent of total world financial assets. In 1976, for example, gross eurocurrency deposits were estimated to be $460 billion (1,000,000,000) and, adjusting for interbank deposits, net deposits $270 billion. In contrast, the stock markets of major OECD countries accounted for total assets of more than $1,600 billion, and publicly-traded IC government and industrial bonds more than $2,000 billion. If other long term assets, such as mortgages and privately placed bonds, and short-term assets including treasury bills, commercial paper, and bank deposits were included, the proportion of total financial assets represented by international markets becomes quite small.

Since domestic money and capital markets are essential elements of individual IC economies, their "health" and control is of great concern to IC policymakers, a fact that has many ramifications for potential DC users of these markets. While at present there are few outright barriers to the placement of DC securities in domestic IC markets, many IC regulations serve to constrain access. Table 6 lists some of the controls imposed by major OECD countries.

Table [illegible]: A Synoptic View of Regulations Affecting Bond Markets

	France	Belgium	Germany	Japan	Luxembourg	Netherlands	Switzerland	United Kingdom	United States
1. Governmental authorization required for public issues	yes	yes	no	no	yes	yes	yes	yes	no
2. Issue calendar	yes	yes	yes	yes	yes	yes	yes	yes	no
3. Ceilings on foreign issues	not fixed	not fixed	fixed	none	not fixed	not fixed	fixed	not fixed	none
4. Separate exchange markets	no	yes	no	no	yes	no	no	yes	no
5. Foreign security purchases:									
a. by individuals	free	free[1]	free	free	free[1]	free	free	free[1]	free
b. by institutions[2]	regulated	regulated	regulated	regulated	regulated	free[3]	regulated	free[1]	regulated
6. Regulation of Eurobonds denominated in currency of country:									
a. lead managers must be by consensus	French	Belgian	German	Japanese	Luxembourg	Dutch	Swiss	British	free
b. Issue calendar	yes	yes	yes	yes	yes	yes	--	--	no

[1]Through the free or investment currency market.
[2]For insurance companies.
[3]Issues denominated in foreign currencies can be purchased only to cover foreign currency liabilities.
[4]Authorities do not permit Euro-Swiss Franc issues.

Notes a. Rows 1,2,3 and 4 apply generally to Eurobonds as well.
b. The severity and detail of regulations vary. It would be misleading/cumbersome to attempt a tabular presentation of it.
c. There are disclosure requirements for issue/listing of securities in all countries. The most comprehensive of these are those of the SEC in the United States.

Taken from Developing Country Access to Capital Markets (IMF/World Bank, 1978).

In addition to these existing regulations, most ICs have a history of imposing credit or capital controls that, although enacted for reasons of domestic policy, have the effect of discriminating against direct DC issues.

Proposal - Borrowers' GATT. Since the factors restricting DC access to IC capital markets are under the control of IC policymakers, the only possible solution is some form of exhortation or "moral suasion" to ICs to bear in mind the interests of DC borrowers. Such an exhortation might carry greater weight if it were made part of a multi-lateral financial code of conduct, a "borrowers' GATT," that would extend "most favored borrower" status to DC government securities. There is precedent for such steps. Some European governments exempt DC issues from bond queues and the U.S. exempted them from the IET, a tax on foreign securities issues in the domestic U.S. market.

Other Proposals. Even in the absence of direct controls on access to domestic markets, many DCs will have difficulty in issuing securities because of insufficient investor knowledge or insufficient potential volume to justify development of a clientele. These factors appear to have been important in the rise in importance of commercial banks and suggest that some type of financial intermediation may be desirable in tapping IC domestic markets. The World Bank and certain regional development banks do intermediate in this fashion, but their own lending is restricted to specific projects or programs. The common financing facility proposed by the Mexican Government and others would do this on a global, or aggregate, financing

basis. We return to this mechanism below in our discussion of institutional innovations. Given the important role played by commercial banks in the international financing of DCs, and the scale economies they enjoy in monitoring the economic performance of DCs, another alternative is to find ways of increasing the ability of commercial banks to place longer term DC securities with institutional and individual investors.

3.2.3. Mechanisms to Increase Financing Flexibility

The Problem. Most DCs experience fluctuations in revenues due to world economic cycles, shifts in the terms of trade, or domestic political and economic events. Properly tailored international finance, however, also can alleviate the effects of revenue fluctuation, in two ways. First, by providing additional financing in the short-run it can smooth consumption and investment over time relative to national income net of "normal" debt service. Second, it can actually shift certain risks to foreign entities. This section discusses the role of international finance in smoothing revenues and outlines certain innovations which might enhance this role. Risk transfers are discussed below in Section 3.3.

Although international finance, by allowing the separation of current expenditures from current output, can be used to smooth the path of expenditures over time, it often does just the opposite. Debt finance with fixed repayment requirements increase the variability of the net stream of resources available for consumption or investment. Further, since most debt financing programs are premised on partial or total "roll-overs" in the future, they expose the country to the additional risk that refinancing will not be available in the desired amount as the result of changes in the country's creditworthiness or totally exogenous factors.

Proposals. The primary mechanisms for limiting these potential negative impacts of international finance are maintaining a balanced maturity structure of debt and diversifying borrowing sources. Both of these are possible within the existing international financial structure, although they may require innovations to increase developing country sophistication in utilizing available resources or to assure developing country access to them.

Beyond these basic measures there are a variety of innovations which could increase the short-run flexibility of external financing to enable developing countries to deal with fluctuations in external revenues resulting from internal or external events. These include new or improved vehicles for short-term finance and measures to increase the flexibility of debt service requirements on long-term debt.

Short-term measures that include the creation of markets for developing country commercial paper and the expansion of lines of credit with commercial banks or other financial intermediaries which increase short-run borrower discretion were discussed above with respect to commercial banks. These non-concessionary mechanisms would supplement the IMF's compensatory finance measures which perform a similar role and incorporate a concessionary element.

Flexible repayment terms on long-term debt would serve the same purpose by freeing resources in the short run. An example of such a mechanism would be a bond or Eurocredit with a normal repayment schedule calling for equal payments of principal in each year, but with a provision that in any one year the borrowing country could opt to repay some lesser amount, subject to provisions for catching up in future years. In essence, such a bond would provide a degree of automatic refinancing of the borrower's discretion.

A bond with the timing of repayments linked to trade flows is another variation on this theme. It would increase the ability of the borrower to cope with trade risks, but would not shift these risks to the lender but merely postpone (at the commercial rate of interest) the repayment obligation.

3.2.4. Mechanisms to Improve Matching of Revenues and Repayment Obligations

The Problem. As noted in the discussion of bank credit, DCs often must borrow in currencies other than those that are relevant in determining their revenues over time. In the case of World Bank loans, for example, the currency denomination depends on current world financial market conditions and the currency that the Bank happens to be borrowing at the moment. Only by accident will this be the proper currency for the DC in question, even if market interest rates are assumed to properly reflect anticipated currency realignments.

Further, for currencies experiencing high rates of inflation, nominal interest rates must rise to cover inflation and maintain a commercial return in real terms. However, the terms of long-term loans or bonds typically call for periodic interest payments and the repayment of some constant proportion of the principal. Thus, the real pattern of payments over time is distorted as illustrated in Figure 5 below.

With floating rate loans or bonds, this problem is exacerbated since total payments - debt service - in any particular year vary as a function of the current nominal interest rate.*

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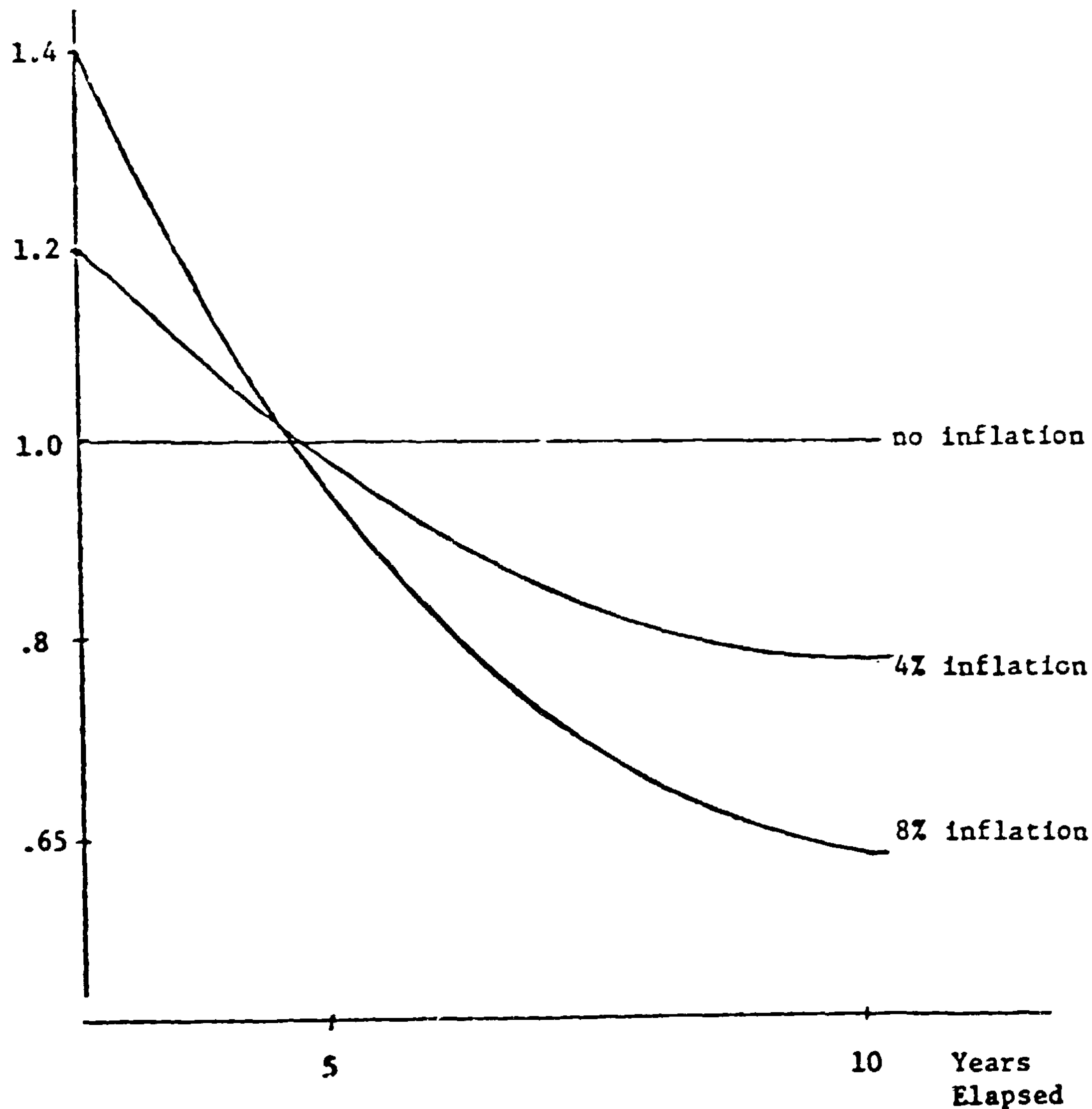
*In fact, a major element in the financial crises faced by many DCs in 1974 was the acceleration of interest payment requirements on external debt due to sharp increases in nominal interest rates coupled with the impact of higher oil prices on imports and their indirect impact, via a world economic downturn, on their exports.

Figure 5

Real Value of Level Nominal Payments as a Function of the Rate of Inflation

(For hypothetical 10-year loan with
interest rate of 4% plus rate of inflation)



This figure assumes equal annual installments of principal and interest. If the loan had called for periodic payments of the interest due plus level repayments of principal, the nominal pattern would have tilted downward over time and the real pattern would have been even more skewed toward the early years.

Proposals - Currency Cocktails and Price-Level-Index-Linked Bonds. A variety of proposals have been put forward to deal with the problems of currency matching and smoothing real repayment flows. Most take the form of loans or bonds denominated in currency cocktails - weighted combinations of particular currencies - or linked to price level indices for particular countries or commodities. Both types of instruments have been used in international and domestic IC financial markets, but to date have met with limited acceptance for a variety of institutional reasons. This resistance is not a sufficient reason to abandon the proposals if they promise major benefits to particular DC borrowers that cannot be obtained through more straightforward and more widely accepted instruments. However, it does suggest that, if possible, the problems should be addressed through existing channels.

In the case of currency cocktails, alternative channels do exist. DCs, by obtaining access to various domestic or international capital markets, can obtain whatever mix of currencies they desire. Further, innovations in bank credit in the form of multi-currency lines of credit suggest that legal indentures covering borrowings in a variety of currencies are feasible. World Bank practices can and should be altered since the Bank is in a much better position to match currencies in its portfolio than are individual borrowers. Even if currency cocktails do develop as viable financial instruments, it should be recognized that the appropriate mix of currencies will vary by country. This in itself may represent a major drawback to their widespread use.

Many of the same arguments apply to bonds whose principal and pattern of repayments are linked to some (combination of) general price indexes.

A major potential advantage of such instruments, however, would be that they would undo the "tilting" of real repayment streams implicit in most nominally fixed financial contracts.* But index linking is not the only way to solve this problem. For example, it also could be treated with (combinations of) <u>floating rate loans with repayments geared to cc stant</u> repayment factor approximating the real interest rate. The nominal payments on such loans would rise over time at roughly the difference between current nominal interest rates and the real interest rates. Thus, they would approximate a smooth real path.**

A major issue with index linked debt is the choice of the index and the pricing of the bonds. If price levels for one or several ICs were used, different borrowers would want different base currencies or combinations of currencies. It is possible, however, that a large number of DCs would find a standard combination - such as a price-level adjusted SDR - attractive. It is unlikely that DC borrower interest alone would justify this innovation, but such an instrument might also serve the needs of OPEC surplus countries concerned with maintaining the purchasing power of their external claims.***

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*J. Williamson, "International Borrowing for Developing Countries: Problems and Proposals" unpublished 1977 suggests an index-linked consol as a means to reduce the repayment burden. In our opinion, such an instrument would be unattractive to both borrowers and lenders because of the infinite maturity. Such contracts depend on highly stable borrower-lender relationships -- unlikely among DCs and ICs.

**For a discussion of this concept as applied to mortgages, see D. Lessard and F. Modigliani, "Inflation and the Housing Markets: Problems and Potential Solutions" in <u>New Mortgage Designs for Stable Housing in an Inflationary Environment</u>, Federal Reserve Bank of Boston, 1975.

***For further discussion, see V.R. Richardson, unpublished UNIDO memorandum, 1978.

DCs that depend on one of a few commodities for the bulk of their foreign exchange revenues could benefit substantially from commodity price index-linked debt. Although technically a credit transaction, such a contract is virtually an equity share given the wide variability of most commodity prices. Therefore, it is treated as risk capital in Section 3.3 below.

It should be recognized that the problem facing DC borrowers is to match the currency and repayment pattern mix of their total foreign liabilities to the characteristics of their anticipated foreign exchange revenues, and not necessarily to combine all desired features in any particular loan or bond issue. A lack of sophistication on the part of borrowers and leaders with regard to the desired characteristics for a country's overall obligations, coupled with a lack of complete information on most DCs' borrowings, are likely to be greater drawbacks to proper currency watching than the unavailability of appropriate financial vehicles.

3.3. INNOVATION TO IMPROVE THE INTERNATIONAL FLOW OF RISK CAPITAL

3.3.0. Introduction

All economic activity involves risk-taking and international finance can play an important role in increasing developing countries' ability to take strategic risks while simultaneously reducing the negative welfare impacts of these risks.

Most non-concessional international finance takes the form of debt. Although there is a wide variety of maturities, currencies of denominations, and repayment patterns, a common feature of virtually all debt contracts is that they call for a pattern of repayment which is independent of the outcome of the project, program, or development strategy being financed. This has two important implications. First, the borrower bears

virtually all the risks of the activity in question, passing them on to the lender only in the case of default. Second, the lender has little stake in the success of the project and hence has little motivation for intervening in its design or management.

At the aggregate national level, this reliance on foreign debt capital increases the variability of foreign exchange revenues net of debt service requirements relative to the variability of foreign exchange flows generated by the underlying real activities. This, in turn, leads to an increase in the magnitude of fluctuations in domestic absorption - the combination of consumption and investment - and limits the country's ability to incur further foreign financial obligations.

At the enterprise project level, heavy reliance on debt financing may have the further effect of limiting the firm's ability to take economically attractive but risky strategic steps and, in extreme cases, may lead to failure even when the firm's real activities are sound. These negative effects at the enterprise level are most serious in a capitalist system where there is little provision for assumption of enterprise risks by the State. However, they also apply to autonomous or semi-autonomous enterprises in a socialist setting.

Risk capital in contrast to debt capital explicitly shifts certain elements of project risk to the lender/investor. It can provide for a pro-rata sharing of the residual risks of the enterprise (project), as is the case with equity, or it can share only in a more narrowly defined set of risks, as is the case of a production sharing agreement or a commodity-price linked security. Since the payoff depends in specific outcomes, investors typically require greater control over the enterprise (project) than is the case with debt capital.

With the exception of the risk capital component of direct foreign investment, there are few North-South or South-South flows of risk capital. . Theory suggests that the financial benefits of flows of risk capital are likely to outweigh substantially those of similar volumes of debt capital. Prior to discussing specific innovation to increase flows of risk capital, we review the basic economic arguments and the reasons why international risk transfers along North-South and South-South lines are limited at the present time.

[a] International Risk Transfers: The Economic Arguments. Developing countries can benefit from international risk transfers for two reasons. First, risks can be reduced by assigning them to those countries (firms or financial institutions) with the greatest potential to control or manage them. Second, the negative impacts of risks can be lessened by allocating them to those countries (firms, financial institutions, or individuals) best able to bear them because of differences in risk preferences, the ability to diversify the risks in question, and the riskiness of their own assets.

The desirability of reducing risk through providing incentives for proper management is self-evident. The ability to do so depends on the extent to which the risks inherent in particular economic activities are, in fact, controllable. Natural disasters or weather fluctuations are beyond the control of all parties, although their potential impact may be mitigated by proper activity design and management. Fluctuations in world economic activity, in contrast, are at best partially controllable by major industrial countries and not at all by developing countries.

Risks of particular changes in world economic relationships which impinge on particular developing country industrialization strategies, such as increased protectionism, are controllable to a greater extent by industrialized countries, although even they are constrained by political realities. Risks associated with strategy selection, design, and management, are manageable to a considerable extent by the parties responsible for these activities. Risks associated with internal conditions in developing countries are most directly controllable by developing country Governments, although they face numerous constraints on their power as well. Risks of commodity price fluctuations are controllable to some extent by producer associations or powerful producers in some cases, and virtually uncontrollable in others. Clearly, there exist many differences in the degree to which given risks are manageable and with regard to which entities can best manage them.

Even given the best possible management of risks, risks partially or totally beyond the control of the parties involved will remain. The ability to minimize their impact on national welfare or on the viability of industrial enterprises via international risk transfers, however, requires some explanation.

Although the argument is slightly different at the two levels, the major elements are the same. The issue is first discussed at the aggregate level where the nation is the relevant unit of analysis. This is followed by a brief discussion of the additional considerations which come into play at the enterprise in the absence of perfect mechanisms for shifting risk to a social level.

Countries, like individuals, are likely to be risk-averse. Therefore, they will place a lower value on an activity with an uncertain future payoff with a given expected value than on an activity which will yield the same amount for sure. However, they should be concerned only with uncertainty at the national level, i.e. the contribution of the activity in question to the uncertainty of aggregate national income. In other words, only those risks which cannot be eliminated through diversification will have a negative impact on national welfare.

To the extent that some of the undiversifiable risk from a national perspective of an activity in a particular country is diversifiable in an international context, value will be greater abroad than domestically. Thus the country in question will gain from selling claims against the asset abroad.

The principle of diversification is quite straightforward and extremely powerful. When two or more uncertain future cash flows are combined, the variability of the combined cash flows is less than that of the weighted average of the individual flows to the extent the individual flows are less than perfectly correlated, that is, to the extent to which they do not vary exactly in tandem.

While there are certain risks which apply to all activities which are directly or indirectly integrated into the world economy, such as that of a major world recession, the vast majority of risks which affect specific projects are at least in part diversifiable on a national level and to a greater extent internationally. For example, the risks of price

fluctuations for certain key commodities only in small part reflect variations in world economic activity. They also reflect industry specific factors such as increased competition from substitutes or major shifts in supply due to new capacity or supply interruptions.

The internal growth of developing country markets is in part linked to aggregate world activity, but to a much greater extent depends on domestic political and economic factors. Even manufactured exports to industrialized countries, which would appear to be closely linked to aggregate activity, will demonstrate a substantial degree of independence since much of the variation for specific products will reflect competitive considerations, the quality of management of export-oriented activities, and a host of other distinguishing factors.

[b] Magnitude of risk reduction through diversification. Some numerical illustrations of the power of diversification in averaging out risks are in order. In the limiting case where the outcomes of different activities are totally independent, the variance of a diversified portfolio falls rapidly to zero as the number of holdings in the portfolio increases. This, of course, is the principle of insurance where, by averaging over a large number of risks, the over-all outcome becomes virtually certain.

Since there are common elements in most economic activity, however, diversification does reduce risk but to a lesser extent. There are some risks inherent in economic activity which cannot be avoided and must be borne somewhere in the world economic system. Estimates of the magnitude of these undiversifiable or social risks relative to the total risks of economic activities as well as the social cost of bearing these risks are

available for major market-oriented industrialized countries. Whether these costs are greater or smaller in advanced socialist countries is not known. Extensive empirical research for the United States, for example, shows that well diversified portfolios of the shares of industrial firms are roughly one-half as risky as the average individual firms are roughly one-half as risky as the average individual share viewed by itself. The social cost of these undiversifiable risks can be estimated by the risk premium demanded by investors for bearing these risks over time. Again, based on empirical estimates for the last 50 years, the aggregate risk premium demanded by investors for bearing the risks of the U.S. industrial system as reflected in returns on industrial shares has averaged from 6 to 8 per cent per year in contrast to a real interest rate of roughly 2 per cent per year. For other industrialized countries, with narrower industrial bases and greater degrees of openness to international forces, undiversifiable risk ranges from one-half up to 60 per cent of total risk. Thus the risk from a national perspective of activities within these industrialized countries is well below their risk when viewed independently. Further, when the perspective is broadened to include international diversification, the undiversifiable portion of the risk of activities in major industrialized countries is roughly one-third the level of the risk of individual activities when viewed independently.

In the case of developing countries, empirical research shows that there typically is less scope for risk reduction through diversification on a domestic level. The economies of most developing countries are less diverse than those of major industrialized countries and often are subject to much larger fluctuations in overall activity due to the circumstances of underdevelopment. Various studies of Latin American companies oriented

primarily towards their own home markets suggest that the risk of a domestically diversified portfolio of shares of these firms is roughly 80 per cent that of the shares viewed individually, but when placed in a globally diversified portfolio only 10 per cent of their risk remains undiversified. Although there are few empirical studies of risk premiums demanded by private investors in these economies, common industrial practice suggests that 15 to 20 percentage points above the basic interest rate is not unusual.

These higher risk premiums in developing countries, however, reflect several factors. First, the total risks of economic activities in developing countries may be higher than those in industrialized countries because of the conditions of underdevelopment. Second, whatever the level of total risk, it is likely that a smaller proportion is diversifiable at a national level for the reasons given above. Third, it is quite likely that the risk premiums demanded by individual entrepreneurs may reflect more the total project risks than their social risks because of inadequate market or social mechanisms for shifting risks. This brings us to the second level of analysis, the entreprise or project.

In a market-oriented economy with a well-developed capital market or a socialist economy where risks are borne directly by the State, the risk of a project from a national perspective is the only risk which should require a risk premium. As a result, there should be no difference between the national and enterprise risk-reward perspectives on a particular undertaking. Undoubtedly this ideal is never reached in either capitalist or socialist economies, but risk shifting through market or social mechanisms does serve to substantially narrow the gap between the two perspectives.

In developing countries which rely on private firms or even autonomous public enterprises to carry out major industrial activities but lack well-developed market or social mechanisms for risk sharing, however, the difference between the two perspectives is likely to be substantial. Private entrepreneurs or managers of public enterprises will be limited in their ability to take on economic risks by their existing capital and the diversification of risks will be limited to the extent that firms diversify their own real activities. In fact, conglomerate business groups substitute for capital market mechanisms in a large number of developing countries with private industrial structures.

A limited capacity for domestic risk shifting will result in higher required returns for risky undertakings which will be incorporated in the cost of production. If domestic production is protected, this cost will in large extent be passed on to consumers. However, if local firms must compete with TNCs in local markets, they will be at a disadvantage because of the higher domestic cost of risk bearing and thus will bear these costs. Further, if the products must compete internationally, the costs will be borne primarily by domestic factor inputs.

Where there is a limited capacity for domestic risk shifting, international flows of risk capital will serve two functions. They will narrow the gap between domestic private and social risk perspectives and they will reduce the cost of bearing the risks which cannot be eliminated at a national level.

[c] Factors limiting international risk transfers. The two primary vehicles for North-South risk transfers are direct foreign investment and portfolio investment in company shares. Both mechanisms penetrate the national economy in that they are linked to specific enterprises and both shift the whole package of risks faced by specific firms. In addition, there are mechanisms which serve to shift risks on a much more narrowly defined basis, such as forward contracts or long-term sales/purchase contracts for specific commodities and securities whose payoff is contingent on some very particular outcome. Again, most of these involve links with specific firms as well. Joint venture agreements of various sorts fall into a middle ground between these two extremes.

The scope for risk transfers on a North-South or South-South basis is limited both by the conditions and policies of developing countries and investor perceptions. Risk transfers via foreign portfolio investment in shares require a very particular institutional setting. The economy must be organized along market lines in such a way that the profits of the individual enterprise in question can be meaningfully defined. The domestic securities markets must be well organized and must provide adequate protection for "outside" minority investors who are not linked to management. Foreign investors must have access to these markets but also must be able to withdraw their funds at will. Clearly, few developing countries satisfy these conditions and many do not want to do so.

From an investor perspective, direct foreign investment is less dependent on the developing country institutional setting since the investor also exercises management control. However, in order for DFI to be socially desirable to the developing country, the economy must be

organized along lines such that private profitability does not differ drastically from social profitability. Further, the element of foreign control which goes with DFI is unacceptable to many DC Governments. Both portfolio and direct investment require foreign penetration of the domestic economy and, as a result, are of limited relevance to economies organized on non-market lines.

"Quasi-equity" investments including joint ventures and complex contractual arrangements are more relevant, but often are extremely difficult to implement. This is suggested by the relatively small volume of North-East or East-East flows of risk capital through contractual mechanisms.

A major constraint on international flows of risk capital of any kind is political risk. Although ambiguous, the term refers to all risks, real and imagined, introduced by the cross-border nature of the transactions involved. It includes the objective risks foreign investors face in enforcing claims against individual enterprises across national boundaries, including the risk that the country for political or economic reasons will not allow the firm to do so, as well as the special risks of dealing with a sovereign entity, especially the limited ability to segregate or "carve-out" cash flows from specific activities. It also includes imaginary risks or biases in foreign investors' perceptions resulting from limited information or cultural and political prejudices.

If foreign investors perceive significant political risks, they will demand a premium for bearing them, partially or totally offsetting the potential gains resulting from a better international allocation of the

underlying risks of the activities in question. Thus a major goal of any innovation with regard to risk capital flows is to minimize the "frictions" resulting from perceived political risks. Although political risk is relevant to flows of debt capital as well as risk capital, it is likely to have a much greater limiting effect on risk capital flows since these involve more complex financial arrangements which require much closer control and monitoring of the activities being financed.

3.3.1. SPECIFIC INNOVATIONS

There is a wide range of new instruments and institutions which provide increased scope for international transfers of risk capital. Four have been singled out for discussion on the basis of their likely significance to developing countries. Taken together, they illustrate the range of specific types of risks and types of innovations which are relevant under various development strategies.

The four types of innovations are:

a) Commodity price linked securities;

b) Trade-linked securities;

c) Mechanisms to increase portfolio risk capital flows;

d) Performance-linked financing mechanisms.

The first two mechanisms deal with narrowly defined sets of risks that are relevant at a national as well as an enterprise level. They are of particular interest since they involve mechanisms which have not been employed to any significant extent in North-North transactions and hence call for new instruments or institutions. The other two forms of mechanisms are relevant at the enterprise or project level.

Mechanisms to increase the flow or improve the terms of direct foreign investment, which is likely to continue to be the dominant form of international risk capital flow, are not discussed here since an entire section of the Joint Study is devoted to them. The direct foreign investment section also explores a variety of "quasi-equity" arrangements which have the potential of extending the scope of risk capital flows coupled with some degree of management control to economies organized along non-market lines.

3.3.1.1. Mechanisms to Increase Risk Transfers at the National Level.

This section examines mechanisms for risk transfers which are operable at a national level and do not require investor access to or control over specific economic activities. As noted earlier, these are commodity-price linked and trade-linked securities. This is followed by a brief discussion of "quasi-equity" investments.

3.3.1.1.1 Mechanisms to shift commodity price risks.

The Problem. Many recent proposals for North-South financial innovations have included bonds or other financial instruments linked to the prices of specific commodities. They were one element of the International Resources Bank proposal put forward by the United States and have been discussed in a variety of forms in conjunction with schemes directed towards commodity price stabilization.

Many developing countries depend and will continue to depend upon a small number of primary product exports as their major sources of foreign exchange earnings. Even as they increase the domestic value added of exports based on these commodities, the commodity component will remain a significant element in total revenues and, in many cases, an even larger element in terms of its contribution to the over-all variability of export proceeds.

As noted above, the key to benefits from international risk transfers is the ability to diversify a larger proportion of the risk of a particular economic activity internationally than is possible in a purely domestic setting. This clearly is the case for developing countries with production and exports concentrated in a small number of product lines. This will be true even if the revenues derived from the activity are substantially dependent on over-all world economic activity.

Empirical evidence for copper, for example, shows that roughly one-half of the risk associated with copper production is diversifiable on a broad global scale, yet for key copper producing countries only 10 to 20 per cent of the whole risk is diversifiable domestically given the key role it plays in their economies.* Thus, it is clear that the producer countries should benefit from shifting some risks to international capital markets.

An examination of the external finances of commodity producers, however, suggests that little risk transfer takes place. Domestic Governments, through public enterprises, take on most risks of such ventures directly. Foreign financing typically is limited to credit, which represents a risk transfer to world capital markets only in case of default and, by implication, only after extensive costs are imposed on the domestic economy. Long-term sales contracts are common, but they typically specify only quantity, leaving price to be determined in spot markets. Thus they do little to shift risk. It is hard to pin down why this is the case and, in particular, whether it is the result of external constraints or of developing country policy. The primary external constraints are political risk and the absence of mechanism for risk transfer other than DFI. The primary policy considerations include a desire to increase autonomy, a belief that financial markets

*See D. Lessard, "Risk Efficient External Financing Strategies for Commodity Producing Countries," Working Paper, Sloan School of Management, MIT, Cambridge, Mass., November 1977, and Cuadernos de Economia, August 1977.

will not pay a "fair" price for risky claims, a belief that producer associations provide a better way for dealing with commodity price variability, and internal bureaucratic or political considerations which inhibit such transfers.

Direct foreign investment as a mechanism for shifting risk is viewed as particularly undesirable because of the desire for national control and the perceived imbalance on bargaining power resulting from the TNCs' market power in those industries dominated by them. Further, from an investor perspective, direct foreign investment involves many political risks for which investors will demand a risk premium.

When a TNC invests directly in a mining project, it faces a series of risks in addition to the commercial risks it would face in a project in its home country. In addition to the risk of outright expropriation, these include the risks that the host Government will change the tax system, exchange rate policies, import and export restrictions, and virtually every area over which the Government has control. Typically, these actions will result in an increase in the public's "take" from the project, although occasionally they will take the form of shifting revenues to another group, such as local labour. Many of these risks cannot be limited by contract provisions and even if they can be, enforcement may be extremely difficult and the leverage of the TNC may not be effective.

Portfolio equity investment in extractive enterprises might be more attractive than DFI to developing country Governments since it avoids the problems of foreign control and TNC market power. However, it requires that extractive ventures be set up so that an independent accounting of

their profitability is possible. From the perspective of foreign investors, however, it involves all of the political risks of DFI without the leverage that goes with foreign control. As a result, it will be a viable mechanism only for those countries with a private sector orientation and a well-developed local capital market in which foreign investors will have many domestic "bedfellows."

Proposal - Commodity Linked Bonds. The most promising mechanisms for most countries heavily dependent on a small set of products appear to be narrowly-drawn contracts which shift only the risks of commodity price fluctuations, risks which by and large are outside their control. These include futures contracts and long-term fixed price sales contracts, which serve to stabilize revenues but do not provide a time transfer of resources, and commodity-linked bonds, which combine the functions of time and risk transfer.

The primary advantage of such mechanisms from the producer countries' viewpoint is that they shift risk without shifting control. From a capital market perspective, these instruments could provide an attractive return for the risks they involve. Investors would still face the risk that the Government might default on the contract, but this risk is not likely to be any greater than that of straight bonds.

A possible advantage of commodity-linked bonds relative to long-term contracts is that the securities could be sold on a recurring, competitive basis rather than through infrequent bargaining sessions typical of long-term sales contracts. However, both types of mechanisms are complementary and the choice between them depends on a wide variety of industry and

country specifics. Commodity-linked bonds appear to have the advantage in dealing with countries with open, well developed capital markets and hence for South-North risk transfers. Long-term contracts, in contrast, are likely to be more viable for South-East or South-South risk transfers.

3.3.1.1.2. Mechanisms to shift risks associated with over-all trade flows.

The problem. Developing countries which choose industrialization strategies premised on a significant volume of manufactured exports are exposed to fluctuations in export revenues due to fluctuations in aggregate world economic activity, changes in the conditions of international trade including industrialized country protectionism, and changes in competition from other exporters. However, to a large extent, fluctuations in trade volume also will depend on factors over which the developing country has at least nominal control. These include the whole array of domestic economic policies which alter the competitiveness of exports as well as strategies and tactical choices made regarding exports. As a result, it is difficult to envisage non-concessional financial mechanisms which would shift the risks of trade fluctuations to outsiders on terms acceptable to the developing country.

One exception is direct foreign investment, when the foreign investor does share in all of the above risks. Although DFI carried with it the negative aspect of foreign control and the need to structure the domestic economy in such a way to limit the divergence between TNCs' private and social profitability, it may be a particularly useful mechanism in those industries where the major risks are associated with access to the TNCs' home markets.

Proposal - Trade Linked Bonds. One possible innovation would be a trade-linked bond, but its terms would have to be drawn very narrowly to make it acceptable to foreign investors in the absence of substantial direct control over export activities. A trade-linked bond could carry provisions similar to a cumulative preferred share in which investors would be entitled to a particular periodic cash payment (which could be a dividend, interest, or principal payment depending on the specific contractual vehicle) as long as it did not exceed a specified proportion of the country's export proceeds of particular products to particular countries. Any shortfall would be carried forward at a commercial rate of interest, but its repayment would fall under the same constraint.

The obvious complexity of such a contract as well as the numerous mechanisms for the issuing country to violate the spirit of the contract without legally defaulting suggest that it is a highly unlikely prospect on a stand-alone basis. However, it might be feasible as part of a new (or expanded) international financial intermediary involving some degree of multilateral industrialized country concessionary support. The same function could be served by bilaterally guaranteed bonds where a particular industrialized country Government agrees that in case exports from a particular developing country (or regional grouping of developing countries) should fall below a specified level, the industrialized country Government will assume a specified portion of the repayment obligation.

3.3.1.2. Mechanisms to Increase Risk Transfers at the Firm or Project Level.

3.3.1.2.1. Mechanisms to increase and improve terms of international portfolio equity capital flows.

The Problem. Mechanisms to increase or improve the terms of equity capital flows through channels other than direct investment are of

particular importance to developing countries which assign a major role in industrialization to private enterprise. If domestically-based firms are to take an increasing role, they must have access to mechanisms to benefit from the international distribution of risks along the same lines as their major competitors in home and world markets, the TNCs. In the absence of such steps, TNCs will continue to have an advantage which can be offset only through restrictions on their operations which may slow and distort the over-all process of industrial development and which will limit the socially desirable effect of international risk spreading.*

Transnational firms are able to accept lower rates of return on local projects than local firms because of their ability to diversity investment risks internationally. This represents an often overlooked benefit to host countries of foreign direct investment (FDI)** as well as a source of competitive advantage for TNCs relative to local firms. In diversifying internationally, the TNC transfers risk capital from its industrialized country base to the host country and, in so doing, serves as an international financial intermediary. In a world with no barriers

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*The argument is developed in greater detail in Agmon and Lessard "International Diversification and the Multinational Corporation - Implications for Capital Importing Countries;" Revista brasileira de Mercados de Capitais.

**It is generally acknowledged that in order to justify foreign investments, the multinational corporation must have some advantage relative to local firms in the countries in which it invests which allows it to overcome the costs imposed by cultural and geographical distance not borne by local firms. Most economists have argued that the primary sources of advantages by TNCs relative to local firms are imperfections in markets for products and factors of production, generally excluding capital. The desirability to host countries of FDI by TNCs depends largely on whether they facilitate a transfer of factors which could not be readily transferred through market channels because of the characteristics of the factors or whether the imperfections are the results of the TNC corporate structure and are maintained through their market power.

to capital flows, this intermediation could take place through a variety of channels and thus would not provide the TNC with a competitive edge. In particular, risk capital could flow directly to local firms via portfolio investment. However, for a variety of reasons, including extensive developing country regulations on inward portfolio equity flows and the limited development of many developing country capital markets, North-South portfolio equity flows are limited in volume and scope, and South-South flows are virtually non-existent.

Proposal - Mechanisms to Improve North-South Flows. Given the concentration of capital in the North together with the extensive network of financial markets and institutions available to Northern investors, most measures for improving equity flows through channels other than DFI will focus on North-South transfers.

In those few countries with well organized and relatively active local capital markets, the simplest mechanism available is to open local capital markets to foreign investors. This has been resisted in most cases on a variety of grounds including a fear of "hot money" flows which might destabilize either the local capital markets or the foreign exchange markets, desires to limit the foreign control of local industry, and desires to preserve investment opportunities for local investors. The first two objections are undoubtedly valid in part, but often are drastically overstated. The third is more complex and subtle. It is true that limiting capital inflows preserves investment opportunities for local capital. However, it should be recognized that while it protects local capital, it is a tax on locally-owned industry and a source of protection or advantage for TNCs relative to local firms.

The questions of market impact and foreign control can be dealt with to a large extent by regulating the magnitude and timing of inward portfolio investment and limiting the percentage ownership of any particular firm's shares by a single investor and/or by foreign investors in aggregate. Such measures are common even among industrialized countries, although substantial efforts are underway to liberalize North-North portfolio flows. It would appear desirable for developing countries with a private market orientation to adopt a common policy or code of conduct towards foreign portfolio investment. Such a policy would avoid competition among developing countries for such flows and, as a result, improve the terms of these flows. It also could serve as a common code of foreign investor rights and obligations which would increase the credibility of such arrangements to foreign investors.

An alternative mechanism which performs a similar role is for developing country firms to list their shares on major industrialized country stock exchanges. This also would require changes in developing country policies and regulations in many cases, but would clearly put developing country firms able to avail themselves of this mechanism on a more equal financial footing with TNCs. However, it is relevant only to those firms which are larger enough to justify the initial costs of gaining a mar[illegible] following and promise a sufficient volume of trading to justify foreign listing. It would not benefit the large majority of developing country firms and, unless accompanied by mechanisms providing them with similar advantages, would discriminate against them in favor of the larger firms. Further, it would tend to shift underwriting and trading activity abroad and, as a result, it might hamper the development of domestic capital markets.

Two proposals for new financial institutions to facilitate portfolio flows also merit consideration. One is an investment trust based in a single developing country which would allow foreign investors to participate in a selected set of local securities without the necessity of allowing them direct access to the local capital market. The other is the international investment trust proposed by the World Bank* and others which would provide investors with an internationally diversified package of developing country securities. On the positive side, either mechanism would allow developing countries to more easily control the nature and volume of foreign portfolio investment flows. Further, these institutions could to some extent make up for a relative lack of development of local capital markets. On the negative side, however, both mechanisms impose an additional layer of intermediation which might cause more problems than it would solve and which is likely to reduce rather than increase foreign investor confidence. In particular, if either type of trust is subject to national or multinational political control, its securities are likely to be perceived as carrying more political risks than the underlying assets.

A compromise proposal which would provide many of the same advantages to developing countries without some of the same drawbacks from the perspective of investors would be a national or international regulatory

*See Developing Country Access to Capital Markets, Chapter V. IMF/World Bank November, 1978.

framework under which private financial institutions would create trusts or mutual funds whose shares could be sold to foreign investors. Such a framework should be based on the co-operation of industrialized country agencies charged with investor protection and developing country authorities responsible for capital market and foreign exchange policies. It would allow far greater investor flexibility than publicly-sponsored national or international trusts, but greater developing country control over foreign investment than would be the case if broad direct access to local markets was allowed. Any of these mechanisms for increasing portfolio equity flows must be accompanied by measures to develop viable local capital markets. The prospect of substantial internation flows, though, might serve to spur such development.

Proposal - Mechanisms for South-South flows: Most of the mechanisms aimed at fostering North-South flows would tend to attract South-South flows as well. However, the South-South case differs in that flows are likely to be limited by controls on outward investment as well as on inward investment. A strong case can be made to developing country Governments that allowing a greater interchange of risk capital flows will be mutually beneficial. An especially important point in this regard is that risk capital flows, in contrast to flows of debt capital, can lead to major benefits even if inward and outward flows balance out, on other words, even without net transfers of resources. This recognition, coupled with the need to strengthen the risk capital base of local firms in order to allow them to grow more rapidly in their home markets or expand on a South-South basis, could open the door for South-South co-operation.

One mechanism which has been proposed and studied in depth is a regional investment fund which would allow private investors based in

developing countries to participate in the growth of firms based in other countries of the region.* As with funds aimed at increasing North-South flows, it has negative as well as positive aspects. A regional investment union, which would allow the formation of private investment vehicles under regional regulations including investor protection provisions but also allowing Governments some control over the volume and nature of portfolio investment flows would appear to offer an attractive compromise.** Its attractiveness to public authorities would be greatly increased if it were coupled with mechanisms to liberalize regional direct investment flows through the formation of regionally chartered corporations. The investment union would provide the capital market base for these firms.

3.3.2.2. Quasi-equity mechanisms for the transfer of project specific risks.

The problem. In addition to the aggregate risks of fluctuating commodity prices and trade volumes, most developing countries are at risk with regard to the selection and execution of particular commercial strategies as well as the design and operation of specific industrial facilities. Such risks should be allocated in a way to provide incentives to perform on the part of foreign advisors or suppliers and, in the case of large-scale ventures, or ventures exposed to certain risks that cut across a large segment of the national economy, to take advantage of the greater ability to diversify these risks internationally.

Direct foreign investment, of course, performs this function since the parties responsible for the choice and operation of the facility as well as the selection and execution of strategy are directly at risk. However, as noted

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*The Andean Development Corporation has proposed the creation of an Andean Investment Fund which would operate on a regional basis.

**For a discussion of the arguments in favor of a regional investment union as well as the type of mechanisms it might incorporate, see D. Lessard "En Pro de una Union de Inversiones Latinoamericana," El Trimestre Economico, Jan./March 1975.

above, open-ended direct foreign investment is not a feasible strategy for activities organized in the social sector. Further, even for private activities it may be undesirable if there are significant differences between the private and social costs and benefits of the activity in question or if DFI terms are viewed as unfair because of the market power of TNCs. Finally, even if DFI is acceptable and feasible, a developing country might want to acquire technology or management from non-TNC sources, the East and South as well as smaller firms from the North, and as a result require an alternative mechanism.

Portfolio investment series to transfer risk but is relevant only in those economies with a large domestic private sector and a well-developed capital market. Further, it does little with respect to managerial incentives since no managerial contract is involved.

Proposals. This problem has received widespread recognition and a variety of differenct mechanisms have been proposed to deal with it.* Many of these take the form of performance guarantees provided by suppliers and backed by performance bonds or by private or government-backed insurance mechanisms performing the same function. Such mechanisms can play an important role and are described in considerable detail in the companion Joint Study report on Direct Foreign Investment. However, they cannot provide a complete solution in those cases where precise performance requirements cannot be spelled out in advance or where those factors relevant to the project's success which are under the supplier's control are intertwined with

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*See, for example, the submission of Algeria to the 1975 OPEC Conference, "Des rapports de droit entre entreprises des pays du tiers monde et entreprises des pays développés."

factors under the country's control. Such cases call for financial mechanisms which put the foreign suppliers of technology, management, or capital goods at risk in the sense of sharing in some specified measure of the project's performance. A variety of these are discussed inthe DFI section as well as in section 3.4 below in conjunction with the proposed International Development Corporation.

3.4. NEW INSTITUTIONS TO IMPROVE NON-BANK FINANCING

If new institutional change is possible, several candidates present themselves for consideration. It is useful to separate these into institutions aimed at providing aggregate finance at a national level and those concerned with the financing of specific projects or transactions although in practice, the two functions are likely to overlap.

At the aggregate level, the most attractive possibilities are a common financing facility (CFF) and internationally chartered capital market (ICCM). The common financing facility would borrow funds at commercial terms in industrialized countries as well as international capital markets. With direct access to the interbank market, the CFF would be able to intermediate just as international banks, although in all likelihood it would take time to establish itself as a force in the market that could command prime rates on interbank deposits. It probably would have bilateral or multilateral support from industrialized countries either in the form of guarantees or capital contributions and would definitely have "most favored borrower" status in industrialized country capital markets, perhaps bolstered by preferential tax treatment. This capital structure would allow it to subsidize borrowing in some cases, thus moderating the cost of loans to DC borrowers, or to take on novel forms of financing of special relevance to DCs such as trade-linked loans. The CFF would differ from existing international institutions in

several important regards. It would differ from the World Bank in that it would lend on an aggregate national basis rather than on the basis of specific projects or programs. However, its liability structure and financing operations would parallel closely those of the World Bank. It would differ from the International Monetary Fund in that its orientation would be longer term and its aim would be to enable countries to structure their external financing so as to minimize financial crises, rather than to intervene once a crisis has occurred. As such, it would fill a major void in the international financial system without jeopardizing or watering down the important role played by the Fund when crises do occur.

In order to justify the substantial effort and resources required, the common facility must promise significant advantage over existing public and private financing mechanisms. One area in which this appears likely is in trade-linked financing.

Developing countries with externally-oriented industrialization programs, whether based on few or many industries, are exposed to risks beyond their control including those of fluctuations in aggregate world economic activity and, in particular, protectionist measures. These risks are diversifiable only to a small extent at a national level and cannot be eliminated completely even at a world level. In fact, it has been acknowledged that the only risk which might result in a simultaneous external financial crisis in a significant number of developing countries is that of a sustained drop in international trade.* Further, as noted in section 3.3, it is extremely unlikely that viable non-concessional mechanisms can be devised for shifting this risk.

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*See, for example, Van Cleveland and Brittain, "Are Less developed Countries in over their Heads", Foreign Affairs, August 1977.

A common facility might be backed by contingent guarantees of industrialized countries to assume stated proportions of the fund's total obligations triggered by particular levels of aggregate trade flows. Alternatively, repayment of developing country obligations to the fund might simply be "stretched" when trade fell short of pre-defined levels, and industrialized countries might provide the additional financing directly or by guaranteeing additional facility borrowing. It would be sensible to maintain a formal separation of the CFF and the Network but to use overlapping staff and other facilities to take advantage of economies of scale. Any effort to establish the CFF should start modestly.

The second candidate at the aggregate level is an Internationally Chartered Capital Market (ICCM). This would be a new financial center managed not merely by the host government but under the auspices of a multilateral authority. Properly managed, it should meet the concerns of users and suppliers to the largely unregulated eurocurrency market of today. For users, the double taxation problem described earlier could be mitigated if loans are booked through the ICCM. For sources of funds, it could ultimately lead to greater coordination in national policies toward international financial markets. For the banks, it could provide a haven from conflicting national demands as well as incentives to allocate more funds to DC borrowers.

At the project or transaction level, a major contribution would be made by an International Industrial Development Corporation (IIDC). The IIDC would be empowered to finance enterprises through loans, "quasi-equity" or equity investment, much like the IFC, but would also be able to deal as a principal in technology flows and/or trade in capital goods.

Specific examples of its activities include the financing of a "turn-key" plant produced by a developing country for another developing country. The purchase of technology, perhaps including funding part of its

development, from one developing country and its "sale" to another developing country firm in return for an equity or quasi-equity position.

Any proposals for the IIDC should be developed in conjunction with specific mechanisms outlined in the trade, technology, and direct investment sections of the Joint Study.

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FINANCIAL CO-OPERATION BETWEEN OPEC CAPITAL SURPLUS AND OTHER DEVELOPING COUNTRIES

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INTRODUCTION

The purpose of this paper is to examine issues relating to the flow of funds from capital surplus oil producing countries to third world economies short of financial resources for development. One of the many effects of the oil price revolution of 1973 was a major imbalance in the international payments system. A few OPEC countries found themselves in possession of large foreign-exchange surpluses on current account while some OECD and most third world countries moved into a position of substantial deficit. Imbalances on that scale raise the issue of recycling funds from one set of economies to another set. They also elicit new worries about economic growth. The imbalances are deflationary which means that they lead to a decline in the rate of increase, and perhaps the level, of economic activity, even though prices may continue to rise. The impact of payment imbalances arise from attempts by the authorities to reduce an unwanted deficit by restricting aggregate demand in the economy.

Both developed and developing countries, if in deficit, suffer when imbalances in the world economy are of a significant magnitude. They are forced to accept lower rates of economic growth. Some developed countries may be able to afford economic stagnation or indeed welcome a period of slow growth in the hope that it will provide relief from inflationary pressures and from other social diseconomies. Developing countries, however, cannot dispense with growth as their needs are immense. Payment imbalances have been accepted after 1973 with an astonishing degree of complacency by the industrialised world precisely because their major adverse impact on economy was not thought - except by a few - to be very detrimental. The point of view of developing countries and their interests are ignored when such an attitude is taken.

There seems to be a strong prima facie case for recycling financial surpluses in an organised manner from both OPEC and OECD countries with a positive balance to countries in deficit, and to recycle these surpluses on terms that are more generous to developing than to industrialised countries. The economic premise of an argument in favour of planned recycling is that it enables Governments to manage their economies with some advanced knowledge about the amounts of external funds available for the financing of a resource gap. Without this knowledge, Governments may either aim at much smaller deficits than the ones they can afford (with damaging deflationary effects in developing countries) or at much larger deficits (with crippling financial consequences forcing Governments to impose later the deflationary measures they thought they could avoid at the earlier stage).

The arguments for considering developing countries as privileged recipients in any recycling scheme are many. As OPEC member countries would provide a substantial part of the funds, and since they are themselves developing countries, it is natural to think that the third world has a prior claim on the recycled funds. In an ideal world they would be the most favoured borrowers. There are clear ethical arguments in support of this resumption. Developing countries have the most urgent and the greatest need for help, and it is the developing world which has been most badly hit by

the oil price adjustment though most fair observers would agree that OPEC was acting legitimately and with proper justification when it decreed the price increase. The political arguments militating for the favourable treatment of developing countries in recycling surplus funds relate to the need for support felt by OPEC member countries in international fora. The actions of OPEC on the oil front are not particularly appreciated by the Western world. There is an element of conflict in the relationship between oil producers and major consuming countries. Enhanced solidarity with developing nations makes perfect sense to OPEC in the context of this potential conflict with the industrialised rich. Transfer of financial resources is a means towards the goal of greater solidarity and mutual support in international relations. The leadership role assumed by OPEC in attempts to establish a new international economic order relates to the same set of considerations and calls also for acts over time, efforts to reinforce the links through further investments and expanded direct flows of funds may become more significant.

There is an aspect of the case for greater financial solidarity between OPEC and the developing world touched upon in this introductory presentation but still in need of explicit elaboration. The difficult question is how OPEC member countries see the case. It is relatively easy to make <u>a priori</u> arguments which reveal possible reasons why funds should flow from capital rich to deprived countries. It is possible to plead with potential donors stressing that the recommended actions will provide them with benefits. But OPEC member countries may see the problem in a different light. It is important to understand their motivations, the way in which their perceptions of possible benefits are formed, and above all the very special circumstances of their economies and of their political system which explain these motivations and perceptions. The <u>a priori</u> case may be largely irrelevant if the OPEC member point of view is not listened to in a very careful manner.

Having briefly introduced the issues we now turn to detailed analysis. In the following sections we shall; <u>firstly</u>, define the concept of surplus funds and discuss estimates of these sums for the recent past and the future, <u>secondly</u>, depict and analyse the pattern of financial relationships established between OPEC and the third world in the period 1973-78, <u>thirdly</u>, discuss the motivations, perceptions and circumstances of OPEC countries with a bearing on the issue of financial solidarity, <u>fourthly</u>, suggest schemes which may be attractive to OPEC donors/lenders and beneficial to recipients/borrowers in the third world.

CHAPTER 1: THE CONCEPT OF 'SURPLUS' FUNDS

The term 'surplus fund' which has received wide currency at the time of the oil revolution of 1973 and which was specifically applied to the positive balance accruing to OPEC countries in their international transactions though now conventional can be misleading. It tends to create the impression that as oil revenues are larger than current foreign-exchange outlays on goods and services the excess is in some sense superfluous. There is no doubt that the term 'surplus fund' has been often used with

this connotation by writers in the West and elsewhere. It would have been useful to have a different term from the outset such as 'net foreign-exchange resources'. The point is not one of pure semantics because language is not neutral: language both reveals and shapes attitudes. Unfortunately, the convention is now well established and little will be achieved by attempts at changing the common usage.

The more sensible course is to explain what these 'surplus funds' are about and the related concept of a capital rich country. It must be emphasised that the 'net foreign-exchange resources' which have become available to some Arab oil-producing countries are not equivalent to the balance-of-payment surpluses of industrialised economies such as West Germany or Japan. Oil-producing countries have a single source of wealth: petroleum reserves which are a depletable natural resource. Foreign exchange earned from oil exports accrue through depletion of these reserves, not through the production of reproducible goods and services. These foreign-exchange revenues are the financial realisation of a natural asset. The sums realised which are spent on consumption are foregone for ever: the sums spent on investment goods involve a change in the composition of the country's assets, the sums placed abroad also represent a portfolio change. The so-called 'surpluses' are the oil-exporting natural wealth held in the form of liquidity, paper assets, claims on borrower country's and other financial instruments. They should be construed both as a source of long-term income which will be called upon by the country in ten, twenty or thirty years time to supplement export revenues when oil begins to run out and as an external investment fund which oil-producing countries will plough back domestically when absorptive capacity expands with the passage of time. These 'net foreign exchange resources' are not mere addition to reserves in the normal sense. The demand for these resources is not determined by the usual 'foreign-exchange reserves' considerations which in the theory of the balance of payments are simply built up to smooth out temporary differences between the import and the export bills.

A clear understanding of the significance of these famous 'surplus funds' for the long-run development of the oil-exporting country and the welfare of future generations is essential for the formulation of correct investment and placement policies. This understanding is also essential for the analysis of the relationship between oil-producing and other developing countries. If 'surplus funds' were construed as extra income which oil producers do not really need (or to which OPEC is not really entitled as some antagonistic commentators tended to suggest in the heat of the 1973 crisis), it would be natural to argue that they should flow back almost freely to the most deprived members of the world community. Important aspects of the case for financial relationships between OPEC member countries and the third world (such as the objectives and national interest of lenders/donors, the perceived burden of loans/grants, the terms on which these loans/grants are likely to become attractive, the genuine obstacles to an increased flow of fund) find little place in the pseudo ethical argument 'surplus funds largely because they are not needed should be ploughed back where they are most wanted in the poor world'.

1.1 A Technical Definition of Surplus Funds

Having discussed the substantial meaning of the concept let us now turn to technical definitions. The literature on surplus funds is particularly loose in this respect. Some authors tend to restrict the use of the term to additions to reserves, others to the liquid and semi-liquid deposits placed with the international commercial banking system. For the purpose of this paper we shall define 'net foreign-exchange resources' as the difference between total foreign-exchange inflows from all sources (oil revenues, earnings from non-oil exports, net investment income from abroad, other net income from abroad) and the outlays on goods and services. This definition identifies the total amount available for a variety of possible placements such as additions to official reserves, short-term deposits in commercial banks abroad, official loans and grants, direct investment abroad, purchase of equity in foreign firms, participation to international lending schemes etc.

Projections and estimates made in late 1973/early 1974 on future accumulation of 'surplus funds' turned out to be wildly exaggerated. Of course, these estimates fell within a very broad range, and though ridiculous forecasts expecting oil-producing countries to accumulate US $1300 billion by 1983 were discounted even at the time, there was a consensus among the most sober observers on an accumulation of US $300 at 1974 prices by 1983. Most early forecasts expected the price of crude oil at least to retain the January 1974 level at constant dollars. This was the low price assumption. High price assumptions expected rises of up to 100 per cent in real terms over ten years. The real price of oil (whichever reasonable deflator one chooses to use) has fallen in a noticeable manner between January 1974 and December 1978. Though most observers expect the price trendline to tilt upwards in the next few years, it is difficult to assess the significance of this movement.

1.2 The Impact of Imported Inflation

Early forecasts tended to underestimate the ability of oil-producing countries to spend money. They also underestimated the very high rate of inflation (a multiple of the rate of world inflation) which hit petroleum economies. There was persistent talk about the lack of absorptive capacity, a term very much misused and abused. Strictly speaking, absorptive capacity refers to the ability of an economy to channel potential investible funds in projects and programmes with expected rates of return at least as high as the rate of interest. In the literature on surplus funds the concept of absorptive capacity was rarely applied in this strict sense. It just meant ability to spend. That there should be inherent limitations on investment opportunities is perfectly understandable. That there should be very tight constraints on the ability to spend is more difficult to imagine. Yet by shifting the use of the term 'absorptive capacity' from investment to general spending, implications valid in one context were wrongly transferred to the other. In any case we know now that though limitations on how much socially useful and profitable investments an economy can carry at a point of time do exist, the ability to spend on armament, consumer goods and services is almost boundless. What can't be spent at home can buy abroad. And the stronger is

the domestic spending spree, the higher is the rate of inflation and hence the expenditure bill in current money.

The oil-producing countries, however, may have reached a turning point in this expenditure spree. The Iranian crisis has many lessons to offer: one which will be heeded by the new Iranian government and most probably by other OPEC countries is about the socio-political dangers of a spending spree. There is likely to be a drastic reduction, not so much in the volume, but in the rate of growth of public expenditures in many an OPEC country. Would this imply a reversal in the downward trend of the rate of 'surplus' accumulation which has marked the period 1974-78? Would this mean that the early forecasts for 1983 may still turn out to be valid because of changed behaviour in 1979-83? Much depends, of course, on what happens to revenues. The Iranian crisis may encourage oil-producing countries not only to spend less, also to produce less. For one of the popular demands is the conservation of oil, a wasting asset which should be made to last for future generations. Conservation in production implies less revenues on account of the reduction in export volumes, but it may also lead (depending on how far conservation measures will go) to higher prices and on this other count, to higher revenues.

1.3 Financial Assets of OPEC

Actual accumulation by the end of 1978 were well below the levels talked about in 1974. Worse, there was such a dip in OPEC aggregate balance-of-payments surplus in 1978 that a new conventional wisdom began to emerge. The main tenets of the recent view is that OPEC will soon (1979?) become a deficit area and that Saudi Arabia, the major 'surplus' country, herself, will come close to a deficit. The main advocate of this view is a Theodore Moran in a book entitled Oil Prices and the Future of OPEC published in Washington by Resources for the Future in 1978. But Moran's book must be read critically because the author has clearly an axe to grind. The argument about vanishing surplus funds is meant to support a thesis about the collapse of OPEC as a price fixing organisation. Without subscribing to such extreme views it remains evident that accumulated funds are not very considerable and that current surpluses are declining to a low level.

Actual figures are difficult to arrive at. The most recent and perhaps authoritative estimate published late in 1978 in Middle East Economic Survey relates to foreign-exchange assets of OPEC member countries. The estimate does not disaggregate by country but by type of asset. The figures are shown in Table 1.

TABLE 1: Foreign-exchange Assets of OPEC Member Countries September 1978

		US $ Billion
(1)	Bank Deposits, Government securities and other instruments in the USA	45
(2)	Eurocurrency deposits (75 per cent of which in US dollars)	70
(3)	Deposits in UK, Europe and Japan (in the currency of the host country)	7
(4)	Government securities, bonds etc. in Europe, UK, Japan (mostly in strong currencies such as DM, Yen and Swiss Francs)	18
(5)	Loans to institutions, industries etc. in OECD countries (including 1.5b to US corporations)	13
(6)	Deposits and bonds in international financial institutions such as IMF, World Bank etc.	10
(7)	Loans to developing countries (other than monies channelled under item 6)	22
	TOTAL	185

A number of comments are in order. The data in Table 1 refers to assets only. Most, if not all, OPEC countries have some foreign exchange liabilities; and a few are heavy borrowers on the international financial market. Algeria and Indonesia are a case in point. Iran has encouraged public sector enterprises to borrow from international banks in 1977 and 1978 while the Central Government continued to accumulate foreign-exchange reserves. Iran's public foreign debt disbursed and outstanding may well be in the order of US $ 7 billion. The net accumulation of foreign-exchange resources is significantly smaller than the US $ 185 billion shown in Table 1).

The distribution of assets displays interesting features. Euro-currency deposits, most of which are in dollars, are by far the largest component of the OPEC countries foreign portfolio. They account for 38 per cent of foreign assets. Though still large, the share of this component has been steadily declining since 1975. Initially surplus funds went directly and almost exclusively into highly liquid deposits. Diversification in a wider range of financial instruments was initially both slow and cautious. It was hindered by legitimate fears about taking a high and aggressive profile on financial markets. It was felt that attempts to purchase substantial amounts of equities, real estate or other assets in the US, Europe and Japan would elicit chauvinistic legislation aimed at protecting 'the national assets' of would-be host countries. Today, the share of official assets accounted for by loans and equity holdings in the industries and services of OECD economies is still a low 7 per cent. To correct this picture one should add that OPEC countries nationals hold real assets in Europe and America. Unfortunately, the data are not available: and though not strictly relevant to our purpose it would have been interesting to compare OPEC official with private foreign assets.

Bank deposits outside the Euro-currency system and the US are small. The holding of Government securities, especially in the US, reflects the way in which official reserves are usually kept.

The prevalence of the US dollar as the currency in which the largest proportion of assets is held is worth noting. The implications of such a concentration of assets in one currency are significant for a number of issues such as the pricing of oil, vulnerability to exchange risks and financial freedom of manoeuvre. But these issues though of considerable interest are only peripheral to the problem of the financial relationship between OPEC and developing countries.

Finally, note that US $ 32 out of US $ 185 billion or some 17 per cent of gross assets (and, by inference, a much larger proportion of net assets) are, directly or indirectly, loaned to developing countries. Direct loans were estimated at US $ 22 billion. But it is fair to add that most deposits and purchase of bonds with the IMF and the World Bank (Table 1, item 6) have been channelled to developing countries. Outright grants, not recorded here because they are outlays rather than assets, have also been made. The flow of funds to developing countries between 1973 and 1978 is more substantial than apparent here. Data on the distribution of assets by country and on annual accrual of 'net foreign-exchange resources' are needed to complete the statistical picture. Compiling from a variety of sources (which means that strict comparability is not ensured) we come up with the following results.

1.4 Asset Ownership Among the OPEC Countries

Morgan Guaranty Trust provides us with tentative estimates of the ownership of assets for 1977. Assets are put at US $ 170 billion which seems fairly consistent with the estimate of US $ 185 billion for 1978 presented in Table 1. The relevant data are shown below in Table 2. Gross assets were probably a bit higher for the countries listed as their foreign-exchange liabilities (admittedly small) are not netted out. The larger liabilities are incurred by Algeria and Indonesia as mentioned before. Morgan Guaranty estimates the net assets of these countries at minus four and minus nine billion dollars respectively.

Table 2 shows very clearly and not surprisingly that the major holder by far is Saudi Arabia followed by Kuwait and the United Arab Emirates. Iran is less wealthy than apparent in Table 2 because of more significant (and unaccounted for) liabilities than other countries in the same list. Nigeria is moving fast away from the black into the red. Iraq, Libya and Venezuela have large but not terribly impressive accumulation. Qatar which seems rich on a per capita basis does not hold funds of considerable absolute magnitude.

TABLE 2: External Assets of OPEC Counties, 1977

	US $ Billion
Kuwait	31
Qatar	5
United Arab Emirates	16
Saudi Arabia	68
Iran	22
Iraq	7
Libya	8
Nigeria	3
Venezuela	10
TOTAL	170

The time profile of surplus funds is shown in Table 3. Estimates of current surpluses shown are the result of calculations performed on trade and other data from IMF; International Financial Statistics, OECD, Economic Outlook and other sources. Data in Table 3 are not very reliable but they are fairly consistent with the aggregates shown in other tables. The main feature is the decline in the size of the global OPEC surplus in 1978. Let us note, however, that the usual procedure which seems to treat OPEC as a single entity is not very satisfactory. The procedure is certainly inadequate in the context of this paper. The surplus that matters is that of surplus countries only. Yet, aggregation removes from the estimate the deficits of some OPEC members. Conceptually, the procedure would make sense if OPEC countries in deficit were entirely financed by their fellow members. But, of course, this is not the case. Funds available for deployment and placements are those of the surplus economies; and these funds may well be larger than suggested by aggregate surplus data.

TABLE 3: OPEC Balance-of-Payments Surpluses

Year	Surpluses US $ Billion
1973	9
1974	62
1975	31
1976	42
1977	30
1978	10

CHAPTER 2: OPEC RELATIONSHIPS WITH THE THIRD WORLD 1973-78

The purpose of this section is to analyse the features and patterns of flows of funds from OPEC countries to the rest of the developing world during recent years. The assessment of past behaviour is fundamental to a correct understanding of the motivations and responses of OPEC to the urgent call for financial solidarity from the third world. It will also provide us with a benchmark against which the feasibility and realism of proposals for future acts of solidarity can be judged.

Financial aid from OPEC member countries to other countries of the third world represents an interesting development in international economic relations. It is a novel phenomenon, characteristic of the 1970s. In the 1950s and 1960s aid was almost exclusively a relationship between developed and underdeveloped nations. OPEC aid is financial co-operation between two sets of developing countries.

2.1 Early OPEC Efforts

The history of financial co-operation between OPEC and the third world had an early beginning with the creation in 1961 if the Kuwait Fund for Arab Economic Development. These beginnings were modest. Cumulative disbursements of the Kuwait Fund between 1962/3 (the first year of its operation) and 1970/71 were of the order of US $ 200 million. But this early start, as a time when the oil exporting countries were neither rich nor the focus of marked international attention, is significant in that it reveals motivations and willingness for financial solidarity. Kuwait had political reasons for engaging in foreign aid. This is not surprising (most aid is primarily political), nor does it rob the phenomenon from its relevance. The interesting fact is that motivations capable of inducing flows of funds towards the third world do in fact exist.

The Kuwait example was followed ten years later by other countries. Aid institutions were established by Abu Dhabi (1971) and by a group of Arab states (the Arab Fund for Social and Economic Development, founded in 1968, and operational in 1972). A development of a different nature took place in 1967. Three Arab oil-exporting countries - Kuwait, Libya and Saudi Arabia - began to extend substantial grants to three states engaged in a front line confrontation with Israel. The recipients were Egypt, Jordan and Syria. The Arab-Israel war of 1967 had led to the Khartoum summit of August 1967 which resolved that financial help should be given. The Khartoum payments were in the form of grants provided for budgetary support. The aid institutions mentioned above had a very different approach. They were more directly concerned with economic development, they specialised in project aid and their scope extended initially to all Arab countries.

Estimates of actual disbursements by OPEC members in the year 1970/73 are shown in Table 4.

TABLE 4: Aid Disbursements by OPEC Members 1970-1973

(US $ Million)

1970	1971	1972	1973
443.5	630.9	688.9	1740

Source: World Bank and OECD

As the Khartoum payments were of the order of US $ 380, it is clear that other types of OPEC aid were becoming substantial in 1971-73, before the oil price revolution.

2.2 The Post 1973 Situation

The events of late 1973 which led to the sudden quadrupling of the price of oil opened a new chapter in the history of OPEC aid. The scale of commitments and disbursements changed radically. Aggregate figures are shown in Table 5. A censory glance at these figures is sufficient to reveal the significance of the effort. But a more careful assessment may be called for. A comparison with DAC official flows put OPEC in a very favourable light. In 1975, for example, OPEC disbursed in concessional and non-concessional aid a sum equivalent to 69 per cent of the corresponding DAC flow. Comparison of aid/GNP ratios is even more revealing. In 1974-76, official development assistance from DAC countries to the developing world represented 0.33-0.35 per cent of their collective GNP. The best performance among DAC countries involved a ratio of 0.82 per cent. The comparable ratios for OPEC range between 2.0 and 2.7 per cent for the same years. In 1976, OPEC countries occupied the top six places in the world donor list as regards the aid/GNP ratio. Ratios of 15-16 per cent are recorded for certain countries such as Qatar. In 1974-76, the aid/GNP ratio never fell below 10 per cent in Kuwait, Qatar and the UAE. Note that all these figures are calculated for concessional aid only using the lowest available estimates.

TABLE 5: Total Net Flows from OPEC Members to Developing Countries 1973-1976

US $ Million

	1973	1974	1975	1976
Algeria	30	52	42	75
Iran	5	1182	1595	820
Iraq	11	436	288	91
Kuwait	581	1369	2112	1807
Libya	414	218	367	262
Nigeria	7	135	545	337
Qatar	94	253	366	445
Saudi Arabia	342	2372	3870	3625
UAE	90	765	1375	1221
Venezuela	18	779	899	296
TOTAL	1591	7561	11457	8978

Note: These figures include payments to the IMF oil facility

Source: UNCTAD

The geographical scope of OPEC aid was considerably enlarged after 1973. In the period 1970-73, the recipients were 23 developing countries (including three low income OPEC members). The number rose to 42 in 1974, 55 in 1975 and 63 in 1976. It was getting close to 90 in 1978. The proportion of bilateral concessional funds received by Arab countries fell from 97 per cent in 1973 to 63 per cent in 1976. And this declining trend continued as markedly thereafter.

A final, and perhaps most interesting characteristic of OPEC aid is the diversification of the channels through which it is given and the variety of its mode . The institutional channels for the granting and lending of funds include: (a) national aid funds, (b) multilaterial and institutions created by some OPEC members in association with other developing countries, (c) the OPEC collective aid facility known as the OPEC Special Fund, (d) Central Banks aid National Treasuries, (e) nationally financed trust funds managed by multilateral institutions, (f) existing multilateral institutions such as World Bank, the IMF and UNDP, (g) new multilateral institutions such as IFAD in the creation of which OPEC played a significant role. Through these channels OPEC aid has been given in a variety of ways. Long and medium-term balance-of-payments, banking guarantees under writing commercial loans to developing countries are among the forms taken by bilateral aid. Multilateral aid involved straight contributions to international developing agencies as well as the creating of new institutions.

Further, financial co-operation between OPEC and developing countries has led to the establishment of joint companies for financial placements and direct investment in the third world. There are many such companies today in the Arab world and a few in Latin America. Developed countries are sometimes involved as third parties in what is fashionably hailed as the new phenomenon of 'trilateral co-operation'.

To sum up. The oil price rise and the emergency of large balance-of-payments surpluses have been associated with a very considerable development of OPEC aid to developing countries. The financial flows, in the variety of their forms (some well-documented here, some less well-known), have been considerable. Not only were absolute amounts significant but the relative burden on OPEC donor countries was unusually high. In fact aid/GNP ratios are of a completely different order of magnitude in OPEC than in DAC countries. All that suggests the existence of strong influences directing funds to developing countries. What is the nature of these influences, or if a different formulation is preferred, what are the motivations and determinants of OPEC aid? Were the factors at play in 1973-78 likely to continue to perform or were they temporary in character? To these important questions we now turn.

CHAPTER 3: THE MOTIVATIONS AND DETERMINANTS OF OPEC TRANSFERS

The starting point must always be that OPEC countries are themselves developing countries. Because of a structural accident - a sudden but very significant increase in exports revenue which cannot be made to match the smoother time profile of expenditure growth - surpluses have accrued. The emergence of these surpluses, inherently, is a temporary phenomenon. Expenditure growth has a tendency to catch up with the initial jump in income. Several OPEC countries ceased to enjoy surpluses within a year or two of the 1973 price rise. In most cases, current surpluses have declined to low levels after four or five years. Of course, a distinction must be made between current surpluses and past accumulation, or between the income statement and the asset statement of the national balance sheet. Even if current surpluses disappear, past accumulation could involve substantial funds available for placements. A further point is of interest. The conditions leading to the emergence of surpluses in one historical instance can repeat themselves. The price of oil is still capable of rises (not as large and abrupt as in 1973) and a pattern in which income increases at first faster than expenditure may re-appear again.

We are thus dealing with a small set of developing countries which enjoy for a relatively short time structural balance-of-payments surpluses and which have foreign-exchange assets at their disposal because of accumulation during the period through which the surpluses accrue. Specifically, these countries are Saudi Arabia, Kuwait and the United Arab Emirates. A second group with less assets include Qatar, Libya, Iraq and Venezuela. Countries of the first group are likely to remain for a long time large owners of foreign assets. Countries in the second group are vulnerable to the incidence of future deficits which could quickly erode their asset position.

We are thus dealing essentially with three or four small countries which happen to have a very lop-sided economic structure. They are developing, they own foreign-exchange assets but their economies suffer from a lack of resources complementary to oil and finance for the purpose of economic development. As mentioned earlier, though capable of spending money with great ease their absorptive capacity in the true sense is limited.

Such a situation necessarily involves a deep rooted sense of insecurity about the economic future. On the one hand oil is a finite and depletable resource. On the other hand economic development, which should enable the country to maintain the levels of both its income and its economic activity at the end of the oil era, turns out to be a very long process hindered by the paucity of non-oil resources. The nagging feeling which worries Governments and people alike (worries are always there not far down the surface though they are rarely expressed in an explicit and anxious manner) is that the oil era will not be long enough to enable a successful transition from an economy dominated by oil to an economy with and versified structure.

We have argued earlier on that in a conceptual sense surplus funds are best treated as a portfolio issue. It can be now seen that they are perceived in a very real sense as essential assets likely to be needed for a very uncertain long-term future. These considerations go some way in explaining the extreme caution which Saudi Arabia and the Gulf states tend to display in their policies about placements. To be sure other causes are at play, Saudi Arabia and the Gulf investor have shown such a strong inclination to keep their foreign-exchange assets in a highly liquid form (the main expression of their cautious attitude to investment risks) partly because other channels for investment were not readily available and partly because it is usual for investors to keep themselves liquid until they had time to study the market, become familiar with its operations and identify the opportunities. It is easy to forget that Saudi Arabia and some of its fellow OPEC members were very inexperienced entrants to the financial world only five or six years ago.

3.1 Risk Perceptions and Costs

Yet there is a fundamental investor's fear about the placement of assets: the risk of losing the principal. In the case of a Government placing assets, which are especially valued because of their significance for long-term development, in foreign countries and foreign hands, the risks are perceived as potentially serious. This explains the deep-seated preference for liquid deposits with the international commercial banking system. OPEC Governments feel that private international banks will not be parties to games of political confiscation.[1/] Bankers are agents loyal for solid commercial reasons to their principals (the depositor) and without conflicting allegiance to the host country. Liquid deposits can be shifted almost instantaneously if not outside the Euro-currency or the international market place at least within it from one institution to another. In short the principal seems to be safe. But this preference for liquidity entails high cost. The monetary returns are not particularly high. Inflation erodes in an implacable manner the value of the deposits. Recently these liquid assets held for the main in dollars have also suffered seriously from enchange losses.

Fundamental features of the investor's attitude are now clear. For reasons which are easy to justify the priority is given to safety (hence the international banks as a safe home) and to ease of disposal (hence the preference for liquid deposits). High returns are a welcome bonus not an essential objective to be preferred to safety and access. There seems to be some preference for placements with private institutions over investment with Governments but there is no over-riding dislike of Government Securities and bonds. Diversification, despite (or perhaps because of) the actual high degree of concentration is certainly desired. Diversification is the normal answer to the worries of risk-averse investors. It is important to recall that OPEC investors will seek to diversify their portfolios whenever possible subject to the constraints imposed by safety and access consideration.

1/ This was written in December 1978

3.2 OPEC Motivations

The other aspect of OPEC members' motivations as regards foreign placements relates more closely to our purpose. We have seen that substantial sums - more perhaps than certain OPEC Governments would ideally have liked, and less than developing countries may have hoped for - have been channelled to the third world; and naturally the question of determinants and influences on the pattern of the flows arises. It would be mistaken to seek an answer by reference to the forces which shape the aid behaviour of major DAC donors. Most OPEC members are small developing countries. None of them is a Super Power with world-wide strategic interests. None of them is a former colonial power with political and economic commitments to dependencies.

Of course there are general ethical, economic and political considerations surrounding aid giving. But here again what applies to DAC is not always relevant to OPEC. It is sometimes said that there is an ethical case for aid. Whether ethics provides, in practise, strong motivations is a matter of debate. Our own view is that a relatively small portion of aid giving activities in the world are inspired by arguments of social or international morality. These factors apply in cases of emergencies natural catastrophes such as floods, earthquakes or famines and in distress situations when, for example, a major refugee problem arises. Ethical considerations have in recent years begun to influence the allocation of aid between potential recipients. Multilateral agencies have developed a new interest in the poorer countries of the world. Concern with 'most seriously affected' economies and in particular with the Sahel region are a case in point. Some concern is also expressed about aid reaching the poorer sections of society in a recipient country and greater weight is now given to measures which may reduce income inequalities or benefit those who are below the poverty line. The 'basic needs' philosophy is related to this concern. Whether these considerations are influencing the volume as well as the allocation of aid is doubtful. Some OPEC aid is given for purely religious reasons especially by Saudi Arabia. However, the sums involved are small. One may infer that ethical considerations play a role in other aid giving by OPEC members. How to explain otherwise financial assistance from small OPEC members to countries outside the region of immediate political interest to them?

3.3 Economic Motivations

The economic motivations for aid by DAC countries may involve such aspects as the need to create commercial goodwill, the need to strengthen and develop existing trade relationships and to create a favourable environment for foreign investment. OPEC countries are different in some of these respects. They have no immediate need for the promotion o their major export-petroleum. On the contrary, some of their aid giving is in the form of oil procurements at a discount. Unfortunately, their non-oil exports are negligibly small and their promotion has not played so far any significant role in their economic strategy.

The economic motivation for financial co-operation between OPEC and the third world should be sought in investment rather than trade. There is need for OPEC, as argued earlier, to diversify its portfolio. Yet the perceived risks of investing or lending money to developing countries (outside the intermediation of international banks) counteract to some extent the drive for diversification. There are checks and balances between determinants of investment acting in opposite direction. One would have thought that joint-ventures between OPEC and third world countries and direct investment in the productive sectors of developing economies would hold much attraction. There is indeed attraction. Witness for example the very large number of joint ventures which have sprung throughout the Arab world in the past five or six years. But there are major constraints too. A joint venture requires an input from the partners which cannot be exclusively a financial input. Each partner must supply some managerial input (if only to retain an element of control). Skills and a modicum of experience in the field of the joint venture are also required. Recall that OPEC countries, especially the capital surplus members of the group, are very short of these particular managerial and industrial skills.

3.4 Political Motivations

There are political (as opposed to ethical and economic) arguments for aid. Indeed one is often tempted to argue that aid is essentially political, that aid is primarily an act of foreign policy. One argument, which is sometimes made with reference to DAC countries, suggests that aid is the least-cost course of action for Governments faced with demands to help the third world by domestic lobbies. Aid is a more palatable form of help than the removal of trade barriers, a liberal immigration policy and the like. There is no strong domestic lobby within OPEC countries for aid to the third world in general. But there are strong forces in Arab countries militating for greater solidarity, if not unity, between members of the Arab region. In OPEC countries aid is not an alternative to removing tariff walls, and judging from the very substantial absorption of foreign manpower in Saudi Arabia, the Gulf states and Libya, it does not seem that immigration is the relevant issue in this context. But inter-Arab aid may be seen by some as the least-cost method of expressing solidarity, the alternative being a strong drive for economic and political unity which has appeal but goes against the sense of independent sovereignty of nation states. Yet such an interpretation is too cynical. It can be easily turned out onto its head by noting that capital flows between Arab countries placed in a broad context of labour immigration, joint ventures, co-operation within regional institutions and that of political solidarity is an important step towards, rather than the substitute for Arab unity.

Another political case for aid is that it serves specific foreign policy goals. Iran had a very explicit and well-formulated regional strategy which involved objectives perceived as critically important; security, check on subversive changes within neighbouring countries, open sea routes in the Gulf and the Indian Ocean. Aid can back within the region such foreign policy objectives. The Arab countries are concerned both within the region and outside it with the international implications of their

conflict with Israel. They need international sympathy for their point of view, favourable votes at the United Nations and general support for a cause which is perceived as vital to the deepest national interests. All OPEC countries are concerned with perceptions in the third world about their role. The rise in the price of oil - inevitable and justified as it was - has nevertheless imposed a burden on the balance of payments of many a third world country. To be sure, changes in the price of traded commodities do not by themselves call for compensation from buyers to sellers or vice-versa. Any attempt to rest a case for OPEC aid on notions of compensation is doomed to failure. Nevertheless, OPEC countries are concerned both about the burden imposed and the resentment that may arise. Hence an important policy objective: to lead the attempts to establish a new international economic order. Financial solidarity with the third world can be seen as an essential back-up for these objectives.

CHAPTER 4: ARRANGEMENTS FOR SOUTH-SOUTH LINKAGE

The needs of developing countries for long term finance does not require much emphasising. These needs are well recognised by all parties concerned. Short and medium-term loans are available to them through the international banking system. It can be argued with ease that OPEC plays an important, though indirect, role in this respect. The capital-surplus member countries are large depositors in the banking system and hence the origin of a proportion of available funds. Long term funds come from ODA and multilateral agencies. OPEC members, as we have seen, are significant OAD donors and they have become very large contributors of funds to international aid organisations such as the World Bank and the IMF. Yet one feels that there is room for increasing very significantly the flow of funds from OPEC to developing countries. This impression is formed from a cursory look at the distribution of OPEC members' assets by type (Table i, above). Whether current surpluses will continue to accrue or not makes an important difference to the quantitative aspect of the question (how much is potentially available?) but not so much to the qualitative aspects (how are the available assets likely to be distributed?) That much is held in fairly liquid Euro-currency deposits and in Government securities in the US and Western Europe indicates the extent of the scope for diversification.

We have established that OPEC member countries are not averse to direct funds to the third world. Their recent record assessed in Section II of this paper speaks for itself. We have also tried to interpret investment preferences. Any scheme designed to encourage the flow of long term finance to developing countries should take these preferences into account. It may be recalled that these preferences involve the security of the placement as a major objective and high markability of the asset (which means ability to get the money back at fairly short notice or to switch it to another investment). If the rate of return is close to non-concessional rates, the placement will be treated as an investment. No special kudos from putting it in developing countries will be necessarily sought. If the return has turned the placement into a concessional type of flow, the donor country will seek some non-monetary return. Aid is not usually given in an anonymous manner. As argued earlier it is not without relationships to foreign policy objectives. The flow of fund will have to be identified as emanating from the actual donor. Finally we have insisted that the foreign exchange assets of OPEC countries is part of their natural (highly depletable) wealth which happens to have been translated into financial instruments. This wealth is needed for the future. To encourage both the willingness of OPEC countries to hold their assets in this form (which would increase in the future the availability of such funds) and their placements in the preferred manner it is necessary to offer investment opportunities that are as good as holding oil in the ground. This does not simply mean that the rate of return should be equivalent to the expected rate of oil price increase over the relevant time horizon. The return should be higher to compensate for the fact that financial placements are held abroad while oil that is not pumped out remains within the fiscal boundary of the country.

4.1 New Investments

Armed with these proposi· ons, it is easy to guess the features that a scheme designed to attract long term fin ce from OPEC to third world countries should display. One such scheme would consi of bonds with variable rates of interest linked to an inflationary index. The · al rate of interest need not be much higher than zero - one half per cent could be sufficiently attractive. The bonds will be sold by an international organisation preferably an existing one as there are serious disadvantages in multiplying such institutions. The money raised would be lent by this institution (World Bank or IMF for example) to developing countries at the World Bank (or a more concessional) rate. Such a rate will be always lower than the borrowing rate. A fund would thus have to be created to finance the difference. Sources of money for this fund would include DAC, OPEC and those developing countries not classified as MSA and who will just pay the difference between lending and borrowing rates on the loans made to them.

Variants of such a scheme are possible. But the main features - an institutional guarantee and a good rate of return - must remain in all variants. This more difficult criterion to satisfy is that of marketability. But as the bonds have a very attractive rate of return a provision could be made allowing non-OPEC industrialised countries to acquire bonds held by an OPEC member if no other OPEC member or no other developing country is willing to buy. In normal circumstances the bonds will not be available to industrialised nations (non-OPEC developing countries would have access and ought in fact to be encouraged). But they could step in whenever the OPEC holder wants to but is unable to unload some of his holdings.

Schemes linking interest rates to commodity prices pose too many problems and do not have obvious advantages. Schemes which involve the OPEC lender in commercial risks are not likely to attract very large volume of funds and need not concern us here.

An interesting area for long term development is investment banking within the developing world. Private banks largely financed by OPEC countries (governments and nationals) have sprung up everywhere since 1973. They have been active in the Euro-currency market and in loans to developing countries. But this behaviour and mode of operation hardly distinguishes them from other international banks.

There is considerable appeal in the idea of self reliance within the third world which means that all the lending and borrowing we have been concerned with is done directly between OPEC and developing countries in institutions exclusively of their own. This is desirable but not yet realistic on the significant scale which interests us. To be sure these institutions already exist. We have mentioned a long list of OPEC countries development banks. But these institutions deal with as much concessional aid as is likely to be given. Increases in the flows of fund to developing countries will have to be non-concessional. At this stage an outside intermediation

is required simply because somebody has to guarantee the placement and somebody has to help the developing countries with the missing concessional element.

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A DESCRIPTION AND PRELIMINARY EVALUATION OF PROPOSALS FOR GLOBAL STIMULATION

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1. INTRODUCTION

Over the past two years in developed and developing countries there have appeared numerous official and non-official proposals calling for a coordinated "global stimulation program." The element common of these proposals is to pool public and private savings from OECD nations with those of OPEC countries for investment in the developing nations. The underlying goal of such proposals is to revive world economic growth by an increase in industrial nations' exports that would result from the expanded investment in the Third World. The present report constitutes TASC's preliminary effort to analyze and assess these proposals, from the perspective of the OECD nations, the OPEC nations, the middle income developing nations and the poorer nations.

The proposition that economic growth is not synonymous with economic development gained increased acceptance in both the North and the South during the late sixties. In the North it was recognized, for many reasons, that increases in GNP did not necessarily translate into an improved quality of life. In the South, concomitantly, the persistance of massive poverty in the context of economic growth "miracles," such as Brazil's lead to the same conclusion. In both cases some observers pressed the argument to a second extreme proposition: not only was growth not synonymous with development, but economic growth, as the nations of the world practiced it was detrimental to economic development in the long run. A major theme of this report and of the proposals for global stimulus it evaluates, is that the second proposition is demonstrably false.

The failure of OECD nations to maintain their post-war rate of economic growth is playing a major role in impeding the economic development of both the North and the South, in terms of both a simplistic formal economic growth criteria and the more complex criteria of structural change associated with the New International Economic Order (NIEO). Slow growth in the North has led to the South's increased debt, declining Official Development Assistance (ODA) and declining export growth -- a function of both reduced demand and increased protectionism. In turn, OECD exports to the non-OPEC Third World have suffered, further slowing OECD growth. The same cycles of negative reinforcement are found in the medium term "structural" areas. Slow growth frustrates North-South negotiations in virtually all spects of the set of issues constituting the NIEO. This is particularly true in the area of OECD structural adjustment to the increasing competitiveness of some Third World nations in manufactures.

1.1 SUMMARY OF FINDINGS

This report describes and evaluates the effects of proposals for "global stimulus" on each of four groups of nations, the OECD countries, the OPEC countries, middle income developing countries, and the poorer developing countries. "Global stimulation" refers to a set of recent official and unofficial policy initiatives designed to restimulate world economic growth by exploiting, for the benefit of all, the economic interdependence among OECD, OPEC and other Third World nations. The common element of these initiatives is to channel OPEC and OECD savings into new fixed investment in developing countries, leading to a supplementary stimulation of the North via the increased export sales resulting from investments in the Third World.

The report considers twelve different global stimulation initiatives, of which three -- the Venzuelan proposal,

the Mexican proposal and the OECD Stepped-Up Investment Fund proposal are sufficiently detailed and politically feasible to merit a preliminary evaluation of impacts on each of the four groups of nations.

The proposals for a global stimulation program fall into two groups. The first group contains programs which are global in scope, large in scale (calling for $10 to $20 billion per year) and rely upon existing institutions, such as the World Bank, for implementation in combination with private capital markets or cofinancing arrangements. These features are common to the proposals by Venezuela, Mexico, OECD, Sweden and Norway and the U.S. House and Senate. The second group of proposals is either more regional in scope or requires new international institutions. Among these are the European Community Marshall Plan for Portugal, Greece and Turkey; the Kreisky Plan and the Japan-Mitsubishi proposal. This report emphasizes the first group of proposals, but provides a more speculative consideration of regional stimulation alternatives in its concluding chapter.

The rationale supporting these proposals emphasizes the need for a supplementary or reinforcing approach to current national policies and multilateral programs, in light of the new, globally interdependent problems causing the decline in world economic growth. These problems include:

- Stagflation, i.e., slow growth with simultaneous inflation, in the OECD industrial countries
- Slowing growth in the developing nations due to the re-emergence of external debt and foreign exchange problems
- A worldwide decline in the rate of capital formation coexisting with an estimated $500 billion of "under-utilized" savings, i.e., savings not being committed to productive investments for new plant and equipment.

An estimated 12 - 20 percent of this $500 billion is held by OPEC countries in deposits and other short term liquid assets. In addition to the forces which have made OECD private savers reluctant to commit their funds to longer term productive, fixed investment, OPEC nations face additional constraints, largely political in nature. An analysis of this rationale leads to our focus on both OECD-wide and international conditions.

Our assessment of the impact of proposals for global stimulus on the four groups of nations relies on the proposals themsevles and supporting analytical literature; a broad and intensive series of interviews with proposal authors and concerned experts from private industry and finance, multilateral and national development agencies in both the North and South; and a simple simulation exercise designed to estimate the change in OECD export sales resulting from one type of stimulus program.

Our preliminary assessment of the potential effect of these proposals on each group of nations is as follows.

The OPEC nations could benefit from a global stimulus program both directly and indirectly at minimum cost and risk. OPEC's major immediate economic benefits are threefold: first, long term placement of a modest proposition of its petrodollar surplus in fixed investment outside of the OECD area at a guaranteed market rate of return. Second, there emerge longer term economic, institutional and political consequences of a stimulus program, if successful, to lay the basis for institutionalizing mechanisms to recycle much larger portions of OPEC's surplus funds into the non-oil exporting Third World. A third OPEC direct economic benefit depends upon the success of a stimulus, in coordination with intra-OECD efforts, in generating renewed OECD growth, which in turn would solidify the demand for OPEC's oil.

Probably costs incurred by OPEC because of a stimulus include:

- The spread between long and short term rates on a small portion of its surplus
- The expenditure of political capital in the event of an unsuccessful OPEC backed effort.

The OECD's nations economic benefits or costs associated with a global stimulus will depend upon the validity of proponents claims that, (a) financing for a program can be secured without creating inflationary impacts, and, (b) the effective demand arising from investments in developing countries can be matched with industries experiencing excess capacity in the OECD.

Our assessment concludes:

- Both the private and public sector financing can be drawn from global capital markets and national budgets without an inflationary impact
- Based upon our simple simulation exercise of a Venezuelan type program, OECD manufactured exports to the non-OPEC Third World, increased by an amount equal to 5.6 percent of those exports for 1977 without generating capacity utilization bottlenecks at the four digit SITC level
- A successful stimulus program is potentially from an OECD point of view, the initiation of North/South areas of mutual cooperation and benefit relevant to the issues of the NIEO including, Northern structural adjustment to the growing comparative advantage of Third World producers in some manufacturers.

The Middle Income Developing Countries potential costs and benefits in a global stimulation effort must be evaluated in the context of these nations' immediate prospects, including

the bunching of their short term external debt in 1980-82, declining ODA flows, and lower export revenues resulting from slow growth and protectionism in OECD markets.

In this context the direct and indirect economic benefits of a stimulus to Middle Income Developing Countries would be:

- Inflows of long term financial capital, lengthening the term structure of these nations' indebtedness
- Increased export revenues to the degree a stimulus succeeds in spurring OECD growth and reducing protectionist pressures.

An issue on the cost side is specific to targeted programs, e.g., the OECD and Venezuelan efforts would restrict sectors of investment in developing countries. In a restricted program with targeted investment in primary sectors the possibility exists that the middle income developing countries might accelerate their raw materials dependency situation, particularly if there are future declines in terms of trade. This effect, interviews indicate, would be mitigated by two considerations: first, transferred funds of a global stimulus might substitute for other finance in the primary sectors, thus freeing-up funds to flow into the manufacturing sector; second, recipients could negotiate that targeted stimulus to the primary sector include processing as well as extractive projects.

<u>The least developed countries</u> will potentially be impacted by a program of global stimulus in ways similar to the middle income developing countries. The least developed could benefit from truly additional financial inflows and, higher growth in key OECD export markets. However, a major issue in relation to the least developed countries is the form of the

program of stimulus. If a global stimulus program is implemented which draws financing from existing ODA and disperses funds unrestricted by sector or country income level, the results could be disastrous for the least developed countries. Specifically such an "unstructured" program could result in a net decrease in concessional and nonconcessional financial flows to these nations with an equal net increase of inflows to the middle income developing countries. The Venezuelan and OECD proposals recognize this possibility and attempt to guard against it by the targeting of sectors and by requiring a percentage of financial transfers to be placed in the poorer countries.

Regional and bilateral trade investment aid packages between developed and developing countries are an alternative to a global stimulus effort. Examples of regional arrangements are the current Lome II negotiations between the EEC and 54 developing nations in Africa, Asia, and the Caribbean, and discussions between Japan and the Association of Southeast Asian Nations ASEAN). Bilateral trade-investment-aid packages have centered on energy. Here, the initiatives of Germany to Saudi Arabia and the U.S. to Nigeria are examples. Notably, this type of arrangement could be extended to other raw materials besides energy.

Underlying these initiatives and the willingness of OECD nations to undertake them are three related issues:

- The differential ability of OECD nations to mitigate the effects of stagflation by traditional domestic monetary and fiscal policy
- The differing degree of OECD nations dependence on Third World trade -- particularly, the share of manufactured exports to the Third World and raw material imports from the Third World
- The differing impact of increased Third World manufacturing competitiveness on OECD economies and their differing ability to structurally adjust to their changing comparative advantage.

The vigor with which an OECD nation or group of nations will pursue bilateral or regional initiatives will depend upon that nation's relation to the three issues, as well as the degree to which concessions are made to particular developing countries in the context of trade-investment-aid negotiations.

The relation between bilateral or regional trade-investment-aid packages and a global effort is complex. The simultaneous pursuit of both options may be limited by financial constraints; yet bilateral or regional successes could underscore the feasibility of a global multilateral approach.

From a Third World perspective the merits of bilateral or regional trade-investment-aid packages relative to a global effort can be reduced to the as yet unestimated gains of regional/bilateral approaches vs. the unknown probability that such approach could result in regional North-South trade blocks. In turn such blocks could destroy the more multilateral, relatively open and free trade order that occurred during the post-war period until the mid-1970s. Whether or not Third World nations would fare better with regional-block or multilateral free trade conditions is already a controversial topic, but one which has yet to be systematically analyzed.

As a final note the report considers the role of proposals for global stimulus in promoting desirable structural change in the world economy. We base this assessment on three criteria of desirable change as follows:

- Global efficiency, the achievement of which depends upon resolution of the interrelated problems of stagflation in the North, structural adjustment, rising protectionism, and developing country debt;

- Global equity, recognition and procedures that world growth and efficiency goals must be at times "traded-off" for equity;

- Global participation, increasing the meaningful decision making role of developing countries in multilateral institutions.

On this score the report concludes both the OECD and Venezuelan global stimulation proposals may serve as effective devices to move the international system towards the goals of efficiency, equity and participation.

1.2 FORMAT

The report consists of three substantive chapters.

Chapter Two is a description of current global stimulation proposals calling for increased financial/resource flows from the "North" to the "South," including an assessment of the current status of these proposals.

Chapter Three presents an assessment of the impact of these proposals on each of four categories of nations, the OPEC nations, the OECD nations, the middle income developing countries and the least developed countries. Highlighted are the capital goods producing industries suffering from excess capacity; and the competitive position of semi-industrial nations (e.g., Brazil, South Korea, India).

Chapter Four concludes the report with a description on preliminary assessment of bilateral and regional alternatives to global "North" to "South" transfers. The chapter concludes with a discussion of the broader implications of a global stimulation program on the structural reform goals of NIEO.

2. GLOBAL STIMULATION PROPOSALS: CONTENT, CURRENT STATUS AND FEASIBILITY CRITERIA

The purpose of this chapter is to describe the various "global stimulation" proposals and to assess their current status. To reiterate, the common element of these proposals is coordination of an increase in financial transfers from OECD and OPEC nations for investment in the non-oil Third World nations, both middle income and poor. The intention is to stimulate growth in all four groups of countries. Proponents of these proposals, while recognizing that economic growth does not necessarily mean economic development, argue that in the context of the current world-wide slow growth situation, increased growth is a prerequisite to development. Accordingly, while the hypothesis -- no growth is an impediment to development -- may be questioned, the proposals should be evaluated with reference to their proclaimed objective, i.e., increasing economic growth, rather than the broader criteria applied to a comprehensive development effort. We will return to this question in the next chapter when evaluating the proposals' impact on the Least Developed Countries with respect to the relation between massive transfer proposals and existing Official Development Assistance (ODA).

Our study of financial transfer proposals has resulted in a set of institutional and economic criteria against which the growth potential and the political-economic feasibility of the various proposals can be evaluated. These criteria are presented before reviewing the proposals.

2.1 FEASIBILITY CRITERIA

The feasibility criteria are broken down into five subsets, one for each of the four groups of nations which would be involved in a resource transfer program and an additional group to reflect the concerns of multilateral and bilateral development institutions. The criteria under each group largely reflect the self-interest of that group and the issues the various proposals have raised pertinent to that interest. For example, the issue of the relation between a global stimulation program and ODA is listed under the Least Developed Country category. This is not to say that OECD nations are unconcerned with the issue. The group of Like-Minded Countries* have expressed great concern, but the issue of ODA is more vital to the Least Developed Countries than to the OECD. The essence of the individual criteria differ; some are political while others are economic. Some are issues of negotiation, e.g., formal institutional participation, while others might be more accurately described as empirical questions than feasibility criteria, e.g., the relation between developing countries export demand resulting from a program and excess capacity in the OECD. Criteria listed as one group's concern are in some cases in direct opposition to the position of another group, e.g., the general issues of investment in manufacturing in developing countries, structural adjustment and protectionism. In these cases the "criteria" are more a statement of initial negotiating positions than final stances. This point is buttressed by interview material, in that spokespersons from all concerned parties have indicated a willingness to negotiate virtually all aspects of a program.

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*Sweden, Norway, the Netherlands, Austria, Denmark, Belgium, Canada, Finland and Ireland.

Our listing of criteria has grown over time, the result of new proposals, on going interviewing with representatives of each of the five groups, and the introduction of finer levels of technical detail. Thus the following listing is tentative and open ended. The order of presentation does not reflect a ranking.

2.1.1 The OECD Nations

Proponents of global stimulus argue that the goal of stimulation with minimum inflation would be realized for the OECD nations through two mechanisms, financing the transfer fund by drawing down on the excessive liquidity of global capital markets and the OECD exports which result from the investments made in developing countries. Each of the following criteria can be related to these issues:

- The investments made in developing countries stimulate industries in the OECD nations which are experiencing excess productive capacity
- The financial contribution of the OECD nations require minimal or no increases in current official development assistance
- Should a mechanism incorporating private capital be devised, the mechanism does not draw upon capital markets to the extent that these markets are significantly tightened for OECD borrowers
- The OPEC nations participate significantly in the financing of the program
- The investments made by the program do not increase import pressure in declining OECD industries -- shoes, textiles, etc.
- The export gains of a program benefit directly all OECD nations

- A feasibility determination be made as to: the ability and timing of investment payoffs where non-concessional transfers are concerned; the ability of developing countries to absorb the transfers; and the time frame in which transferred resources are translated into export demand for the OECD nations' products

- The program be administered by a technically competent agency(s).

2.1.2 The Middle Income Developing Countries

The goal of growth in Middle Income Developing Countries would be accomplished directly by the transfer program's long-term lending. These loans would represent a positive contribution to the Middle Income Countries' debt problem by lengthening the term structure of these nations' debt. In addition, to the degree that the program contributed to OECD growth, Middle Income Developing Countries' export markets would be stimulated, and, to some extent, OECD protectionist pressures lowered.

The following are the list of criteria raised in relation to Middle Income Developing Countries' interest:

- The program should provide long-term financial resources which will alter the term structure of MIDC external debt

- The program funds should be a net addition to those currently available to MIDCs via private capital markets, bilateral export credits, and bilateral or multilateral ODA

- The implementation of the program should be accompanied by a drawback from increased OECD protectionism, particularly if the program should target funds away from manufacturing investment in recipient nations

- The export demand resulting from new investments should be untied, and MIDCs permitted to compete for that export demand

- Investments made under the program should be subject to host country laws concerning foreign investment, if TNCs participate or, alternatively, implementing agencies, e.g., IBRD, should regulate TNC participation

- The program should be unrestricted as to sector of investment, or OECD nations should make other concessions if program funds are targeted by broad sector away from manufactures

- Recipient nations should enjoy greater participation in decision making in all aspects of the program than is the case in existing development institutions.

2.1.3 Least Developed Nations

The poor nations of the Third World could conceivably benefit from certain types of stimulation programs in the same ways as the Middle Income Nations, particularly via access to long-term capital. These nations have been most concerned with the relation of a program to ODA. The following are the list of criteria raised in relation to the poorer nations:

- The program should represent a net addition to the public and private inflows of financial resources to the poorer nations

- The program should not decrease concessional bilateral or multilateral ODA, even if total net inflows are increased

- The program's emphasis on stimulation of OECD industries should not lead to the exclusion of projects within poorer countries, which may have relatively lower export demand for OECD goods

- The funds transferred should be untied with reference to source of procurements necessary to implement investment

- Recipient nations should enjoy greater participation in all aspects of decision making than is the case in existing development institutions.

2.1.4 The OPEC Nations

The OPEC nations' share in the direct effects of a resource transfer program would be relatively smaller than those of the other national groups. OPEC investors would benefit from the opportunity to invest in longer term assets at competitive rates which do not increase the leverage of the OECD countries via OPEC. In addition, in certain areas OPEC's non-oil exports could be minimally stimulated. OPEC's major gains from a stimulation program would depend upon how successful the program was, in coordination with other efforts, in generating world economic growth leading to increased demand for oil. The issues of immediate concern to OPEC include the following:

- The OPEC's financing in the program should be complemented by a meaningful OECD contribution and the mechanism should guarantee OPEC a competitive rate of return
- OPEC's voting share in decision making directly reflects its financial contribution, in contrast to existing development institutions
- The resources transferred to recipient nations should represent a net addition to present private and public flows
- OECD nations should make a commitment to intensifying their domestic structural adjustment programs in order to alleviate rising protectionism.

2.1.5 Multilateral and Bilateral Development Agencies

The concerns of the multilateral and bilateral development aid agencies represent a mixture of institutional self-interest and technical concern with the feasibility of financial transfers. These criteria are the following:

- Current multilateral and bilateral development agencies should participate in the transfer program (meaning administer and technically service), and funds from the resource transfer should be allocated for these purposes
- The program's financial mechanism should not be competitive with outstanding or future development agency financial instruments
- The program should not be competitive with OECD donor nations' legislative approval of ODA funds or increased callable capital contributions to existing development agencies.

2.2 THE VENEZUELAN INITIATIVE

The first serious consideration and study given to a joint OPEC-OECD financed global stimulation effort for Third World countries came from the President and Foreign Minister of Venezuela during the spring and early summer of 1977. After discussion with OPEC leaders in Saudi Arabia, Kuwait and Iran, President Perez of Venezuela commissioned a further study. Thereafter, extended discussions were held in Caracas in August 1977, between United States' U.N. Ambassador, Andrew Young, and President Perez. At the December 1977 Caracas meeting of OPEC ministers, Intra-OPEC discussions were held, after which President Perez held a press conference to announce OPEC interest and support of the idea.

The Venezuelan initiative called for a pool of OPEC and OECD (public and private) monies to be placed at a "special window," i.e., special trust fund, of the World Bank and the International Finance Corporation and/or at regional institutions (e.g., African Development Bank). One portion of the monies would be raised from OPEC nations <u>and</u> private investors by floating an "OPEC Development Bond" in international capital markets. The underwriting services of private multinational

banks would be used to float this bond. OPEC members would agree to purchase some percentage, e.g., 20-25 percent of the total subscription of these Triple-A long-term (12 to 20 year) bonds, perhaps on a prorated for level of payments and cumulative surplus basis. The remainder of the issue would be sold to private investors. OPEC would act as a "first guarantor" of the bonds. The funds raised by the bond would go to the World Bank Family which would act as a "second guarantor" of the issues. The financing raised by the bond issues would be supplemented by contributions to the World Bank's "special window" fund by OECD nations. Of this total fund, some 20-25 percent was proposed to be channeled to the Least Developed Countries. The remainder would go, through the intermediation of the World Bank and IFC, to projects in developing nations capable of generating a rate of return equivalent to the Triple-A Bond at maturities of 12 to 20 years. The total "special window" fund envisages a per annum financial transfer to the Third World of $10 to $12.5 billion, of which a minimum of $8 billion would represent net additional financing to non-OPEC developing nations.

The Venezuelan initiative recognized many of the economic and political prerequisites of the OECD, OPEC, and non-OPEC Third World nations listed as feasibility criteria.

First, the "OPEC Development Bond" serves four purposes:

- It would be an international credit mobilizer absorbing the underutilized savings of both OPEC and OECD private investors (now held in near-liquid or other non-productive assets). This effect is estimated to be $3 to $5, i.e., each $1 of bond purchases by OPEC would mobilize an additional $3 to $5 of bond purchases by private investors. This feature of the financial mechanism was designed to maximize the "sopping-up" or absorption of excess liquidity,

particularly from the Eurodollar market, and therefore, provide financing "additionality" with a potential anti-inflationary effect.*

- It would employ the underwriting and intermediation services of the international private banking community avoiding OPEC technical, administrative involvement in raising the monies.

- The bond mechanism would provide a centralized means for prorated OPEC member purchases (through the OPEC Development Fund) of bonds based on differences in their current account positions.

- The Triple-A issue underwritten by private financial institutions allows an instant secondary liquidity market which, in combination with the "special window" feature affords OPEC both flexibility over time, as well as a decision-making role on the end uses of the funds.

Second, in addition, the "special window" arrangement permits "tripolar" decision participation (OPEC, OECD and recipient nations) on allocation to end-uses of the pool's funds, but without resort to changes in the constitution and voting shares of the World Bank.

Third, use of a second guarantee plus direct contributions by the World Bank's OECD donor-member nations permits both co-equal sharing of financial responsibility with OPEC and budget flexibility for OECD countries. The "second guarantee" should require only callable capital that, while necessitating in some cases legislative approval (e.g., the U.S.), does not require increased deficit spending by OECD countries. Direct contribution to the "special window" fund could, in the first two years, be reallocated out of current levels of budgeted official development assistance monies. Note: If that portion of the "special

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*Assuming a significant "sopping-up" effect, there is an anti-inflationary impact if one accepts the view that Eurocurrency deposits and other monies generate unplanned credit increases in OECD economics as well as feed exchange rate instability.

window" fund coming from OPEC and private investors through the bond subscription runs at $8 - $10 billion per annum, then, assuming matching direct contributions from OECD donors to total the same, the amount contributed by each donor would not be very large. In fact, since the critical design of this initiative, further refinements, done in conjunction with experts at multilateral development institutions, suggest a feasible means of using the $2 - $2.5 billion from current ODA levels but without drawing down on existing uses. (For details, see Chapter 3, Section 3.3.1 below.) It is assumed that by the third year OECD contributions of ODA would have to increase and a portion of this increase could be allocated to cover the direct contribution at the "special window" facility without drawing down on other aid uses.

Fourth, the commitment of some 20-25 percent of the pool to the least developed countries is to assure that the benefits of the pool's transfers would not go to only Middle Income Developing Nations, thereby minimizing possibilities of worsening international income disparities while gaining the support of the Least Developed Nations. However, it should not be assumed that all transfers to Least Developed Nations would be at concessional terms. Certain projects, such as in minerals and energy, are fundable under non-concessional transfers, particularly if five-year grace periods on principle and interest are granted.

Fifth, certain aspects of the Third World "absorption problem" are alleviated by use of the World Bank lending mechanisms (and/or their regional equivalents), taking a project approach within sector-target allocations. These sector target allocations would attempt to match exports of OECD excess capacity industries with import-absorption potential of the projects funded in recipient nations. In addition, the absorption

problem can be limited in some sectors by project participation with TNCs, often in a non-equity role, particularly joint ventures with national public and private enterprises in host countries. In addition, World Bank/IFC intermediation as an "honest broker" could help assure equitable agreements.

Sixth, the Venezuelan initiative suggested a plan of five to ten years, contending only a sustained and strong official commitment by governments could generate sufficient credibility to help overcome the OECD-wide decline in private investor confidence. In this regard, the Third World was viewed as a new source of sustained demand, a "new growth frontier" for the world economy.

Seventh, the Third World sectors suggested for project financing were energy and minerals and their related inputs, food production and inputs, and infrastructure, including indirect basic human needs. The "targeting" feature would attempt to take account of declining OECD industries where current structural adjustment problems, combined with an overall slow-down in growth, have generated protectionist pressures. This might especially be the case during the early years of the program; thereafter, "targeting" efforts could be refocused on other policy issues of mutual benefit.

Eighth, the Venezuelan initiative, therefore, assumed a quid pro quo in negotiating a global stimulation program; that OECD members commit themselves to intensified, domestic structural adjustment and/or redeployment efforts. These would commence during the third year of the plan, thereby giving OECD governments "breathing time" gained from the three year initial targeting effort to maximize exports from excess capacity industries.

Ninth, other forms of OPEC-OECD co-financing could and should take place. In fact, the Venezuelan initiative was seen as a catalytic mechanism and experiment to demonstrate the feasibility of other joint OPEC-OECD transfer mechanisms (including the OECD's own proposal for co-financing).

Tenth, this initiative also attempts to avoid "competition" with current efforts to increase the capitalization of the World Bank and other regional-international development institutions. For example, it is argued that the proposal's "special window" fund supports the proposed raising of the U.S. capital contribution to the World Bank because it demonstrates how increased development assistance can be designed to be of direct and mutual economic benefit to both donors and recipients. The program was designed to facilitate OPEC capital contributions, by offering economic and political conditions acceptable to the oil-producing nations, which were also acceptable to private investors. Thus, the initiative argued that it met the "addition ality" criterion of new financial mechanisms for increasing long-term external financial flows to the Third World. Finally, the "special window" facility was held not to be internally competitive to other World Bank activities, but, in fact, complementary to them. To illustrate, the "special window" fund could earmark some portion of its monies to the World Bank's proposed $500 million per year financing for oil-exploration in non-OPEC Third World nations. This would allow the World Bank's programming and planning to proceed while assuring it an additional source of financing. The same could be true for other World Bank programs that fall within the sector and recipient nation (by income level) criteria and targets of the "special window" fund.

2.3 THE MEXICAN/GROUP-OF-24 PROPOSAL

In the May-June 1978 meetings of the Interim Committee of the Joint World Bank-IMF Development Committee, the Group-of-24 through the government of Mexico proposed the design and implementation at the World Bank of a "long-term recycling fund" of $15 billion for the purchase of capital goods by developing nations. The World Bank's staff has completed an evaluation report of the Mexican Proposal discussed below. At the March 9, 1979 meeting of Senior Officials of the Developing Committee, the Mexican and other proposals are on the formal agenda for review and discussion.

The Mexican proposal applauded the IMF and private multinational banks short-term recycling of international payment imbalances, but noted the "financial community had not adequately faced the long-term structural problems that affect developing and developed countries, a problem that might well become more serious in the coming years." Emphasis was placed on "establishing a recycling mechanism to provide long-term finance," in that "it is not a sound banking principle to finance long-term capital investment needs with medium-term resources," as has largely been the case since 1973.

The financial mechanism is similar to the Venezuelan proposed OPEC/OECD initiative. The World Bank facility, for example, is to be a managed trust fund, issuing SDR denominated debt instruments (bonds, notes, or certificates) to lenders for a 15-year term at a market rate of interest. The fund would be separated from the Bank's normal borrowing operations. As in the Venezuelan proposal, the use of debt instruments was preferred because of its liquidity via sales in secondary markets. A *de facto* guarantee on the money borrowed by developing nations would be provided by the value of the purchased capital goods. It was also suggested that industrial countries should provide additional backing

The proposal relies strictly on the technical expertise of the World Bank in approving profitable loans. No mention is made of distribution of loans among the least developed, middle-income, and higher-income developing nations. Because all of financing will be at market terms, the result could be stimulation of growth in only the middle-income and higher-income Third World nations. No mention is made of targeting specific sectors in developing nations, e.g., energy, basic commodities, etc., nor to possible adjustment problems in OECD nations, nor to tripolar decision-participation in the facility but infers responsibility as now allocated within the World Bank. As with the Venezuelan initiative, it emphasizes, however, that the proposal would generate "breathing time for developed nations to make necessary structural adjustments to the changing patterns of international trade due to the interim period of revived stimulation that is foreseen."

The Mexican proposal has recently received two high level policy evaluations from the "Brandt" Commission and from the technical staff of the World Bank.

The Brandt evaluation was the more favorable of the two, although questions were raised concerning the feasibility of the proposal. The commission approached the proposal in the context of developing country debt and the question of increasing the term structure of that debt's maturity. Its review of the 1974-1976 round of private bank lending to developing countries concluded that the credit record of developing country borrowers was sound, and could serve as a basis for "the mobilization of resources...essentially on the credit of developing countries...." The recent growth of developing country bond issues was cited as evidence. As for the lenders (holders of balance of payments surpluses) the Commission argued they face no greater risk than is presently the case when the current mechanism recycles funds

to developing countries. In concluding its consideration of the proposal the Commission states, "If a new common finnacing facility of developing countries can be established, with the support of developed countries..., a new chapter in international financing would be open."

Concerning the feasibility of the Mexican Proposal, the Commission raised several points unconsidered by others. Particularly, is the SDR based deposit the correct strategy for assuring exchange rate stability; is the guarantee of developed countries necessary for floating the bond; and, for at least some middle-income countries, are the benefits of going it alone in international capital markets greater than the group approach implicit in all of the proposals?

The general tone of the World Bank staff appraisal of the Mexican Proposal (and its supplementary appraisal of the Swedish and OECD initiatives) is neutral. Questions are raised concerning technical and political considerations. Technically, the question of absorption is raised followed by the suggestion that a more gradual flow of funds (than envisioned by the Mexican Proposal) might be necessary. In turn this raises the question of whether a slower resource transfer would accomplish the aim of stimulating the more developed nations. Additional questions concerning the stimulation effect of a transfer include, the match of developing country demand with industrial nations excess capacity and the lag between disbursement of funds to developing nations and new orders for OECD goods. A suggestion is made that the stimulation effect of a resource transfer program could be enhanced by funding on-going projects as well as new ones and/or by selective program lending.

Political questions (largely related to the World Bank's self interest) are also raised. These concern the need for

parliamentary approval of expanded industrial nation contributions to development efforts and the possibility that even the guarantee of loans by industrial nations on a callable capital basis, "...may prejudice the expansion of the 'guarantee umbrella' of the international financial institutions."

2.4 THE OECD-DAC REPORT

In May 1978, the Development Assistance Committee of the OECD released a draft report on "Elements of a Program of Stepped-Up investment in the Third World in the Context of Interdependence -- Key Issues and Choices." The objective of the program proposed in the report is to:

> "...initiating a major increase in investment flows from the OECD and OPEC countries in the short-run for development within Third World countries in ways which would stimulate demand and increase production in both less developed countries (LDCs) and developed countries."

The time perspective of this stimulation effort is medium-term (three to five years) but implications are recognized for long-term structural change in the world economy. Envisioned is an increased investment flow of some $10 billion per year facilitated by the use of various co-financing operations in cooperation with the World Bank, other international and regional funding agencies, private commercial banks, as well as through an expansion of bilateral export financing.

The Third World sectors suggested for targeting are energy, food, and other basic commodities, with infrastructure investments envisaged as supportive to realizing the other sector's expansions. Major concern about participation is not detailed, but the need is noted for taking a "...collaborative approach between OECD nations and Third World countries..."

who "...must themselves be ultimately responsible for working out the details of a new investment program within a frame of jointly agreed objectives." It should be noted that the concept of "targeting" has been rejected in several different fora, among them the World Bank staff appraisal of the Mexican proposal.

As in the Venezuelan initiative, the major sources of funding are OPEC's cumulative surplus and "under-utilized savings" of private investors in OECD countries. However, the details are not provided as to what co-financing is, exactly why it would be supported, and how it is to work.

As regards the absorption capacity of developing nations, the report concludes that because additional needs in the energy, food, and other commodity sectors for all Third World nations are at least $25 billion per year, the suggested level of a $10 billion stepped-up investment program should, therefore, not create an "absorption problem." The argument, however, skirts the issue of whether the need of developing countries in these areas is synonymous with resource contributions in the form of local saving. Our interview data indicates that absorption is not a simple problem, but probably one which can be solved by increased planning allocation, controlled use of TNCs and program lending.

2.5 INTERNATIONAL LOAN INSURANCE FUND

During the 1977 IMF/IBRD meetings Professor X. Zolotas (Governor of the Bank of Greece) suggested the creation of an insurance agency to provide guarantees for private bank lending to developing countries. This proposal, as do two others reviewed below, is reminiscent of the Horowitz Proposal for subsidized loans of the late sixties. Although such a facility would not be as substantial institutionally or financially as the

other proposals, it is clearly better than no change, ultimately the limited objectives of these subsidization schemes may make them more feasible than some of the more ambiguous proposals. The rationale underlying the proposal holds that an international insurance fund is necessary both to service the longer term needs of developing countries, and to insure the financial stability of the Euromarket. The objectives of the International Loan Insurance Fund (the Fund) are to: a) open the Euromarket to lower income developing countries, b) assure continued access, but with longer term lending and lower cost, to developing countries presently in the market, and c) to insulate all developing countries from roll over problems arising from short run variations in Euromarket liquidity. Although the Fund is envisioned as an independent agency it would coordinate with existing international development agencies, the IMF and IBRD. Funds to guarantee the loans would be provided by the "highly industrialized countries" and OPEC nations holding petrodollar surpluses.

Professor Zolotas cites several "attractive features" of the proposal. The Fund's loans would not preclude continued commercial bank lending, but would introduce superior risk assessment in that the Fund would have available information held by public agencies. The capital contributed to the Fund by surplus nations would be on a callable basis. Potentially the Fund is self-supporting. The level of subsidy, or the amount of loans guaranteed, would depend on the credit worthiness of the borrower. This would allow lower income nations to develop a favorable credit rating facilitating greater access to private capital markets.

The Zolotas proposal presented only these broad outlines with no detail given as to financing mechanisms or changes in institutional arrangements to win developing country and OPEC support for the program.

2.6 NORWEGIAN/SWEDISH INITIATIVES IN THE U.N.

In the May 1978 meetings of the Overview Committee of the Whole of the United Nations, the Swedish and Norwegian governments made a proposal to study the advisability of globally-coordinated initiatives to implement a "massive transfer of resources" to the Third World with the purpose of stimulating the economies of the world community. On November 8 and 9, 1978, Sweden and eight other nations held a "Special Meeting of the Like-Minded Countries on Transfer of Resources," to discuss global stimulation proposals and determine their future action.

The meeting emphasized several potential advantages of such a massive transfer. The transfer was viewed as a means for inducing long-term non-inflationary growth for the OECD and world economy. Additionally, the meeting saw the transfer program as a means to avoid increasing OECD protectionism and to address the problem of structural adjustment, particularly as concerns OECD imports from developing nations. The sense of the "Like-minded" meeting is best summarized by its view of a massive transfer as a means to overcome "...one of the greatest paradoxes of our time..." -- namely, the existence of excess productive capacity in OECD nations concurrent with increasing poverty in the Third World.

Specific questions were raised concerning whether restrictions on the use by developing countries of such a massive transfer should be made because of:

- The need to target export purchases from the OECD to industries at high levels of under-utilized capacity, thus having minimal inflationary impacts
- Possible restrictions on uses of these funds because of intra-OECD market share imbalances, and therefore, imbalances in benefits that could accrue to OECD exporting nations

- The level of the resource transfers necessary to alleviate the strains on the international financial community from Third World debt as well as to generate a "significant" stimulatory effect for OECD economies.

Emphasis was also placed on the question of choice of sector and recipient countries based on criteria of their absorptive capacity and level of income. Here again the issue was raised of the redistribution effect that could be made within ODA funds from middle- and higher-income to lower-income developing nations.

In early November 1978, the Swedish government, through the Swedish International Development Authority (SIDA), held a high-level inter-ministerial meeting (prior to that of "Like-Minded Countries") to decide whether to pursue global stimulation initiatives at international organizations and in discussions with national governments. Expert reports were prepared for this occasion and an affirmative decision was reached. The following excerpts from the summary report of this decision are important:

- "The need for new forward-looking measures to induce long-term non-inflationary growth in the world economy now seems to be generally recognized..."
- "Needless to say, such transfers would not solve all problems; they might, however, form one essential part of a concerted program aimed at stimulating global economic activity -- the total effect of which would be greater than the sum of its parts."
- "...and noting that the short-run psychological impact on business confidence and foreign exchange markets could yet be considerable given the present world economic situation. Hence it might be worth trying to find a stabilization scheme committing the major nations to a new concerted action for the world economy with both short- and long-run effects."

Unconfirmed official sources have stated that the group of Like-Minded countries may include formal discussion of a Venezuelan-type bond mechanism proposal at the OECD during the spring of 1979.

2.7 CONCURRENT RESOLUTIONS BEFORE THE U.S. SENATE AND HOUSE OF REPRESENTATIVES

On April 26, 1978, a bipartisan group of eight Senators introduced Senate Resolution 441 into the 95th U.S. Congress. This proposal calls for the establishment of a capital pool of some $50 - $100 billion, "...for productive investments in the developing countries on appropriate terms and conditions which will recognize the concerns of the OPEC countries, the recipient developing countries, the developed countries, and the international financial institutions." While the wording is vague, the resolution calls for the U.S. President to mobilize governments of OECD industrial nations to join with OPEC in the establishment of this capital pool. Particular emphasis is given to, "...the concerns of the OPEC surplus countries regarding the sustained value of their funds invested in the capital pool and their need for liquid assets in the event of unforeseen economic emergencies."

An accompanying resolution, Senate Resolution 440, drafted by the same group of Senators, requests that the, "...President undertake discussions with the industrialized countries with a view toward developing a common approach to the grave problems facing today's international monetary system." The main feature of the latter Resolution calls for recognizing the, "...essentially structural problems facing the international monetary system caused by the exclusive reliance on the dollar as the key international monetary reserve assets and, consequently, should focus on a long-term solution to meet that problem." (A similar resolution was presented to the U.S. House of Representatives on April 26, 1978, H.R. 581.)

2.8 PROPOSAL FOR RECYCLING SURPLUSES AS PRESENTED IN THE REVIEW OF THE ECONOMY REPORT OF THE JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES, (OCTOBER 1978)

In addition to the U.S. House of Representatives and Senate Resolutions, the Joint Economic Committee of the U.S. Congress (JEC) issued a report in October of 1978 advocating a loan subsidization type of coordinated resource transfer.

The proposal to explore the possibility of a resource transfer arises from the report's analysis of the U.S. economy in general, and stagnation and U.S. balance of payments deficit in particular. The mode of analysis is Keynesian, and holds that the persistent surplus position of the OPEC nations and some OECD nations, in combination with the deflationary domestic policy of Europe and Japan, has created a situation in which, "...desired savings exceed investment," opening the possibility that, "The world economy is in danger of remaining in a permanently stagnant condition." The report continues that the workings of the private sector from the industrial countries is unlikely to close the gap between planned savings and planned investment. Investors are seen as unlikely to create sufficient effective demand at prevailing interest rates to generate acceptable economic growth.

The report advocates a solution to this dilemma falling into the class of global stimulation. OPEC surplus countries should lend funds to non-oil developing countries, which in turn would generate demand for world output. The OECD countries would facilitate the transfer by subsidizing, in part or as a whole, the loans to non-OPEC nations, so that funds would be available at concessional or zero interest rates. In order to make the proposition more attractive to OPEC nations the involvement of the World Bank is proposed to implement investment projects and to insure "...against expropriation."

Because the proposal was made as a suggestion for further study, its lack of detail should not be faulted. The same cannot be said of the suggestion of the relatively low OECD financial commitment outlined. It is doubtful that OPEC nations would participate in a scheme where at the most the OECD financial commitment would only be a tenth of OPEC's exposure (assuming a long-term interest rate of 10%).

A final point of import relating to the JEC report was the reaction of some of the U.S. Congress to the report. Senator Abraham Ribicoff (Dem., Connecticut) stood in a small minority in stating that the report's suggestion, "...regarding U.S. participation in subsidizing OPEC loans to Third World countries and backing expropriation insurance for such loans detract from the more practical worth of much of this paper." More substantive points are raised by others, some expressing concern over the contribution a massive transfer might make to competing imports into the U.S. In general, in sharp contrast to Senator Ribicoff's rejection, the suggested subsidization scheme has been favorably received by the Committee's members.

2.9 JAPAN/MITSUBISHI RESEARCH INSTITUTE

Under the title of "A Proposition for the 'Global Infrastructure Fund'" (August 1978), Mitsubishi Research Institute sketches the rationale for, and the broad outlines of, a "Global New Deal."

The "Proposition" sees the need for this most ambitious of the efforts proposed, arising from both the failure of postwar Keynesian economic policy to prevent stagnation in the North and the urgency of eradicating poverty in the South. Regarding the former, emphasis is placed upon the "Global Stimulation Fund" as the only viable means of sustaining growth in the

context of faltering technological progress, the inflationary bias of strictly national deficit-financed stimulation efforts and the collapse of the Bretton Woods international monetary system.

Specifically, the "Proposition calls for a $500 billion investment between now and the turn of the century in a series of "super projects" -- such as massive solar power generation or harnessing sea currents to produce electricity -- amounting to an international public works program. The projects would be targeted to expand energy and food supply for developing countries. It is estimated that an annual investment of $13 billion would result in an annual $25 billion post multiplier expansion of aggregate demand. Mitsubishi contends that the inflationary impact of the proposal would be mitigated through the effect of the project on loosening potential tight supply constraints in the food and energy sectors.

The "Proposition" calls for joint OPEC/OECD funding with the suggested $13 billion annual investment divided among the West Germans, the Japanese and the United States ($5 billion), OPEC ($5 billion) and other industrial nations ($3 billion). These funds would come from public sources requiring a 30% increase in ODA from the industrialized nations. Regarding institutional arrangements, the need for a new agency is foreseen so as to escape an implied U.S. domination of existing international development institutions.

The Mitsubishi "Proposition" is predicated on a sense of crisis and calls "for mankind to positively assert a bold and long range vision...which transcends narrow and short term national interests." Its strengths are precisely its long-term and visionary emphasis. Unfortunately, it fails to appreciate fully the present crisis in proposing an expansion of ODA in the

context of slow growth or no growth. Without demeaning the ethical relevance of comparisons between defense expenditures and development assistance, such analogies carry little weight where increasing ODA is concerned in industrial societies beset by stagflation. A second point concerning the feasibility of this proposal is its complete reliance on super projects. While a modicum of innovative projects may add to the implementation possibilities of a stimulus proposal, a program exclusively comprised of "engineers' dreams" creates obstacles for itself which need not be present. Finally, there is neither explicit discussion nor criteria on (a) absorption capacity in developing nations in general, nor (b) specific means to channel benefits to the poorest countries and the poorest segments in "advanced developing nations" like Brazil.

2.10 THE INTERNATIONAL FUND FOR ECONOMIC COOPERATION AND STRUCTURAL ADJUSTMENT

Chancellor Kreisky of Austria first outlined in 1976 an idea for aiding growth in developed countries via stimulation of the Third World. Mr. Claude Cheysson of the EEC Commission, another early proponent, put forth a "New Marshall Plan" for the Third World for $10 billion per annum funding to run for three to five years. He viewed this as a short-term anti-cyclical device, "...based on traditional Keynesian theories..." applied on an international scale. In early January, 1979, the EEC interest in a global approach to stagnation continued, as a study was initiated, possibly as a percursor to a new policy initiative.

In addition, informal discussions among European governments have focused on regional North-regional South initiatives. One is the idea of a European and Arab-member-OPEC regional initiative pointed at development stimulation of Africa. Another is an EEC Marshall Plan for Greece, Spain and Portugal. One

major but informal consideration of such regional approaches was the fear that reluctance by the U.S. Congress toward global stimulation for the Third World could forestall a truly-OECD-wide effort. We will return to this theme in the Chapter 4 discussion of regional and bilateral alternatives to a global stimulus.

The International Fund for Economic Cooperation and Structural Adjustment developed Chancellor Kreisky's original idea. This Austrian government initiative is aimed directly at matching Third World project financing to use of excess industrial capacity in participating industrialized nations. The Fund would get paid-in capital based on national quotas of participants and also raise finance in private capital markets. The proposed initial $1 billion would be primarily for projects in industry and infrastructure.

2.11 JAPANESE GOVERNMENT INITIATIVES

In late 1977/early 1978, Japan announced its intentions to either double or triple its development assistance efforts.* It introduced suggestions through the United Nations Economic and Social Commission for Asia and the Far East (UN-ESCAP) for a similar regional initiative in that area. To date, Japan's initiative involves no officially proposed form of co-participatory financing schemes with OPEC countries.

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*The Japanese-American Trade Centre in Washington, D.C. gave official confirmation that aid would be tripled in three years, 1978-1980, from fiscal base years 1977 (valued there at $14,021 million, or 0.21% of GNP). Japanese scholars at the Rockefeller Foundation in New York differ on this view regarding Japanese official development financing. According to them, aid would be doubled in the aggregate from Fiscal Year 1977, and in their view, could imply that aid to Asia, and particularly the ASEAN region, could go down, to be replaced by "special investment-trade packages."

Unconfirmed sources, however, indicate a new Japanese consideration that relates to structural adjustment problems vis-a-vis Third World exports. In return for a significant relative increase in its aid funding, there may be mutual interest for a "targeting of future comparative costs and advantages" with developing nation recipients. General agreement on Third World export sectors to be emphasized would give the Japanese government sufficient early-warning time to implement structural adjustments for reallocating resources out of affected home industries. Concomitantly, countries would agree to the targeting of sectors in which Japan would concentrate its export development.

The most recent Japanese initiative is a global stimulation-like multilateral effort, or "Mini-Marshall Plan," to finance China's purchases of OECD exports over the next ten years. This and other Japanese regional efforts (at least in regard to recipient nations) are discussed in Chapter 4.

2.12 OTHER PROPOSALS

In their new book, Peter Odell and Luis Vallenilla* propose the establishment of an OECD/OPEC Agency for Cooperation and World Development, to be instituted by co-equal contributions amounting to $16 billion per year for concessional loans and grants to oil-important developing countries. The OECD part of the contribution would come from budgeting increases in the aid expenditures of its member governments as would that for OPEC. The proposed agency is not viewed as competitive to existing national and international aid programs because of its strictly concessional grants/lending program and because it could remove individual donors' foreign policy objectives from the motivation

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*The Pressures of Oil: A Strategy for Economic Revival," (New York: Harper & Row, 1978), Part IV.

of aid. The vagueness of this last point is notable except for the very specific objective of making OECD and OPEC nations absolute equal partners in this proposed development agency.

3. IMPACTS OF PROPOSALS FOR GLOBAL STIMULATION

The purpose of this chapter is to assess the impacts of different proposals for global stimulation on each of the four groups of countries, the OECD, OPEC, the Middle Income Developing Countries (MIDCs), and the Least Developed Countries. The assessment will focus on the likely impact of various proposals on the growth potential of each group, including financial transfers, direct investment, debt level, and structure of debt. In addition, where appropriate, the impact of different types of proposals, or the proposals as a whole, on broader North-South issues will be considered. These include the Commodity Stabilization Fund, increased development assistance, and the problem of structural adjustment and redeployment of industries in the North as a result of changing international comparative advantage.

The scope of this evaluation is not exhaustive in that a major quantitative comparative exercise concerning the impacts of different proposals has not been undertaken. Secondly, only three of the many initiatives discussed are sufficiently developed to merit comparison. These initiatives are the Venezuelan proposal, the OECD Stepped-up Investment Proposal, and the Mexican Capital Pool proposal. Of the remaining proposals, both the Japanese Mitsubishi and the Kreisky proposals are not considered in that they are no longer receiving serious political attention. The remaining proposals are broad initiatives providing support for the general idea of a global stimulus, but little detail as to the form the stimulus would take.

Several different sources of information are used in our evaluation in addition to the proposals themselves and supportive

analytic literature. Over the past year we have performed numerous interviews with both proposal authors and with concerned experts who have reviewed these proposals. These expert opinions were drawn from the private banking sector, bilateral and multilateral organizations, and from other agencies of national governments in the OECD, OPEC and non-OPEC Third World nations.

Also, the evaluation benefits from a simple simulation exercise designed to estimate the change in OECD export sales resulting from one type of global stimulus program.

The remainder of this chapter will consider the impacts of global stimulus proposals on each of the four groups of nations.

3.1 THE OPEC NATIONS

The OPEC nations could benefit from a global stimulus proposal, both directly and indirectly, at minimum cost and risk. In addition to economic benefits, OPEC may benefit even more in the long run from the institutional and political developments associated with at least some of the major transfer proposals, although these greater benefits infer higher risk. Additional costs for OPEC could include the loss of some flexibility by committing long-term funds, and the fragmenting influence expansion in world energy supply (a goal of some proposals) exert on the OPEC cartel.

To review, the three major proposals see different roles in a global stimulus effort for the OPEC nations. The Mexican proposal is most vague about the role which OPEC might play, indicating an opening for OPEC financial participation only in that these countries are large holders of surplus investable

funds. The OECD Stepped-up Investment Proposal envisions an economic, but not necessarily, an institutional role for OPEC in its co-financing vehicle. The Venezuelan Proposal views OPEC financial participation as an essential ingredient, and OPEC institutional participation as a prerequisite to significant financial participation. It is our judgement, based upon the interviews we have performed, that the Venezuelan argument is essentially correct. That is, that the feasibility of a global stimulation effort depends both on OPEC financial participation, which is in turn dependent (from OPEC point of view) on an increase in its political and institutional participation, at least relative to the levels currently enjoyed in world institutions. Such a development could mark a turning point in translating OPEC's economic power into a significant, and from a Third World point of view, positive factor in international relations. The risk in this domain may also be greater in that should a stimulus in which OPEC plays a major role fail, its "political" capital will be depleted.

Concerning OPEC financial participation in a global stimulus proposal, the highest proposed level of $2 billion per year for four years (the Venezuelan initiative) would represent no significant strain on the OPEC payments situation. At the end of 1977 OPEC's unspent surplus was estimated by the Brookings Institution to be $155 billion. Various estimates of OPEC's surplus for 1978 and 1979 place the additional surplus anywhere between $25 billion and $30 billion. Thus, by the beginning of 1980, the OPEC surplus could stand at approximately $185 billion.* The size of even the most ambitious OPEC contribution then is small relative to the total surplus. Furthermore,

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*Brookings Bulletin, Vol. 15, No. 2, Fall, 1978, p. 3; International Finance, Chase, Vol. XIV, No. 3, February 5, 1979; Morgan Guarantee Trust Estimate as quoted in New York Times, February 4, 1979, International Economic Survey, p. 38.

because some guarantee of the prevailing rate of return is most likely, a prerequisite to OPEC participation, its risk is accordingly decreased. At least as far as its direct financial contribution is concerned, OPEC's cost is potentially the spread between long term and short term interest rates on a minimal part of its surplus.

The greatest potential benefits to accrue to OPEC nations rest on the success or failure of the proposals in accomplishing the interrelated feats of restimulating the OECD and institutionalizing mechanisms to recycle surplus funds into non-OECD fixed investment projects in the non-oil exporting developing countries. Such investments will also increase OPEC's stake in the structural adjustment problem, exerting a positive influence on the process of finding a solution. This OPEC problem of an investable surplus should persist at least into 1985. A recent Rand study estimates the accumulated surplus of only Saudia Arabia, Kuwait and Iraq to range anywhere from $225 to $286 billion by 1985.* A successful placement and significant development of longer term bonds for developing countries could lead to a situation where OPEC might be able to place a significant amount of its petrodollar accumulation outside of the OECD consuming nations. Such placements, particularly for the high production, low population nations, would provide an additional degree of freedom in OPEC's pricing decisions. That is, less weight would have to be given to the possibility that a price increase would encounter retaliation through confiscation of assets held in the West.

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*Smithies, Arthur, "The Economic Potential of the Arab Countries," A Report prepared for Director of Net Assessment, Office of the Secretary of Defense, November 1978, Rand, Santa Monica. The portion of each estimate accounted for by Saudia Arabia is in 1976 dollars.

The indirect economic effects of a global stimulus effort on the OPEC nations should also be considered. On the positive side, there are several. First, to the degree that a stimulus, in coordination with the OECD domestic efforts, contributes to an increased non-inflationary growth of the Western economy, OPEC's sales will improve. Slow world growth since the 1973-74 price increase and the increased supply called forth by that same price increase, have led to an oversupply of oil (hardly a glut) and price shaving, dangerous to the existence of the cartel. OPEC nations would also benefit to the extent that a return to growth in the OECD nations leads to stability in international financial and currency markets. The OPEC benefits in this area occur because surplus countries have been holding their assets in international capital markets and because the bulk of these assets are denominated in U.S. dollars. The destabilized condition of both has diminshed OPEC real purchasing power.

The point should be made that several of the proposals, the Venezuelan and OECD efforts among them, suggest a targeting of stimulation funds into the expansion of world petroleum supplies. On the surface, it would appear that such an expansion would not be looked upon favorably by the OPEC nations. However, recent OPEC support of the World Bank energy extraction and exploration fund for non-oil exporting Third World nations indicates that the OPEC nations do not view an expansion of world petroleum production as a fundamental threat to the cartel.

3.2 OECD

The economic effects of a globally coordinated resource transfer program on the OECD nations are an open question. The impact of financial transfers to Third World nations on those nations has been the subject of intense study for over twenty

years. It is only recently, however, that the possibility has been considered that interdependence can be exploited for mutual benefit of North and South. Hence assessments of the OECD's macro economic benefits from expanded trade, and investment vary greatly. At one extreme is the view that the developing nations are the last remaining growth frontier for the industrial nations, while others argue the only basis for increased financial transfers to the developing nations is the charitable inclination of the developed nations. To date, little quantitative evidence exists to substantiate either view.

Our assessment will consider likely impacts on OECD growth and inflation, examining both monetary and real effects. The assessment benefits from both interviews and a simulation of the effect of a particular stimulation program on OECD export sales and the ability of one OECD economy, the U.S., to accomodate at an industry level the increase in capacity utilization. In addition, the assessment includes consideration of the program's potential effect on OECD economic policy in the areas of protectionism and structural adjustment to ongoing changes in the international division of labor.

3.2.1 Growth and Inflation

Proponents of global stimulus have predicted a surge in developing country demand for OECD output would produce significant growth with minimal inflation. As a strategy such a stimulus effort is in harmony with the OECD Outlook's call for "...measures which simultaneously increase demand and reduce pressure on costs and prices."*

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*OECD Economic Outlook No. 23, July 1978, p. XIV.

The proponent's case assumes, in broad terms, (a) financing for a program can be secured without creating inflationary effects, and (b) the effective demand arising from investments in developing countries can be matched with industries experiencing excess capacity in the OECD.

3.2.2 Monetary Effects

The validity of the monetary assumption rests on the current state of global financial markets and to a lesser extent the feasibility -- both political and economic -- of various mechanisms suggested to raise OECD governmental contributions to the fund.

If a stimulus is to have minimum inflationary impact the world economy must be characterized by a situation, in Keynesian terms, where planned savings exceeds planned investment, with the difference represented by "idle balances." The evidence lends at least partial support to this characterization of the world economy -- partial because of the inherent difficulty in tracing the use of savings and the lack of systematic and detailed empirical study. The OPEC nations have not been able to absorb their yearly current accounts surplus leading to a cumulative surplus of $155 billion as of year end 1977, of which an approximately $60 billion, as estimated by the Bank of International Settlements, is held in short term near liquid assets. After 1973 OECD new investment slowed relative to other post-war business cycles. Profits, although off, were still high enough to lead to increased private sector liquidity. This building of liquidity is understandable in the beginning of the recovery. The persistance of liquidity throughout the expansion is not indicative of a health economy, but of great investor uncertainty as to the future rate of return on fixed investment.

Thus, the investor's problem of holding liquid reserves in the face of an uncertain future, has led to the continued expansion of the short-term holding in the Eurocurrencies market, the recent surge in corporate acquisitions (not liquid but low risk), the increasing value of the non-productive asset (e.g., gold and real estate), and the proliferation of short term cash management techniques and instruments. One such instrument, corporate commercial paper in the U.S., has grown from $41 billion in 1973 to $84 billion by 1978.*

It is our view that the case is plausible. In combination, the shift in the distribution of income to those unable to spend (OPEC) and the uncertainty, and resultant drawback from new fixed investment in the OECD has left a significant pool of idle balances from which a stimulation program could draw. Furthermore, this financing could be obtained without significantly effecting other borrowers in these markets, particularly national governments, by increases in the cost of borrowing.

Although the different stimulus proposals would draw upon these balances in different ways, a common theme is present. All seek to provide institutional guarantees or "encouragement" to diminish the uncertainty of investing in longer term productive assets in developing countries. Thus, "idle balances" would be reintegrated into a world cycle of investment, growth and jobs. Such an effort does not preclude a similar attempt to decrease the uncertainty related to investment in the OECD area. Many proponents of a global stimulus see greater problems in such an effort, under present uncertainty regarding rising protectionism, shifting international comparative advantage,

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*Examples of recent arguments supporting the thesis of excess liquidity are: "Outlook for Eurocredit Market," OECD Observer, March 1978, p. 14; P. Nagy, "The International Monetary Fund: It's Time to Call in Commercial Banks," Euromoney, February 1979, p. 114; "Stateless Money," Business Week, August 21, 1978, p. 76; "Commercial Paper Surve," New York Times, February 4, 1979, p. D-1.

exchange rate uncertainty, and most importantly, fears concerning the availability and cost of energy supplies in the future.

The Venezuelan and Mexican proposals suggest similar mechanisms to draw idle balances into a productive recycling, both calling for the use of guaranteed debt instruments to attract funds. The Venezuelan proposal is more ambitious, seeking to trigger net additional, non-concessional investment financing of $8 - $10 billion per year for at least four years. The Mexican proposals seek total funding on approximately $15 billion over a five-year period. The OECD suggests the mechanism of co-financing to draw upon the same source funds, in an amount of approximately $8 - $10 billion per year.

At a minimum, therefore, any of these stimulus proposals could draw from what Euromoney describes as, "...hundreds of billions of dollars worth of highly liquid short term funds..." in private capital markets, a substantial sum of at least $20 billion for fixed investment in the early eighties without contributing to inflation. To the extent the funds are productively utilized, they would create effective private sector demand without inflation induced by tightening credit markets. On a more speculative plane, it is difficult to prove or disprove the proponent's claim that a global stimulus would decrease liquidity in international private capital markets, so as to have an anti-inflationary effect.

A second monetary aspect of assessing the non-inflationary growth potential of a global stimulation program concerns the manner by which OECD governments would finance their ODA contributions. In the case of the Mexican proposal, this question is inapplicable since its intentions to finance only capital goods exports from OECD nations, pertaining therefore largely only to MIDC recipient nations, makes it rely on only private

capital markets as a source of funds. In particular, the discussion of donor government budgetary participation is germaine to a Venezuelan-type initiative which has an explicit OECD donor nation ODA contribution requirement, as well as to the OECD-type proposal. Obviously, if an actual global program involved raising ODA contributions that came from increased government deficit financing, this must be viewed as inflationary. Given the current OECD-wide stagflation environment, such a provision would risk the political acceptability of the program.

In the initial Venezuelan study formulation, envisaged was a commitment of 20-25% of the program's funds to projects in least developed nations. These were to be met from ODA-OECD contributions. In order to avoid competitiveness with existing bilateral and multilateral planned allocations and not to draw down on them, the stimulation program's ODA monies were to come from increased OECD government cash outlays -- seen as a negotiation parameter to gain OPEC involvement. The persistence of high inflation, particularly in the U.S., has since made it necessary to develop an alternative "fallback" negotiation's position in order not to jeopardize the entire proposal and to meet the political constraints of a number of OECD governments (U.S., Canada, Italy, France, etc.).

This fallback position, should it be necessary, results in the program generating net additions in non-concessional long term investment financing of \$8 - \$10 billion per annum for the initial two years operation. This is instead of the originally more optimal version of an additional \$2 - \$2.5 billion per annum of ODA concessional flows (over current levels) in combination with the \$8 - \$10 billion increase in non-concessional flows. In the third year of operation, the \$2 - \$2.5 ODA contribution to the program's trust fund would commence and could be met out of anticipated increased (over 1979 levels) from OECD government budgets at that time.

This fallback position does not imply, however, that the least developed nations would not receive any of the global stimulation's funding. As noted in Chapter 2, many of these nations have viable potential projects in energy and minerals as well as related inputs and basic infrastructure that could qualify for non-concessional financing out of the $8 - $10 billion derived from the sale of OPEC development bonds. In fact, experts interviewed on this point noted that part of the fallback negotiation would stipulate that during the first two years, priority be given to non-concessional funding to least developed nations up to some portion, say 20%, of the $8 - $10 billion.

A number of other important refinements to meeting the non-inflationary criterion of OECD government financing of ODA contributions have been worked out in conjunction with interviewed financial experts and policy-makers of public and private, national and multilateral agencies. These include also three feasible alternatives for meeting the callable capital requirements that either an OECD or Venezuelan type proposal would necessitate. These details, however, go beyond the terms of reference of the present study; but they lead us to the conclusion that, on both the criteria of a non-inflationary and politically acceptable means of OECD government participation in a global stimulation program, there should be no substantial obstacles.

To summarize in the monetary area, if idle balances exist and the proposed mechanism draw upon these, inflation induced by money creation or credit market tightening will be minimal. Concerning governmental ODA allocations, if a callable capital mechanism is established, inflationary effects within the OECD will be insignificant.

3.2.3 Real Effects

The second assumption underlying proponents' claims for a global stimulus is that a stimulus could be structured so that the demand generated by investments in non-oil exporting developing countries matched OECD industries experiencing excess capacity. This statement is not to be confused with matching demand with OECD "declining industries," such as textiles, leather, and consumer electronics. These industries are considered in some of the stimulus programs but in relation to the question of structural adjustment.

The degree to which OECD exports are stimulated will depend upon the type of program implemented. Even assuming equal levels of financial transfers different compositions and levels of OECD export demand will result depending upon:

- The distribution of funds between high and low income developing nations
- Whether or not funds are targeted to particular sectors, or are unrestricted
- The mix of concessional and non-concessional transfers
- The mix of project vs. program transfers.

The maximum stimulus per dollar transferred would be obtained by a program of non-concessional transfers, unrestricted as to sector of investment and recipient nation. This is the aim of the Mexican proposal, and with the exception of a shift to longer term structures, replicates the private sector lending to developing countries in 1974-75. The OECD program, at least implicitly, by proscribing sectors of investment, lowers the short term stimulus to OECD exports and growth, if one assumes some higher OECD export content projects are to be found outside

of these sectors targeted. Finally, the Venezuelan proposal has the lowest potential short term export stimulus per dollar transferred of the three. In addition to prescribing sectors of investment, it calls for a country allocation by income level, again probably excluding some higher export content projects.

Although both the OECD and Venezuelan proposals would have a lower short term export content, each recognizes this element as a trade off necessary to meet other constraints. For instance, not stimulating Third World industries competing with declining OECD industries, or encouraging production of output in sectors where medium term shortage would contribute to world inflation, e.g., energy, or including a "new development strategy" component in the program.

Our simulated program provides an example of the OECD benefits of a global stimulus program. Under assumptions most similar to the Venezuelan proposal a program of transfers of $10 billion per year over four years produced direct OECD export sales of $31 billion. The direct sales impact is lower than the sum transferred because the transfer is assumed to take place in a project context, where a part of the transfer is used to plan, purchase local inputs and set aside for contingencies. The increase in export sales compares with a total public OECD/ODA contribution to the fund of $4 billion, an OPEC contribution of $9 billion, with the remainder of the fund ($27 billion) drawn from private OECD capital markets. On an annual basis, the program's direct export sales would represent 5.6% of the industrial nations' 1977 sales to non-oil developing countries.

The simulated program targets investment to agriculture, energy, mining, and related infrastructure. Within the agricultural and energy components are included basic human needs projects, e.g., small scale farmer development and rural

electrification. On the basis of recent investment projects undertaken in developing countries our excise identified at the four digit SITC level the OECD industries which would enjoy direct increases in export sales. Table 3.2-1 presents the percentage distribution of these sales per dollar of transfer assuming an equal distribution of stimulus across sectors of investment.

The question of how a stimulus would effect capacity utilization in the OECD is critical. Stagflation is in many ways a self-perpetuating entity. The capacity utilization investment relation is an example. When growth and investment are slow an economy's productive capacity does not expand. This makes demand expansion a potentially inflationary force. An exogenous stimulus of any sort could lead to a stiuation where increases in demand create bottlenecks in key industries, or sectors, adding a "cost push" to the many forces causing inflation. A valid question concerning a global stimulus is, then, how will a stimulus affect capacity utilization in the industries it stimulates?

A recent study for the U.S. Council on Wage and Price Stability and aggregate levels of current OECD capacity utilization both indicate that bottlenecks will probably not materialize, meaning OECD industry could accomodate the increase in export sales arising from a stimulus without generating cost push inflation. The U.S. study focuses on capacity utilization in fifteen primary product groups and estimates utilization levels under various U.S. growth rate and composition of growth assumptions. Its findings show that even under an optimistic assumption of an annual U.S. average rate of growth equal to 4.2% from 1977 to 1981, bottlenecks are unlikely to occur in the studied industries.*

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*de Leeuw, Frank, and Bruce T. Grimm, "The Growth of Materials Capacity and the Outlook for Its Utilization," Survey of Current Business, September 1978, pp. 48 - 56.

TABLE 3.2-1

INDUSTRY DISTRIBUTION OF STIMULUS PER DOLLAR
BASE ESTIMATE*

SITC	DESCRIPTION	%
2428	Poles, pilings, posts, and other wood	1.14
5120	Organic chemicals	1.15
5133	Inorganic chemicals	5.08
6299	Rubber articles	0.04
6328	Articles manufactured of wood	-
6613	Building stone	1.16
6623	Refractory brick and other refractory building materials	0.52
6636	Manufactures of minerals	3.68
6643	Sheet glass	0.3
6721	Iron or steel primary forms	0.93
6732	Iron or steel bars and rods	2.56
6780	Iron or steel tubes, pipes and fittings	1.0
6782	Iron or steel tubes and pipes seamless	1.28
6840	Aluminum and aluminum alloys wrought and unwrought	0.01
6911	Iron or steel finished structural parts	1.86
6942	Bolts, nuts, etc., iron, steel or copper	0.04
6952	Tools for use in hand or in machines	1.15
7112	Steam generating power boilers and parts	2.82
7121	Agricultural machinery planting and cultivation	3.00
7122	Agricultural machinery harvesting	3.19
7125	Agricultural tractors	4.19
7151	Machine tools for working metals	0.03

* Base Estimate assumes equal distribution of stimulus across energy, agriculture, mining and infrastructure sectors. Percentages are of stimulus per dollar transferred and used to purchase goods. In energy and mining twenty cents on the dollar is assumed to be used for planning or purchases of local inputs. Agriculture and infrastructure projects are assumed to use twenty-five cents on the dollar for the same purposes.

TABLE 3.2-1
INDUSTRY DISTRIBUTION OF STIMULUS PER DOLLAR
BASE ESTIMATE*
(cont.)

SITC	DESCRIPTION	%
7184	Construction and mining equipment	26.29
7185	Mineral crushing, sorting and washing machinery	3.82
7191	Heating and cooling machinery	2.66
7192	Pumps for liquids and gases	3.86
7193	Mechanical handling machinery	1.62
7220	Electrical power machinery	6.70
7221	Electric power machinery	9.66
7231	Wire and cable; insulated	1.53
7232	Electrical insulators and fittings	2.12
7292	Electric lamps and parts	1.50
7295	Electric supply meters, measuring and control apparatus	0.62
7320	Passenger vehicles	1.79
7329	Motorcycles	0.03

Aggregate figures for the entire OECD region show measures of manufacturing capacity utilization are substantially below their 1964-1973 trends as seen in Table 3.2-2. For the U.S. at least, utilization has increased above this average as the expansion peaked in late 1978, but should even the most optimistic of forecasts be realized, utilization should be substantially below pre-1973 trends well into 1980.

Our simulation also considered capacity utilization. On a practical basis as measured by the Federal Reserve Board, these figures indicate adequate industry-level capacity to accomodate the stimulus increase in output, assuming current industry group U.S. market shares for the stimulated industries. More sophisticated econometric analysis of the relation between the changes in output associated with the stimulus and changes in capacity utilization and new investment are currently being completed.

In summary, the problem of stagflation presents the possibility that expansion may immediately be confronted with accelerating inflation provoked by supply bottlenecks. However, preliminary evidence indicates sufficient OECD idle capacity exists at least to initiate a stimulus program without generating this type of inflation.

3.2.4 Longer Term Effects

Our assessment of global stimulation proposals has been limited to direct and short term impacts. The proposals indicate both problems requiring a longer term approach and ways in which a stimulus addresses these problems. The three major issues are future OECD growth and inflation, structural adjustment in the OECD economies, and increased participation for the Third World and OPEC nations in international decision making.

TABLE 3.2-2

MANUFACTURING CAPACITY UTILISATION RATES
Seasonally Adjusted, Percent

	Average 1964-1973	1977 Q3	1977 Q4	1978 Q1
United States Federal Reserve Board	85.4	83.0	82.9	82.2
Japan MITI Index*	92.6	83.1	83.1	85.7
Germany Ifo	86.3	81.7	82.6	83.2
France INSEE	84.8	-	83.1	82.8
United Kingdom CBI†	45.3	32	30	33
Canada Satistics Canada	88.8	83.4	83.3	82.7
Italy ISCO‡	78.5	71.6	71.5	72.1

* 1973 average = 100.

† Percentage of firms at full capacity.

‡ Last month in period; average covers 1969-73; total industry.

Two points are of relevance concerning the effect of stimulus proposals on future growth and inflation; the intent of some proposals to provide an institutional push to investment in the developing countries so that the Third World becomes the world economy's new growth frontier, and the effect of massive transfers on generating new supply in sectors likely to experience inflation bottlenecks, i.e., energy, other raw materials and agriculture.

In the view of proponents, the relation between a massive transfer program and future OECD growth is analogous to the role of the original Marshall Fund aid in initiating world economic growth through the post-war reconstruction of Europe and Japan. Proponents see a stimulus program serving as an initiation mechanism to overcome investor uncertainty and allow investments with a higher productivity (than those in the OECD area) and growth potential to be made. Such investments would directly contribute to growth by allowing world trade, seen as a whole to have been beneficial to all nations in the past twenty years, to continue to expand. This case, of course, makes the major assumption that the potential investments in the Third World do in fact have a higher growth potential than those in the OECD area. The higher growth potential claim is not based solely upon economic consideration but also upon a political judgement that OECD nations will be unable to solve the problems of energy policy, living with slower growth and the like, currently lowering rates of return on OECD investment. A slightly different version of this argument holds that the impediments to new growth in the OECD can only be overcome if growth rates are increased, and thus growth induced by investment in the Third World is a logical option to provide the "breathing space" necessary for the OECD economies to adjust.

The theme of developing nations as a "new growth frontier" of the world economy has interrelated implications for

the intra-Third World division of wealth and income, as well as for industrial societies. The maximum OECD growth from such a view of a global stimulation proposal would be realized by concentrating investment in the middle income developing countries and the poorer European nations -- Spain, Portugal, and Greece. This would imply greater gaps in welfare across developing countries. As far as the proposals for stimulus are concerned, it is for this reason that the Venezuelan proposal advocates an inter-country distribution requirement among recipients. A proposal most acceptable to poorer nations should recognize a "two track" growth and development approach. We return to this theme in the following sections.

Although proposals for stimulus (implicitly, via sector targeting, or explicitly, the U.S. Department of Labor's criterion of "complimentary" vs. "competitive" stimulation) recognize the question of structural adjustment, the issue stands as a major problem in realizing proposals for massive transfers. Inherent in the OECD and Venezuelan proposition that funds be targeted to energy, agriculture, etc. is the position that investment <u>not</u> be targeted to the manufacturing sector where resulting output of exports might be competitive with that of OECD industries experiencing secular or cyclical decline. The hope of both proposals is that a successful stimulus, in coordination with domestic OECD efforts, can help increase growth rates while affording "breathing time" to permit OECD nations to implement new adjustment programs and help minimize the rate of rising protectionism. Nevertheless, the recent OECD adjustment record bodes ill for a successful policy of structural adjustment under any circumstances, unless significant caveats are offered to offset domestic political pressures. But whatever the validity of the proponents' case that structural adjustment and stimulus can be linked as discussed in the next section, targeting of a stimulus' investment into non-manufactures <u>need not</u> result in negative consequences for developing nations.

The impact of proposals for stimulus on international decision making, specifically for more meaningful developing country and OPEC participation, could be substantial, if the economic benefits which proponents foresee are realized. Simply put, could a successful stimulus of mutual interest be used as an incentive for the OECD nations to consider more cooperative and mutually beneficial outcomes in other areas on North-South issues, e.g., role of technology transfer?

3.3 MIDDLE INCOME DEVELOPING COUNTRIES

An assessment of the impacts of proposals for global stimulation on the middle income developing countries (or in the OECD terminology, the newly industrializing countries) requires an examination of the immediate prospects of these countries. Only in this context can the potential benefits and costs of the stimulus proposals be seen. In general, proponents of global stimulation take the position that middle income developing countries are being hurt by stagnation in the OECD nations. Only if the OECD nations return to higher growth rates can the middle income nations benefit. Our assessment will proceed by considering the immediate prospects of middle income developing countries in the absence of a global stimulation effort, and then discuss the economic benefits and costs for the more developed countries of a proposal of programs for global stimulation.

3.3.1 The Immediate Prospects

The immediate prospects for middle income developing countries are unsettling. The related issue of the bunching of short and medium term debt in 1980-81 and low export revenues as a result of slower growth and protectionism in the OECD are the major considerations.

The increase in private bank lending to middle income developing countries during the middle-70s is a well known and documented phenomenon. On the heels of the first wave of lending, many prophesied economic disaster for both the developing countries and the lending banks. These prospects have obviously not materialized. The banks have thus far shown a willingness to refinance, or roll over their loans to developing countries. But, problems still remain; as agreements for refinancing are completed, the already high debt service burden of many middle income developing countries increases. At year end 1977, the debt service ratios of some high income developing countries were over 30%, notably Mexico, Chile, Argentina and a staggering 47% for Brazil. The debt service figure for countries with slightly lower per capita GNPs was also increasing, with Thailand and the Philippines registering debt service ratios of 14% and 19% respectively.* As debt service ratios increase, the problem for middle income developing countries (and for the OECD, as proponents of global stimulus are quick to point out) is that an increasing portion of these nations' foreign exchange earnings are being devoted to paying back old debt, rather than purchasing capital goods, services and other materials necessary to continue economic growth and development.

As higher debt service ratios will be placing more demands on the export revenues of middle income developing countries, these revenues are themselves subject to increasing pressure. The obvious and well analyzed phenomena of slower growth in the OECD and increased protectionism are to blame. With the economies of the OECD exhibiting higher growth rates throughout the 60s and early 70s, world trade expanded at an annual rate of around 10%. For 1977, this rate was projected

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*Euromoney, October 1978, "The Richer Developing Countries May Be Poor Risks," Pancras Nagy, p. 145.

at 4% and for 1978 at a slightly higher 5%.* Hence, even if protectionism were not on the increase, the export revenues of developing countries would be beset by slow growth and demand in major markets.

But protectionism, particularly toward the manufactured goods of the middle income developing countries, is on the rapid rise. While as indicated above, world trade as a whole increased from 1977 to 1978, for the first half of 1978 the growth of exports from developing nations was barely 50% of its 1977 rate.** Finally, to the slowing growth in MIDCs major export markets, protectionism, and increased debt service, must be added the increased price of both capital goods imported from the OECD area and energy, subject to the 14% OPEC price increase for 1979.

3.3.2 Economic Benefits and Costs of Proposals for Global Stimulus Affecting Middle Income Developing Countries (MIDCs)

The major positive element of proposals for global stimulation affecting middle income developing countries is their advocacy of longer term lending to these nations. Although the round of private bank lending in the mid-1970s to these nations served a useful economic function, although perhaps more so for the OECD nations, this short to medium term finance capital's maturity structure is at odds with the gestation periods of the investment projects into which it went.

Against the benefit of increasing the term structure of the developing nations' debt must be weighted whether there

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*World trade figure, "International Economic Survey," New York Times, February 4, 1979, p. 9.

**"The Rise of Third World Multinationals," David A. Heenan and Warren J. Keegan, Harvard Business Review, January-February, 1979.

will occur a tightening of available medium term loanable funds and whether there is the possibility that a global stimulus would preempt concessional ODA funds going to these nations. Regarding the former, the discussion of international liquidity in relation to the OPEC nations, even were a global stimulus program undertaken.

A large question mark in this area, however, is the effect of the recently announced Chinese intention to borrow heavily on international capital markets. China's borrowings for the 1979-1985 period are estimated to range from a total of about $24 billion (U.S. Commerce Department) to $35 billion (European and Japanese sources). The Chinese factor is a two-edged sword: if China should substantially draw down on credit that otherwise would have been available to middle income developing countries, ceterus paribus the need for subsidiary lending facilities such as those proposed by advocates of global stimulus would be even greater.

Concerning official development assistance, at least the Venezuelan and OECD stepped-up investment initiatives, recognize that a global stimulus proposal should be designed to be non-competitive with both bilateral concessional flows and multilateral concessional or near-concessional flows, while the Scandanavian's discussions emphasize the potential of planned complementary use of ODA and global stimulus monies.

An issue of major concern to middle income developing countries is whether the transfers of funds occurring through a global stimulation effort will be restricted in use, targeted to specific sectors such as energy, minerals and agriculture, or whether these funds will be unrestricted. The Mexican proposal advocates an unrestricted flow which, from a middle income developing point of view is probably the best alternative.

The economic costs of targeting to the middle income countries and to the global economy in general is of course that such designation of funds to particular sectors will distort rates of return and allow economically viable projects with high rates of return to go unfinanced. In addition, on the structural side, it could be argued that the targeted sectors proposed by the Venezuelan and OECD versions will perpetruate the type of raw material dependency experienced by many of the middle income countries in the past, and serve to stop attempts of nations such as Brazil and India to diversify into non-traditional exports. It should be noted though, that this effect will be mitigated for several reasons. First, certainly projects in energy and minerals have a potential high rate of return, both with regard to export revenues in the future and additional foreign exchange generating power through import substitution. Second, to the degree that capital is fungible, a point made in many of our interviews, funds which otherwise would have gone to investment in energy and mineral projects will be freed up for investment in manufactures. Third, funds targeted to mineral sectors undoubtedly will have some portion being invested in processing activity while other components will finance related physical infrastructure.

Finally, in the middle income developing countries' assessment, it must be considered whether the "costs" of insisting on an untargeted stimulus proposal will be to make it politically unfeasible for OECD nations. Should it come to pass that targeting is a requirement for the feasibility of a global stimulus proposal from an OECD point of view, middle income developing countries might well be able to use acceptance of a targeted program as a bargaining lever. For instance, it might be argued that targeting was acceptable if procurements resulting from the investment program were open to middle income developing countries, for instance, South Korea and Brazil in construction and steel production. Or, the possibility exists that a targeted

program could be linked to an assurance of OECD efforts to pursue more aggressively structural adjustment programs. The Venezuelan initiative anticipated the debate on targeting by suggesting a compromise: the first half of the program's duration being targeted, giving "breathing space," and the second half relaxing the sector target restrictions.

3.3.3 Institutional Impacts

A program of global stimulus could provide an opportunity to incorporate the middle income developing nations more fully into the process of international decision making. While a group of these nations have grown rapidly in their share of world trade, this growth has not been fully translated into global political participation. Although suggestions have been made that countries such as Brazil, Mexico and Venezuela be incorporated into the OECD, such a development has yet to occur. A global stimulation program of the Venezuelan or OECD type, would provide an experiment in more balanced and equitable decision making, without attempting the more difficult exercise of changing permanent voting shares in established institutions such as the IMF or World Bank.

3.4 THE LEAST DEVELOPED COUNTRIES

The logic of proposals for global stimulus emphasizes mutual and near term benefits for donor and recipient nations. Proponents of a stimulus, while steadfastly arguing such benefits exist in the case of transfers to the middle income developing countries, concede that at least in the short run the level of mutual gain is lower for transfers to the least developed countries.

Our assessment of programs for stimulation recognizes this consideration. Only a program taking explicit consideration of potential negative impacts, or the absence of positive gains for the least developing countries can insure that these do not occur. We proceed by identifying the safeguards necessary to insure benefits for the least developed countries, and indicating which proposals have included these safeguards.

3.4.1 Insuring Least Developed Country Benefits

The worst case scenario for least developed countries would consist of a stimulus program which was untargeted and drew contributions from existing ODA funds. An untargeted program by sector of investment and/or unrestricted as to country (by per capita income category) distribution of investment, would benefit the middle income developing countries (MIDCs), but largely excluded poorer nations. If, in addition, such a program, because of the politics of domestic OECD aid appropriate processes resulted in ODA currently going to poorer countries being reallocated to a stimulus fund the consequences for the poorer nations could be very negative. On the surface, the Mexican proposal appears closest to this type of initiative. However, since it does not use ODA and relies only on a voluntary callable capital contribution, at worst its net effect will be to give MIDCs a larger share of stimulus funding than the least developed nations.

The Venezuelan and OECD proposals attempt to avoid the possibility of a stimulus effort excluding least developed countries. Particularly, the Venezuelan effort advocates specific mechanisms to insure poorer nations a share of the benefits of a stimulus. As indicated in the discussion of the OECD and middle income developing nations this insurance is not costless, in that the specific mechanisms providing for poorer nation

participation probably decreases immediate export stimulus for the OECD nations. To determine how true this is, however, this effect should be subjected to quantitative testing..

The Venezuelan proposals services the concerns of the poorer nations by providing for their participation in decision making, by advocating country (by income class) and a sectoral allocation of funds, by suggesting means by which OECD financial contributions to a program would be noncompetitive with existing ODA and by prescribing a mix of concession and nonconcession funds. The first point is perhaps the most critical in that only effective participation in decision making of an ongoing program by the poorer nation can assure their vulnerability is not exploited. The distribution of funds by country and by sector is an area upon which negotiations might focus. The sectoral requirements would include the poorer nation with greatest needs (in the case of agriculture) and/or those endowed with natural resources via mining investment. Additionally, funds would be directed to the least developed countries through allocating a portion of total transfers to these nations on a concessional basis. The Venezuelan initiative suggested 20% to 25% of the total funds, concessional and nonconcessional, would be set aside for the poorer nation. Summing up, under this proposal 25% of the funds transferred, including those invested in commercially viable projects, will flow into poorer countries. The poorer nations would benefit, in addition, from increased export revenues to the extent that the world economy is restimulated.

3.4.2 Longer Term Effects

In the longer term a stimulus has potential benefits for the poorer countries.

First, the possibility that the new investment of the fund will increase both private and public inflows, the former through increasing the credit worthiness of the poorer countries and the latter if a successful stimulus results in increased ODA. A strength of the proposal recommending graduated subsidization of loans to poorer countries is their long term aim of building the credit rating of poorer countries for independent access to private capital markets. Concerning increased ODA, if a stimulus is established that drastically increases access of middle income countries to longer term private capital it may be possible to redirect some portion of ODA from the middle income to the poorer developing countries as suggested by the Scandinavian discussions.

Finally, a general ODA negotiation point of mutual concerns to MIDC and least developed Third World nations should be raised. If in the 1979-1980 period OECD stagflation worsens with greater consequent recognition of a global stimulus' benefits for industrial nations, the Third World could argue as follows: their participation would be contingent on some formula of committed OECD donor increases in ODA. For example, after the first year or two of the program OECD nations would commit increasing their ODA contributions by some agreed upon level.

4. EVALUATION OF GLOBAL STIMULATION PROPOSALS IN LIGHT OF BILATERAL, REGIONAL, AND OTHER ALTERNATIVES FOR ACHIEVING THIRD WORLD-NIEO GOALS

4.1 PURPOSE OF CHAPTER

The major part of this chapter is an exploratory sketch of possible alternatives to global stimulation proposals. These include regional and bilateral trade-investment-aid approaches between developed and developing countries as well as intensified "South-South" relations among Third World countries. The purpose of this chapter is to identify these new trends in international economic relations in that they represent another possible parameter for Third World nations in determining their position and eventual negotiation stance on global stimulation proposals. In closing the report, both bilateral/regional alternatives and global stimulation are viewed in the context of a transition to a new global order characterized by efficiency, equality and participation.

We caution that this chapter makes no attempt at a detailed assessment of these varying alternatives. Such an evaluation is not feasible because of the limited amount of systematic research which has been done on these topics. A basic objective of the chapter is to generate a set of questions and hypotheses that would have to be systematically investigated if Third World countries were to take seriously the prospects of a global stimulation program. In so doing, they would have to look at other potential international alternatives for achieving the objectives of the proposals for global stimulus. Because global stimulation proposals themselves are so new, the questions, let alone answers, needed to construct a Third World

negotiation posture, or more practically, a posture for different categories of developing nations, have yet to be formulated. Should a global stimulation effort be pursued actively on a diplomatic level by Third World nations, this chapter may be a helpful first step towards that end.

The historical legacies through the 1950s of colonial and semi-colonial bilateral relations and regional/bloc spheres of influence among countries of the North and the South should not be confused with new trends in trade-investment-aid that have commenced since the mid-1970s. Throughout the 1960s and up until the mid-1970s, the major emphasis on changing the international economic order rested with the pattern established by various UNCTAD conferences in the context of a North-South discussion in which until recently both groups took relatively unified positions. As discussed below, it is no longer clear that such a simplified North-South pattern continues today.

As noted in earlier chapters of this report we emphasize that our discussion on global stimulation proposals and their alternatives is limited to the promotion of economic growth and not to overall developmental objectives. The basic assumption of this report is that growth is a prerequisite for development, however the latter may be defined. This does not mean that growth itself will bring about development in Third World countries, but rather that without growth it is difficult to imagine how most Third World nations' developmental process can proceed.

4.2 NO CHANGE TO PRESENT NORTH-SOUTH APPROACHES: ONE ALTERNATIVE

One logical alternative to global stimulation proposals and their regional and bilateral equivalents is to continue to pursue the present NIEO/UNCTAD agenda (including commodities stabilization, debt, development assistance, and trade) in

existing multilateral fora. By continuing along these lines, however, we will encounter a number of assumptions whose validity is problematic. First, the dramatic change in the conditions of the world economy, particularly those of the industrialized nations since 1974, will pose further difficulties in gaining agreement on the major agenda items of North-South discussion. The persistence of stagflation, the attendant rise in protectionism and leveling of ODA flows have already made more difficult the current North-South approach, an approach which was based on the economic environment of the later 1960s and early 1970s.

With regard to Third World debt and the related issue of ODA and other financial transfers, the Brandt Commission recently concluded that this "no change alternative,"

> "...at best implies continuation in the deterioration of the debt structure, recurring cases of payment crises and damage to the debtor's economies. At worst it would lead to an undesirable (some would say unacceptable) reduction in borrowing countries growth in output and investment with adverse effects on both developing and developed economies, and it may lead to an international credit crisis with world-wide economic and social implications."

To pursue the present mode of North-South negotiations overlooks the effect of slower secular growth trend of the world economy since 1974 of creating growing divergences of policy views among the industrial nations of the North. Almost as noticeably, the same is also occurring among the countries of the South.*

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*Typical of recent literature emphasizing intra-North and intra-South schisms are: Viatos, Constantine U., "From a Colonial Past to Assemetric Interdependeces, the Role of Europe in North-South Relations," presented at the General Conference of the European Association of Development and Research Training Institutes, Milan, September 1978; Kaldor, Mary, The Disintegrating West, New York, Hill and Wang 1978; Barraclough, Geoffrey, "Waiting the New Order," New York Review of Books, October 26, 1978.

4.3 NORTH-SOUTH REGIONAL AND BILATERAL ALTERNATIVES TO GLOBAL STIMULATION

Since the early 1970s there has emerged a new pattern of trade-investment-aid relations at bilateral and regional levels among certain industrial nations and developing countries. The first of these were the two Yaounde Conventions of 1963 and 1969 between the European Economic Community (EEC) and 18 associated African states and Madagascar (AASM). In 1969 the Arusha Convention between the EEC and East-African states made the latter a party to the second Yaounde Convention. Thereafter, the Lome I convention expanded the earlier contractual agreements to include 46 nations of Africa, the Caribbean and the Pacific with the countries of the EEC. Currently, Lome II is being negotiated in Brussels for an expanded effort in both the nature and the number (54) of countries to be involved in the new draft contract.

In Asia, the government of Japan has held two ministerial-level discussions with the Association of Southeast Asian Nations (ASEAN) to explore commodity stabilization agreements (similar to the STABEX of the Lome Convention) as well as reported talks on other forms of special trade, investment, and aid relations. On a bilateral level new forms of trade-investment-aid packages have commenced most notably where oil and gas and other energy resources are involved. In energy and mineral sectors these packages usually involved a "swap" -- the developing country guarantees quantity exports of the commodity produced from one or more investment projects, in exchange for negotiated financing and imports of technology and/or technical assistance from the developed nation. First pioneered in negotiations between Third World host governments and multinational corporations of developed nations, increasingly these arrangements are being implemented at a government to government level.

While initially these package arrangements involved energy and were confined to financing and technology for that sector, more recently OECD nations' exports of the latter are going to projects and programs outside of the energy sector. Such expanded arrangements are beginning to lead to a similar pattern between developed countries and Third World exporters of minerals. (A demonstration effect originating in the oil sector often propagates to other primary sector negotiations.)

Japan took the lead in establishing these special bilateral relations. Recently, however, France has made it public policy in terms of its imports of oil and gas. Germany has announced similar arrangements with respect to Saudi Arabia. Even the United States, a notable latecomer, is considering a trade and investment package with Nigeria, and the Carter administration is facing growing criticism of its failure to initiate a similar effort with Mexico.

For Third World mineral exporting nations, such swap arrangements could involve additional development assistance, particularly, through the special financing terms -- thus, the terminology of "trade-investment-aid packages." Bilateral trade-investment-aid (TIA) packages are not limited to the primary sector. Emerging capital goods industries in Third World nations are a prime candidate for extending these packages. Capital goods for petrochemical production in Mexico and Brazil, as well as for the computer industry in the latter country, are prime examples.

Some observers see the Lome II negotiations as an extended TIA package involving special trade preferences, assured market access in both directions, commodity stabilization (STABEX), and special development assistance terms.

Whether or not Japan follows the same route in the Asian region is still not certain. Yet, the recent ASEAN-Japan discussion on a STABEX scheme as well as other conditions point in this direction. As noted earlier, there are also the recent news announcements concerning a "mini-Marshall Plan" for Asia, particularly China, that are emanating from Tokyo.

Among the industrial nations there are three dimensions of differential economic characteristics that underlie this drift towards TIA bilateral and regional relations. The first is the differential ability of OECD nations to cope with persistent slow secular growth rates accompanied by inflationary pressures by means of traditional monetary and fiscal policy. Second, among developed nations there are differing degrees of dependency levels and differences in composition of their trade dependency on Third World nations. For example, Japan and the European community send 50% and 40%, respectively, of their total exports to Third World nations, whereas the value is 26% in the case of the United States. Also, the former are much more dependent than the United States for various categories of strategic raw materials.

Given the differences among industrial nations' investment, trade, and strategic raw material dependencies on the Third World, their foreign economic policy reaction to the new constraints of persistent stagflation will also differ. A final factor determining divergences among industrial nations towards the Third World concerns their differential abilities in meeting problems of structural adjustment, particularly vis-a-vis the imports of manufactured products from developing nations. Here, we have already referred to the limited and incomplete evidence that suggests both Japan and the European community are more actively considering the role of North-South investment "targeting" (in Europe termed North-South "complimentary") in

bilateral and regional TIA packages that would help in mitigating future structural adjustment problems between themselves and Third World exporters.

These differential economic characteristics among industrial nations, in terms of their relations with the Third World, explain not only the differences in pursuing bilateral and/or regional arrangements, but also their differing degrees of interest in global stimulation proposals per se. To date, the United States has been the most reticent and the least active in considering any type of complimentary growth stimulation effort.

The secular downturn in world growth and investment has also led to the emergence of differences among Third World nations. One obvious example was the difference between newly industrializing Third World nations in contrast to their least developed counterparts concerning proposals for relieving external debt during the 1974-76 period. Obviously, should there not be a permanent revival of the secular growth to rates enjoyed in the pre-1974 period, these differences will be accentuated. From what has already been discussed, it is clear that both large developing nations such as India and those heavily endowed with natural resources such as Brazil or the OPEC countries have greater access and potentially greater "bargaining power" in negotiating special bilateral and/or regional arrangements with more developed nations. For example, the significant differences in per capita income between Brazil and India, on first glance, make one overlook their common characteristic: import substitution has been both more intensive and extensive than in smaller economies. Following the well-known "Linder hypothesis," for certain industrializing nations one could derive a greater array of industrial categories in which complementary trade-investment -aid packages can be worked out than for other Third World countries.

On the other hand, it could be argued that the breadth and depth of import substitution processes in such nations makes them natural candidates to pursuit of South-South trade arrangements with other developing nations. This will be discussed later. Since the objective of stimulating economic growth is in the mutual interest of both Third World and industrialized countries, three major questions arise from our identification of the alternative approaches discussed towards stimulation. First, can bilateral and regional stimulation approaches substitute or complement a global approach? Second, from the perspective of Third World nations, by the criteria of Third World goals agreed at the Lima conference, or the more recent pre UNCTAD V Arusha meetings, what are the relative gains to the Third World from these respective alternatives? Third, and intimately related to the prior two questions, will the pursuit of special bilateral and regional relations reinforce and expand the degree and types of protectionism that now becloud the world economy?

With regard to the first question, it would not be overly-speculative to judge that both regional and bilateral North-South sitmulation efforts are not compatible with a global effort. Because of the downward pressure, in real terms, on ODA flows due to domestic circumstances in the industrial nations, and to the extent that public-supported development assistance is required in a stimulation effort, the financial constraints prohibit a simultaneous pursuit of both. Whether or not a heavy reliance on private savings in industrial nations and those of OPEC governments would be used in one or both of a regional and global stimulation effort, and thereby avoid the financial constraints on ODA, is a question that cannot be dealt with here.

With regard to a simultaneous pursuit of special bilateral stimulation efforts and a global approach, the question is

governed by a number of limiting factors. For example, should Japan decide to stimulate its own domestic growth by a heavy subsidization of trade-investments-aid packages with China, it may well be that this would eliminate Japanese involvement in either a regional or a global stimulation program. Given the overwhelming size and growth potential of China however, it is obviously a special case, and one to which we shall return momentarily. Special bilateral packages with other developed nations need not necessarily be a substitute for a joint agreement towards global stimulation among members of the North and the South. It is not clear that the financial constraint would make these approaches substitutes for each other. However, one could speculate that a potential participating nation such as the United States, might push for stipulations in a global agreement that would limit the type of bilateral packages that could be utilized. Other industrial nations, should they opt for a global approach, may also have such an interest. This is because of the question of "equitable" market shares among developed nations from the derived export demand from a global stimulus.

Without systematic research and reflection, it is also difficult to answer the second major question concerning relative gains from these different alternatives to growth stimulation to North and South. The potential gains include, for the Third World, export growth. access to external finance, stabilization of trade, technology transfer, and, importantly, the issue of structural adjustment between developed and developing nations.

From limited and casual observation, it is our judgment, however, that the impact of China's entry into North-South trade-investment-aid relations must be given due attention in considering which of the stimulation alternatives are preferable from the point of view of Third World nations. Perhaps the most important impact of China's new foreign economic policy will be its

effect on international financial markets and other Third World nations' access to medium and long-term external financing. Estimates, and they should really be termed "educated guesses," place the value of China's medium to long-term external loan capital needs, from 1979 through 1985, in the range of $24 - 35 billion. (See Chapter 3, above.) Given both the potential size of the China market as well as the national security priorities placed on it by industrial nations, it will be safe to say that the Chinese will be in an excellent negotiation posture to gain medium and long-term external finance. While at this time it is unanswerable as to how much of this financing could have otherwise gone to Third World nations, China's entry into external financial markets should shed some new and, in our judgment, positive light on the Third World nations' considerations of North-South growth stimulation alternatives.

Should Japan, perhaps in consort with Australia and through the Asian Development Bank, initiate a "mini-Marshall Plan" for the Asian region it would have to include China. While such an effort should not preclude special bilateral arrangements between China and non-member industrial nations of such a regional stimulation, it still would detract from new ODA and external financing that may have been available to other Third World countries.

It is our speculation that a global stimulation effort would be in the best interest of Third World nations to aid in access to external financing in the future. Utilization of either a Venezuelan-type, Mexico Capital Pool, or OECD Stepped-Up Investment Program stimulation effort would free up anywhere from $5 - $15 billion of external financing that otherwise would not be available. In this case, at the minimum, this should alleviate a Chinese-induced downward pressure on external financial access of other Third World nations.

Concerning relative gains using the criteria of technology transfer, this issue should primarily be considered in the context of North-South structural adjustment problems and the shape of the future international division of labor. Here, as on other issues, there is almost no prior research. Where this question has been addressed, there are divergent views.

On the surface it appears that special bilateral agreements and regional approaches may well allow for a greater degree of planned complementary so as to minimize future structural adjustment problems in the industrial North. Yet, offsetting this is the potential of "locking-in" Third World countries to a limited upgrading of the scope of industrialization they could gain. For example, Constantine Vaitisos argues that the current Geneva negotiations between EEC and Lome participating nations, on a proposed "code of conduct for host countries" on foreign mineral investments, is already an indication of a return to past symptoms of Third World dependency. Another equally sympathetic Third World oriented scholar, Geofrey Barraclough, however, argues that it is not at all clear that new and more limited North-South spheres of influence would necessarily result in lesser gains to developing countries than would be the case in the absence of these new arrangements. The major point here (assuming that secular growth of the world economy is not restored to its pre-1974 levels. the absence of a global stimulation program, and in addition, the growing divergence in policy between nations of the North and between countries of the South) is the likelihood that the goals of the Lima conference or the pronouncements in behalf of a NIEO (New International Economic Order) will be achieved.

This brings us to the third major question raised in consideration of bilateral vs. regional vs. global growth

stimulation. That is, to what extent can a global stimulation program help to alleviate protectionist pressures, particularly those in the North against the imports of the Third World? Stated otherwise, would reliance on special bilateralism and regional/block spheres of influence between the North and South promote a polarization process both within the North and among countries of the South? Obviously at this time domestic and foreign economic policy approaches by the industrialized North have resulted only in what the GATT has termed "an intensification of protectionist pressures to levels that haven't been seen since the great depression." An even more recent report released by the Economic Commission for Latin America (U.N.-ECLA) concludes that the former optimism about economic prospects for Latin America during 1978 were largely unwarranted. The 1979 forecasts are even less optimistic. The major reason cited by ECLA is that "protectionist policies in the developed countries are a threat to the major effort being made by Latin American countries to earn enough through diversified exports to pay debt service and maintain imports needed for growth."

As is well known, this mounting protectionism is a combined result of both slow growth and inadequate structural adjustment policies in the industrial countries. Bilateral, regional, and global stimulation approaches all offer participating nations the potential for more rapid growth in the Northern nations as well as in the South. It is our view that any such stimulation effort must be tied to the condition of accelerated structural adjustment policies by the North. The question then remains whether or not any one of these three alternatives offers at least those nations involved a better negotiating capacity for bringing about the necessary conversion of certain existing OECD industrial structure, and a likelihood at agreed complementarity for certain sectors in terms of future North-South investment policy.

As noted in Chapter 3, the most likely of the global stimulation approaches that may eventually be implemented would be that of either the Venezuelan, Mexican, or OECD types of programs. Both the Venezuelan and OECD initiatives are limited to Third World stimulation in energy, minerals, and basic infrastructure as well as food production. The Mexican Capital Pool proposal would appear to largely favor middle income and rapidly industrializing developing countries. The Mexican proposal also makes no allowance for any structural adjustment provisions between the North and South because it relies on only private capital markets for its funding sources. The Venezuelan initiative, as currently designed calls for a global agreement conditioned upon a commitment by industrial nations to accelerate their structural adjustment efforts. Such a condition, although now not existing, could be built into the proposed OECD Stepped-Up Investment Program. In both the Venezuelan and OECD approaches use of OPEC funds is a key ingredient and, therefore, OPEC nations' views on the structural adjustment problem will be crucial.

To date, no special bilateral TIA package has included any provisions or, apparently, concern about structural adjustment. Theoretically, at least, bilateral approaches could be seen as the most expedient to implement "complementary" or "targeted" investment policies by the North and South nations involved. Unfortunately, however, it is uncertain whether the South participants in such bilateral arrangements would have as much bargaining power on this issue as its Northern counterpart. On the regional level, it would appear that Japan and Asian participants could be in a position to implement planned targeting and structural adjustment programs. Again, this can only be said speculatively.

4.4 SOUTH-SOUTH GROWTH AND TRADE PROMOTION

Whether the South-South trade and growth stimulation alternative is a realistic prospect in the near term of the next five years is doubtful. A significant effort in this direction would by necessity have to involve a heavy commitment on the part of OPEC surplus nations because they are the only members of the South from which large-scale financing can originate. In addition, perhaps ten to twelve rapidly industrializing nations could generate some private external financing towards investments for export oriented industries geared to Third World markets. Again, in looking at this alternative we are faced with the problematic question of this entire chapter, namely, there has been little systematic research on the underlying issues and facts which must be addressed to answer these questions. One could speculate, however, whether there are any apparent reasons why a North-South growth stimulation program, under any alternative, would necessarily threaten the pursuit of an expanded South-South trade and international division of labor.

4.5 THE CRITICAL JUNCTURE BETWEEN THE OLD ORDER AND A NEW ORDER: GLOBAL STIMULATION AS ONE TRANSITION MECHANISM

As we noted earlier, certain proponents of global stimulation see it as a promising new initiative at what is held to be a critical juncture of the world economy. This critical juncture is identified by a number of new and interrelated phenomena which have emerged since the early 1970s. First, there is the inability of the industrial democracies of the North to maintain relative non-inflationary, full employment secular growth rates of the levels experienced in the first 25 years after World War II. Second, as this stagflation phenomenon has persisted, progress on achieving even limited success of the major issues of the North-South dialogue has further dimmed.

Third, and both a cause and effect associated with the first two phenomena, is that the major international structures of the "old order" of the 1950s and 1960s -- IFC, GATT, and the World Bank -- are having increasing difficulty in performing their global management function of maintaining stability in international finance, investment, and trade. Obviously, the occurrence of the first phenomenon, OECD-wide stagflation, in combination with the third, inability to maintain a stable world economy, relates to the second, the key issue of progress towards a new international economic order.

It is in the context of these multilateral governmental bottlenecks, that the concluding section of this study raises a final question: Can a global stimulation program be viewed as a transition mechanism, a "bridging device," that provides at least one, albeit limited, basis for pursuing the objectives of a new international order from a Third World perspective?

Before proceeding, emphasis must be given to properly defining this question. What is not being asked is whether global stimulation is the only transition program to bridge the present critical juncture of the world economy. Surely, the depths of today's problems will necessitate more than just one new initiative. More importantly, is whether global stimulation or any other new program, contains policies that would prevent achievement of the type of international structural reform connoted by a "new order." Conversely, and more positively, do the types of global stimulation proposals reviewed in the prior two chapters contain certain essential structural components which, while dealing with specific real economic problems of the world economy, also contain some of the basic structural approaches that will eventually have to be incorporated into the institutions of a new international order?

Defining the question in this way necessitates a further question. Given our earlier review of the growing schisms and divergences in policy views, both among nations of the North, and among those of the South, can we identify a minimum set of goals that all Third World countries, regardless of their category, would agree upon for the objectives of a new order? Three such goals have emerged from our research and scores of interviews with Third World policy makers and experts, representing a variety of developing nations of highly different characteristics.

In a world economy as diverse and globally interdependent as ours, the international structures of a new order would have to be designed to achieve at the minimum the following three goals:

- Global efficiency
- Global equity
- Global participation.

It is not our purpose to summarize the prior analyses on why the "old order" did not achieve these goals, but rather to briefly assess global stimulation proposals from the perspective of these three basic goals of a new order. Again our focus in this section will be limited to an assessment of the Mexican-type, OECD-type, and Venezuelan-type proposals.

4.5.1 Global Efficiency

This goal obviously implies the resumption of revived world economic growth. If the analyses of proponents of global stimulation are correct with their rationale about the present critical juncture of the world economy, then there are four major problems that have dovetailed to impede future growth. These

include stagflation in the North, structural adjustment difficulties worldwide, rising protectionism globally, and in the South, resulting new external debt constraints. The obvious cause and effect relationships in the past between these four problems are not important to our current assessment. That is, these four problems have now converged and been institutionalized, and over the past five years, have brought us to a vicious circle: each of these problems compounds and intensified the other. A policy approach designed to deal with one must recognize the other three.

The Mexican global stimulation proposal is an attempt to deal with external debt, protectionism, and slow growth. However, it contains nothing that would address the structural adjustment problem. In fact, its critics from industrialized nations believe that it would even intensify the structural adjustment issue since its stimulation of capital goods and imports into Third World countries could lead to a greater acceleration of competitive manufactured exports back into OECD nations.

The OECD and the Venezuelan-based initiatives are an attempt to address all four problems simultaneously. By temporarily offering to stimulate OECD growth, including in declining sectors, these proposals are politically pragmatic in recognizing a necessary "breathing time" to alleviate protectionism and mount new structural programs in those nations. But this is a temporary reprieve for those inefficient sectors. It does not accept a permanent halt towards a new realignment of the international division of labor between North and South that would be needed to achieve the longer range goal of global efficiency. Thus, during the interim "breathing time" of the first three years, these proposals set the basis for structural adjustment while alleviating stagflation to the extent that they are a <u>non</u>-inflationary growth generator, and thereby alleviate protectionism and external debt constraints.

4.5.2 Global Equity

Although a global stimulation program must be seen as a limited and modest mechanism to attack global efficiency and growth, with the hope that it may indeed be a catalyst for indirectly reactivating fixed investment through a psychological impact, the OECD and Venezuelan versions also make an attempt to recognize explicitly, measures that are not detrimental to establishing forces that in the long run can attain greater global equity. Both formulations make an explicit commitment to allocate given portions of their funds to the least developed nations, although clearly this may lessen the growth stimulus impacts on OECD nations. Thus, both the goals of global efficiency and global equity have become acknowledged and accepted parameters in these proposals.

This does not mean that the expressed percentage allocations going to the least developed nations categories and ose being assigned to sectors where there may be a greater impact directly on the poorest people (e.g., food production and limited aspects of basic infrastructure) are optimal. What is important is making the criterion of equity an official item for negotiations.

4.5.3 Global Participation

This is perhaps the most important structural ingredient contained in the OECD and Venezuelan versions of a global stimulation program. Given explicit detailed treatment in the Venezuelan study, but also emphasized as an item of negotiation in the OECD scheme, such a program would be the first formal organization within an international institution that gives effective decision-making influence to the Third World. The initial idea in the Venezuelan study was to give one-third of the

total votes of the Board of Directors of the special trust fund of a global stimulation program to OPEC nations, one-third to OECD nations, and one-third total votes to the non-OPEC developing nations. Within the one-third total votes of the non-OPEC developing nations bloc, no explicit formula was suggested for allocation between the middle income developing and least developed nations. Obviously however, the one-third explicit commitment to non-OPEC Third World countries introduces a realistic basis to devise a more detailed formula for adjudicating influence within this group of countries.

Thus from the point of view of what appear to be three agreed-upon Third World goals for a new international order -- efficiency, equity, and participation -- a global stimulation program may be one type of feasible mechanism for commencing the restructuring of international economic relations in this direction. At the minimum we conclude that this type of mechanism should be more systematically studied from a non-OPEC Third World perspective. To date, however, and as we have mentioned above, global stimulation proposals have been initiated and evaluated from either OPEC or OECD participants. Should one or another form of these proposals be brought forth as an official agenda item in an international forum, clearly non-OPEC Third World nations will have to react. In the case of the Mexican initiative, however, when it was raised at the IMF-World Bank Development Committee, other Third World nations were not able to respond because of lack of preparation.

This very limited and preliminary assessment made in the study would suggest that these proposals may, indeed, have merit. Should further research indicate this to be the case, it may be that non-OPEC Third World nations in international fora should themselves take the initiative in formulating and proposing their own version of a global stimulation proposal.

By Third World nations taking the initiative in proposing a global stimulus program, a number of advantages may accrue. First, it would show their interest to more than a score of OECD and OPEC nations in continuing this effort. Second, an active role by non-OPEC Third World nations would, at this stage, condition and balance a momentum which to date has been kept going only by the other two groups of nations. Given that there is already sufficient detail about the various existing proposals, a third advantage would be to permit non-OPEC Third World nations to systematically structure their own proposal based on the strengths and weakness of this prior work.

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BARTER-RELATED INVESTMENT MECHANISMS

by

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CHAPTER 1: GENERAL ASPECTS OF BARTER-LIKE EXCHANGE MECHANISMS AND THEIR ROLE IN FINANCING INDUSTRIALISATION IN DEVELOPING COUNTRIES

1.1 The Concept of Barter-Related Investment Mechanisms

Although barter, the world's oldest form of commercial exchange, is a well-known concept, there seems to be some confusion in international economic literature with respect to its distinction from other bilateral agreements. The main reason for this is that in current international economic relations pure barter is rather rare. More frequently it appears in more refined forms, that is either in combination with other bilateral agreements or with certain multilateral features. Therefore some clarifying discussion seems to be justified before pointing out the main characteristics of barter-related investment mechanisms.

Barter represents the most rigid form of bilateralism. In its strictest sense it is defined as a straightforward contractual exchange of goods and/or services of approximately equal value without the use of any money. In international economic relations this means that no payment in international currencies is made. Complete avoidance of money, however, appears to be rather difficult and so it usually enters into the picture at some stage of the relations. For instance, the volumes to be exchanged are defined in monetary terms using international prices, and international currencies, although usually applying certain premiums or discounts.

Another essential feature of barter is that the off-setting purchase is an integral part of the commercial arrangement. Two parallel agreements or contracts are simultaneously concluded, that is, both contractual partners arrange at the same time import and export transactions. More recently, barter has also often been called "reciprocal" or "counter trading".

"Compensation arrangements" are very similar to barter and are therefore frequently confused with it. But in its original sense, the term "compensation" defines a commercial arrangement, in which payments for exports and imports are of equal value and are made between importers and exporters of the same country. The exporter thus sells his "foreign proceeds" to another trader in his own country, who may use it for the purchase of imports from the other country. As in a barter arrangement, a compensation agreement requires no payment in international currency, but the exports and imports are not limited to goods specified in type and in quantity in the agreements or contracts, as was the case in barter arrangements.

Clearing arrangements equally have a strong barter character in the sense that the off-setting mechanism of the clearing accounts avoids payment in international currencies to a large extent. Under such agreements each contractual partner, be it the Government, a State trading institution, an industrial or a trading company of a country, establishes a special clearing account with the central bank, a commercial bank or a state bank of the contractual partner's country. Into these accounts all payments are made in local

currency, thus largely bypassing the foreign exchange market. International currencies, mostly US dollars or pounds sterling, are in these relations only used for accounting purposes "as clearing units" or for settlement of imbalances exceeding the swing limits or in the case of termination of the agreements. But even in the latter cases, usually within a specified period, settlement through deliveries of goods is foreseen until payment in convertible currencies is required. Generally, these clearing arrangements are associated with compensatory arrangements through offsetting targets on the commercial side, thus strengthening the barter character of the relationships.

Apart from the bilateral kind, the offsetting arrangements with barter character just described, may equally be set up in a multiangular form. Particularly frequent are triangular arrangements. Moreover, the described arrangements may also only cover a part of the commercial exchanges between the contractual partners, for example in the case of partial barter or partial compensation.

Increases in these different kinds of offsetting or barterlike arrangements during the past fifty years seems to have been clearly related to world economic cycles.[1/] Moreover, there seems to be some relationship between periods of increases in international barter and particular stages of economic development of countries, particularly regarding their international economic relations.

Finally, switch arrangements, which may be regarded as a consequence of rigid bilateral arrangements with barter character - intending to inject greater flexibility into them - should be mentioned. There are three types of switch arrangements to be distinguished. Two of them, the "import switch" and the "export switch", are particularly related to bilateral trade agreements, while the third, "switch arrangements to convert clearing units into hard currencies", is more related to bilateral clearing agreements. An "import switch" means that the commodities are bought from a country other than the country of origin. For instance the Federal Republic of Germany buys Moroccan oranges from Yugoslavia, which the latter had to accept due to a bilateral trade agreement with Morocco. An "export switch" consists of an arrangement in which exported goods are imported by a country other than the actual buying country. For example, the USSR, with the help of a switch trader, might sell goods which it accepted in a bilateral trade agreement to another country rather than to its contractual partner. Sometimes such switch arrangements imply a direct trans-shipment of the goods into a third country. Here the bilateral trade agreement exists in only a formal sense (see Graph 1).

1/ See in this context the discussion in: "The Development Impact of Barter in Developing Countries", by I. Outters-Jaeger, to be published in March 1979 by the OECD Development Centre.

The third type of switch arrangement, defined as the conversion of bilateral clearing funds into hard currency for payment to a third country, is the most frequent. These switch arrangements arise from surplus balances in the bilateral clearing accounts, which cannot be used for additional trade. In this case a switch arrangement can be used for selling the clearing units, which represent claims on the bilateral trading partners' goods to a third country, at a discount. Similarly import licenses for specific goods and clearing units resulting from bilateral trade and payments agreements can be sold at a discount under a switch arrangement. For some clearing currencies large discounts prevail in international switch markets like Vienna, Zurich and Amsterdam.[1/] For example in 1974 Indian clearing units belonging to Bulgaria were sold at discount rates of 25 to 30 per cent;[2/] clearing units belonging to Eastern European countries from Egypt were even sold at discounts of 35 to 40 per cent. Switch arrangements at such discounts have frequently caused serious financial difficulties for certain developing countries, in particular for India.[3/]

This study is now concerned with barter-related investment mechanisms, that is, with the financing of investment on a barter-like basis. This means the use of the previously described offsetting agreements in order to finance imports of investment goods, technical know-how, training and technical assistance, without recourse to international currencies. It may be done either on a direct barter basis - through deliveries of goods, which may be part of the output of the project itself, or other traditional or non-traditional export products - or on a barter-like basis by payment in local currency into special clearing accounts, which means a claim on the contractual partner's production.

In this context, in addition to the previously discussed basic agreements, a great variety of contractual arrangements providing for offsetting exchanges of imports of investment goods has been developed. In fact, the rapidly expanding exports of capital goods, in particular of industrial aggregates, during the last decade from commercially advanced, industrialised countries of Western Europe and of North America to the centrally planned countries of Eastern Europe and, in more recent times, such exports from all different country groups to developing countries, have been associated with the development of a large number of new forms of international relationships. They all reflect the tendency towards greater economic interdependence and more division of labour on an international level. Both governments and private industrial and trading companies have developed new forms of industrial co-operation, which not only imply the development of common interests between the contracting parties, but also close co-operation over a long period. Most of these arrangements provide, apart from traditional buying of goods and

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1/ See articles "Vienna gets switched on", R. Palmer, The Observer, 9th April 1972, and "How switch trading works", The Economist, 14th January 1967.

2/ Quoted in Institute on Switch and Barter Trade, Monthly Reports, April/May 1974.

3/ Compare article "How switch trading works", The Economist, op. cit.

services on a barter-like basis, also for co-operation in production and marketing, as well as for transfer of technology. The most commonly practiced forms of barter-related investment mechanisms are in this context. The main forms of such offsetting or barter-like commercial arrangements are:

Reciprocal purchase or counter-purchase contracts which, in contrast to barter arrangements, imply two separate contracts, that is a sales contract and a purchasing contract. In the frame of these relationships the exporting contractual partner accepts to purchase (or to have purchased) during a specific period, in exchange for its exports to a certain percentage, goods from the contractual partner. Unlike in the case of pure barter and compensation, in these arrangements usually (at least to a certain extent) an exchange of currencies takes place.

Buy back arrangements, under which the exporting contractual partner accepts, either partial or total, payment in resultant products for the supply of plant or industrial equipment, for example supplies of phosphorus in exchange for phosphorus mining equipment, or ammonia in return for an ammonia plant. With the rise in exports of industrial aggregates to developing countries, this kind of barter related investment arrangement experienced a considerable increase since the beginning of the 1970s. Similarly, licensing may be made against payment in resultant products.

Industrial technical and/or economic co-operation agreements in which countries or government institutions agree to provide development assistance in exchange for exports or payment in local currencies into clearing accounts.

Sub-contracting agreements, under which the contractor agrees to buy back a part of the sub-contracted production in exchange for supply of raw materials or industrial equipment.

The main characteristic of all these barter-like arrangements is that they not only give rise to financial flows, but in particular to flows of goods. This may occur either on the basis of pure barter, or on the basis of a compensation arrangement, or through the offsetting mechanism of a clearing account. All the arrangements may be contracted not only as simple bilateral agreements, but in the form or in the frame of complex multiangular arrangements.

1.2 The Importance of Barter-like Exchange Mechanisms for Financing Industrialisation in Developing Countries

Considering the above-mentioned need of accelerated industrialisation in developing countries to procure the necessary financial resources for it, barter and barter-like exchanges appear as an appropriate means for them to provide the necessary imports. The major feature of these exchange mechanisms being to minimise payments in international currencies through offsetting deliveries of goods, the conclusion of commercial arrangements with barter character thus providing for an automatic linking of imports and exports allows developing countries to widen import capacity without requiring any payment in

international currencies. This is particularly important for them, since their possibilities to increase their earnings from exports have become rather limited because of low demand elasticities of their major export commodities and of the appearance of substitutes for them, while their dependency on imports of basic food products has been steadily increasing. In addition, the prices of the export commodities of developing countries mainly have been developing less favourably than those of the products which these countries need to import, their terms of trade thus deteriorating more and more.

In cases, where necessary imports of capital goods and technical know-how can be related to offsetting exports of products which are relatively in surplus, or not yet introduced into international markets, the arrangement of barter-like exchanges appears to be particularly advantageous. In this context, not only can the developing countries' import capacity be increased, but the country can also dispose of products difficult to sell in other ways in international markets. Moreover, worth noting is the fact that the provision of basic essential imports on a barter or barter-like basis, often allows allocation of scarce foreign exchange reserves to other necessary imports. This was, for example, the case for Sri Lanka, which could obtain, since the beginning of the 1950s, its essential imports of food products, especially of rice, sugar, wheat, and of crude oil, on a barter or barter-like basis, and pay for them mainly with exports of its surplus products, i.e. rubber and medium and low-grown tea.[1/] In this way, Sri Lanka could allocate its scarce resources in foreign exchange to imports of capital goods from Western countries which were only available against international currencies.

Apart from allowing additional imports without any further payment in convertible currencies, the main interest of barter-related investment mechanisms, barter and barter-like arrangements in providing for additional exports often may equally help to achieve other trade policy objectives. Thus, non-traditional products, in particular new industrial products, can, with the help of such arrangements, be introduced into markets without much marketing efforts. In fact, the marketing process remains mainly with the contractual partner, who accepts the deliveries of goods in exchange for its supplies of capital goods and technical know-how. This is particularly the case in the frame of so-called "buy-back arrangements", which provide for the import and setting up of an industrial plant as well as for related technical assistance against total or partial payment in resultant output. In these cases, automatically a stable market is created for the new product over a longer period.[2/] If the supplying industrial company disposes

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1/ Compare in this context a more detailed explanation: I. Outters-Jaeger, "The Developing Impact of Barter in Developing Countries - the Case of Sri Lanka", OECD Development Centre Conference Document, March 1977.

2/ Compare in this context the results of various case studies on different forms of industrial co-operation in East-West economic relations by the Economic Commission for Europe, published under the title: "Promotion of Trade through Industrial Co-operation", TRADE R.373, Add. 3 and 4.

of its own trading company or is part of a bigger group with such an institution, the re-sale of the offsetting deliveries of goods can be carried out through its own outlets and the question of the cost of disposal of the barter goods does not even arise.

In the context, it should also be mentioned that in the case of centrally planned economies, where no marketing policy by foreign companies is possible, barter-like arrangements, be it in the form of industrial co-operation or of purely commercial arrangements, are often the only possible access to the market of these countries for foreigners. If the "barter goods", i.e. the offsetting exports, are no priority goods in the sense of "the plan" of these countries, they could not even enter the country, since no foreign exchange would be allocated to them.

1.3 Problems for Developing Countries Involved in Barter-related Investment Mechanisms

While financial and commercial transactions in international economic relations on a multilateral basis are, at least theoretically, to a large extent determined by international market conditions, such transactions under barter-like arrangements are mainly subject to the bargaining power of the negotiating parties.[1/] Whether the terms of exchange under a bilateral arrangement with barter character are favourable for the participating developing country depends mainly on its market alternatives and on the kind of products which it wants to exchange against each other. In a barter-like exchange aiming at the import of investment goods and technical know-how, a developing country is thus at a disadvantage from the beginning, since the goods which it may offer in exchange for payment, i.e. mostly primary commodities or resultant output, are generally of lower value per unit. Exceptions are cases in which the developing country can offer for the offsetting deliveries relatively scarce raw materials, e.g. crude oil or petroleum products, which are greatly needed by the contractual partner supplying the industrial equipment. The developing country thus needs to be well informed not only about its own market alternatives, but also about those of its contractual partner. This means particular constant awareness with respect to international price movements and developments of international raw material markets. In this context problems arise for the developing countries simply from the fact that they mostly dispose of less developed international communication possibilities than do their industrialised contractual partners.

Another prerequisite in negotiations of barter-like exchange providing for exports of industrial equipment and technical know-how is good knowledge about international norms

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1/ Compare in this context theoretical discussions on possible terms of exchange under bilateral arrangements with barter character in: I. Outters-Jaeger, "The Development Impact of Barter...", op.cit. and in: J. E. Meade "Trade and Welfare", Vol. II of "The Theory of International Economic Policy" Oxford University Press, 1955.

and standards of industrial goods. Moreover, successful experiences in barter trade, as in the case of India[1] indicates, appear to require a well developed machinery of economic planning and administration. Developing countries entering into negotiations on barter-like exchanges without well determined objectives, plans and negotiating strategies, are clearly at a disadvantage from the outset.[2]

A particular problem in barter-like exchanges are also the prices, especially when the offsetting exchanges occur with a time lag. In these cases price developments have to be taken into account and thus have to be planned in advance. Moreover, the supplier of the industrial goods, who accepts in return payment through deliveries of goods, generally attempts to apply a certain discount margin in order to cover the expenses in disposing of the barter goods. This margin again is largely determined by the bargaining power of both negotiating parties.

Another factor influencing the effective prices in barter-like exchanges are the periods of imbalances; that is if one contractual partner is holding a surplus balance over a longer period in a barter-like relationship, he is offering interest-free credit to its contractual partner.[3] In barter-like arrangements which provide for offsetting payments in local currencies through clearing or so-called special accounts, the swing-limits have a similar influence on the prices effectively paid.

The absence of money in barter and barter-like exchanges implies coincidence of wants[4] in order to satisfy both contractual partners, since the "proceeds" from the barter exchanges can only be used for "purchases" which are specified in the contract unless they are re-bartered or re-sold. As a consequence of these restrictions on the choice of products to be exchanged, there are frequently long-lasting imbalances in important barter-like arrangements, implying the granting of interest-free credit from one contractual partner. If the contracting party who supplies to the developing country

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1/ See R. Banerji, "The Development Impact of Barter in Developing Countries: the Case of India", published among the Technical Studies of the OECD Development Centre, Paris 1977.

2/ Compare for a more detailed explanation, I. Outters-Jaeger, "The Development Impact of Barter...", op.cit., and related case studies, published as working documents in March 1977, by the OECD Development Centre, on India by R. Banerji, on Ghana by K. Imboden, on Nepal by M. S. Rana - K. Imboden, on Egypt by F. el Rafail (R. Banerji) and on Sri Lanka by I. Outters-Jaeger.

3/ Ibid.

4/ Compare R. M. Starr, "The Structure of Exchange in Barter and Monetary Economies" in: The Quarterly Journal of Economics, Vol. /XXXVI, No 2, May 1972.

industrial investment goods, accepts in return as payment goods which he cannot use himself, as mentioned, the problem of disposal of the barter goods arises for him and he might try to take this into account in his prices. This is particularly the case when industrial plant and technical know-how is supplied against one hundred per cent payment in goods. Furthermore, the developing country buying capital equipment, technical know-how and development assistance is often limited in choice with respect to quality and after-purchase service.

On the developing country side the supply of industrial complexes or other longer development projects in association with necessary technical assistance against payment on a barter basis, has often caused great problems. In many cases the fulfillment of export obligations resulting from larger barter-like arrangements has implied trade diversion from convertible currency markets to barter-like trading partners, thus resulting in a reduction of the developing countries' foreign exchange earning potential. It also has the effect of the neglect of expanding multilateral market opportunities because barter-like targets have to be achieved. Particularly serious, in this context, has been the repayment of USSR development assistance - especially the construction of the Asswan high dam - by Egypt through deliveries of raw cotton, which represents for the country the major foreign exchange earner.[1/]

Finally, worth mentioning is that the relative stability of markets over a certain period provided by the arrangement of barter-like arrangements, may have serious repercussions on both trading partners in the event of sudden interruption of the contract due to political changes. Particularly with respect to the developing country partner, this causes some uncertainty. Moreover, most developing countries do not accept the intervention of international courts or committees of arbitration in cases when they cannot fulfill their obligations resulting from the contract, particularly in the case of political change. A frequently advanced argument by developing countries against these committees is that they are built up by developed countries and are thus not very suitable to act as advocates of developing countries.

1.4 Policies and Attitudes of Developing Countries Concerning Barter and Barter-like Exchanges

In contrast to the benefits and problems arising from barter-related investment mechanisms for developing countries, which were pointed out in the preceding sections, it seems to be of interest to review briefly official policies and attitudes of developing countries concerning this kind of exchange.

1/ Compare, for a more detailed analysis, F. el Rafai (R. Banerji revision) "The Development Impact of Barter in Developing Countries - the Case of Egypt", published as a working document by the OECD Development Centre for an expert meeting in March 1977.

As before with other country groups, i.e. the Western European industrialised countries during the 1930s and Second World War up to the middle of the 1950s, and the Sino-Soviet Bloc countries since the middle of the 1950s,[1/] towards the end of the 1950s more and more developing countries began to encourage barter and barter-like exchanges. Latin American countries, in fact, had already earlier practised extensively barter among themselves - mainly as a consequence of difficulties in trade with Western Europe. In the middle of the 1950s about 90 per cent of total trade within the area took place on a barter or barter-like basis.[2/]

While during the 1960s developing countries encouraged this kind of exchange, mainly for commercial policy reasons, i.e. to promote exports - to dispose of surplus commodities - and to provide for essential imports of food products and raw materials, in later years barter and barter-like exchanges were more and more related to imports of investment goods, of technical know-how and development assistance.

In this context, many developing countries have set up so-called "Barter Laws" with the intention to promote this kind of trade and to regulate and control it as far as is possible. Mostly, it was intended to channel trade in certain commodities through this kind of commercial arrangement. Developing countries endorsing, and even officialy encouraging, barter and barter-like exchanges were particularly India, Iraq, Pakistan, Columbia, Ecuador, Ghana, Sri Lanka and Egypt, and later also Iran. Brazil and Algeria. In the case of Egypt, barter exchanges were largely related to the country's policy of industrialisation.[3/]

Two varieties of transactions were permitted. The first took place via a so-called "troc account", which is a simple foreign barter account usually maintained in a foreign country, e.g. Switzerland, for the reception of foreign credits. These credits were sold to local importers at fixed rates of exchange, at high premiums, and were to be used only for certain authorised products. The Egyptian goods to be exported in exchange were determined in advance at specified minimum prices. The second type of barter arrangement permitted was the straight barter deal, available only to manufacturers engaged in export. Products had to be priced at minimum levels, and imported raw materials had to be used in their own plant or for other officially approved industrial purposes.

1/ For a detailed historical overview on periods of growth in international barter, see I. Outters-Jaeger, "The Development Impact of Barter..." op.cit.

2/ Quoted in J.P. O'Hagen, "International Barter involving Agriculture Products", in: FAO Monthly Bulletin of Agricultural Economics and Statistics, Vol. 11, Nos. 7/8, July/August 1962.

3/ Compare information quoted in M. Schubert, G. Reimann and E.G. Wigglesworth, "Barter and Compensation Transactions," in: The Challenge of International Finance by G. Reimann, New York 1966, and F. el Rafai (R. Banerji), "The Development Impact of Barter in Developing Countries - the Case of Egypt", op.cit.

For India, barter arrangements have represented an important means of overall economic policy.[1/] Evaluation and negotiation of possible barter deals was generally in the hands of the State trading corporation of India; for this purpose the following guidelines were utilised:

- a minimum value of the barter deals of US $ 250,000;
- products suitable for exports had to be either surplus products, (e.g. manganese ore, ilmenite, chrome ore or vegetable oils), or non-traditional industrial exports, for which an export market did not yet exist on a multilateral basis;
- products suitable for import had to be essential for India's development or immediate food requirements and essential raw materials;
- the barter deal should help save scarce foreign exchange.

As will be pointed out later in this study, in more recent times India has used barter-like arrangements frequently to promote exports of its new industrial equipment production and related technological know-how to other developing countries, in particular to oil-producing countries.[2/]

Oil-producing countries, like Iran, Iraq and Algeria, have frequently entered into barter and barter-like arrangements with all different country groups, i.e. OECD member countries , Sino-Soviet Bloc countries and, more recently, also with certain developing countries such as India, Brazil and South Korea, in order to provide for necessary development assistance and imports of capital goods and technical know-how by paying through deliveries of crude oil.[3/] In contrast to most other barter-like exchanges of developing countries, in these relationships often the initiative for barter-like offsetting transactions came from the investment goods supplying country, who intended to provide for stable long-term supplies of the essential scarce raw material, oil.

In more recent times, various developing countries have also attempted to link imports of capital goods and technical know-how to exports of their raw materials or new industrial products, in order to overcome difficulties in financing the development of

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1/ R. Banerji, The Development Impact of Barter in Developing Countries - The Case of India", op.cit.

2/ Compare also information quoted in the Middle East Economic Digest, various issues 1977 and 1978.

3/ Compare articles in the Financial Times, 14 February, 1977, and 15-18 February, 1977, and Frankfurter Allgemeine 13/2/77, and "Die Welt" 15/2/77, as well as in the Herald Tribune of 6 August, 1977, and also information quoted in various issues of 1976, 1977, 1978, of the Middle East Economic Digest.

their industrial sectors. This was particularly the case for Tunisia, Brazil and Nigeria.[1/] Thus Tunisia aims at promoting its exports of phosphorus, which because of its lower quality does not easily find an outlet in international markets, with the exception of through the "buy back" deliveries to Eastern European countries. In fact, these latter countries have largely developed the phosphorus mining and processing industry in Tunisia on the basis of barter-like agreements on Economic and Technical Co-operation. Brazil attempts to provide for imports of investment goods, apart from those of crude oil already mentioned, by paying through deliveries of its minerals and new industrial goods.[2/]

1/ According to information supplied by the French "Association pour la Compensation des Echanges Commerciaux" in February 1979.

2/ According to information from the "Direction des Relations Extérieurs", the French Government and the Brazilian Government are actually negotiating barter-like exchanges of this kind.

CHAPTER 2: THE INTERDEPENDENCE OF AID AND TRADE ON A BARTER-LIKE BASIS WITH ECONOMIC RELATIONS OF SINO-SOVIET BLOC COUNTRIES

2.1 The Main Characteristics of Sino-Soviet Bloc Development Assistance

In accordance with the principle of equality and mutual benefit, which Eastern European countries, particularly the USSR, emphasise as the basic idea of their economic relations with developing countries,[1/] Sino-Soviet Bloc development assistance is generally granted on a bilateral basis in the form of so-called Agreements on Economic and Technical Co-operation. This implies not only co-operation of both contracting partners in the different projects agreed on, but also mutual participation in their costs.

Another basic characteristic of Sino-Soviet Bloc Development Assistance arising from the above mentioned basic principle, is that repayment of loans and assistance as well as eventual payment of interest, is generally to be made either on a direct barter basis through deliveries of goods, or on a barter-like basis in local currency via clearing accounts. The debt servicing exports as well as the various imports connected to the different projects agreed, are taken into account in the trading lists of the different trade agreements and related annual protocols, while the corresponding loans are extended in the frame of so-called credit agreements. Trade and aid are thus closely interrelated in Sino-Soviet economic relations with developing countries. In many cases the close interrelationship of all these different agreements is already indicated by the fact that they are concluded simultaneously.

All payments associated with the different flows of trade are accounted in the clearing accounts, which are set up with the Central - or other - state banks of the contracting partner countries. In the case of India there are even such clearing accounts with both kinds of banks.[2/] Thus each Sino-Soviet Bloc bilateral assistance donor maintains with the Reserve Bank of India a central clearing account and one, or even several, subsidiary accounts with Indian commercial banks, which are authorised to undertake business involving payments in foreign exchange.

As will be pointed out in more detail, in some cases repayment of development assistance and payment of related interests is simply foreseen in local currency into the clearing accounts and the deposits may be used by the Sino-Soviet donor country for purchase of goods from the developing recipient country. But again, these purchases will

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1/ See articles "Wirtschaftshilfeabkommen des Ostblocks" and "Technische Hilfe der Sowjetunion" in: Handbuch der Entwicklungshilfe Verlag August Lutzeger, Baden-Baden, 1968 ongoing.

2/ For further details, see R. Banerji "The Development Impact of Barter in Developing Countries - The Case of India", op.cit.

generally be agreed upon in the trade agreements and/or related annual protocols. In general these clearing accounts use international currencies, for example the £ sterling or the US dollar, for accounting purposes as a so-called clearing unit, only in rare cases the clearing unit is the convertible local currency of the developing country contracting partner, for example in the case of India - the Indian Rupee. But always all offsetting payments into the respective clearing accounts are made by both contracting partners in local currencies. Mostly, the clearing accounts include not only the financial flows associated with the development assistance, but also those related to purely commercial exchanges on a barter-like basis between the contracting partners. In some cases, however, for example in that of Tunisia,[1/] for both kinds of relationships are used different clearing accounts. The general conditions for the utilisation of the clearing mechanisms (in particular for settlement which is generally within a certain period foreseen through deliveries of goods in case of imbalances exceeding the so-called swing limits, or in case of termination of the agreements) are generally laid down in a payments agreement concluded between the countries concerned. More rarely, the terms of payment through clearing accounts are set up within annexes to the trade agreements or in additional protocols to them.[2/]

Another main characteristic of Sino-Soviet Bloc development assistance is that it involves a large network of various agreements, protocols and individual contracts. Thus the general agreements on economic and technical co-operation mostly only set the frame of the relations to be established and indicate the different areas and/or projects for which the Sino-Soviet Bloc partner is prepared to grant assistance. For the implementation of the individual projects a large number of protocols and individual contracts, as well as of other agreements, is necessary in order to provide for the different stages, i.e.. project planning, feasibility studies, eventual necessary geological research, the execution of the project, the necessary deliveries of equipment and raw materials, etc. The different credits granted and their terms of reimbursement are in the general agreement on economic and technical co-operation only mentioned in an indicative way. Generally, specific credit agreements or additional protocols indicate the terms under which the loans are extended and how they have to be reimbursed, as well as their exact volume. (Compare various agreements and protocols quoted in Table 1.)

In this context, the 1958 agreement on economic and technical co-operation between Egypt and the USSR represents a good example (see Table 1 under Egypt). This agreement listed more than 20 different projects, among them the well-known one of the Aswan High Dam. The execution of the projects finally agreed upon required 103 different supplementary protocols and individual contracts, which were concluded between the different state trading institutions or industrial companies involved in the different stages of the projects and supplies of equipment, capital goods and raw materials.

1/ See I. Outters-Jaeger, "The Development Impact of Barter in Developing Countries", op.cit.

2/ Ibid.

This type of contracting system allows particularly the donor country to modify the projects initially listed in the general agreement on economic and technical co-operation without any political and economic consequences. The developing recipient country, in contract, is generally more constrained by the agreement, since it is usually unable to choose another donor for the execution of the project. Moreover, the large network of protocols and contracts provides Sino-Soviet Bloc countries with a certain publicity, since due to it the public gets the impression of a far greater aid volume to developing countries than in fact is the case. Often this system leads to misunderstandings, that is double counting, with respect to the volume of different loans granted.[1/]

Considering the fact that the general agreements on economic and technical co-operation mostly contain only initial suggestions for development assistance and economic co-operation, it is not surprising that the actual aid disbursements from Sino-Soviet Bloc countries are rather divergent from their initial commitments. This is also indicated by the large difference between the number of projects actually carried out and that of those which were initially proposed in the agreements on economic and technical co-operation. Consequently, although these are mostly used in international economic literature,[2/] in the case of Sino-Soviet Bloc development assistance data on aid commitments arising from the general agreements on economic and technical co-operation are not very representative for the actual aid volume from them.

Another characteristic of Sino-Soviet Bloc development assistance is its double tying. That is, on the one hand, it is almost entirely bilateral, the only exceptions being contributions to UNDP, and tied to the donor country. Thus the loans extended under the credit agreements or protocols generally are linked to deliveries of raw materials, capital goods and equipment as well as of supply of development assistance from the donor country. Only in a few cases, particularly in more recent times in the frame of the so-called Agreements on Tripartite Co-operation involving OECD member countries, do supplies from a third country occur. On the other hand, Sino-Soviet Bloc development assistance is largely tied to specific projects, i.e. USSR and Eastern European development assistance is 90 per cent tied to projects, while in Chinese aid this is only the case for 50 per cent of the total aid volume.

Soviet development assistance in general is large scale and concentrated on the industrial sector, in particular on heavy industry (i.e. ferrous and non-ferrous metallurgy, machine building, electric power and metal working). The most famous projects

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1/ Apart from the already mentioned study by I. Outters-Jaeger, see also in this respect: J. Voss, "Die Abkommen der USSR mit den Entwiclungsländern" in: Der Ostblock und die Entwicklungsländer, Monatsberichte des Forschungsinstituts der Friedrich-Ebert-Stiftung, July 1964.

2/ See, for example, Annual Reports of the Chairman of the OECD Development Assistance Committee.

in this context were, in the past, the steel plants at Bhilai and Bokaro in India, and the Aswan High Dam in Egypt, to which many other industrial and agricultural projects in Egypt were related.

Another sector receiving the main interest of Soviet development assistance was the mining sector. Particularly since 1971, Soviet development assistance has been increasingly concentrated on geological research and mining projects. In 20 developing countries the USSR had such projects. The most frequent were projects on oil and natural gas prospections and exploitation (in Afghanistan, Algeria, Egypt, Syria, Iraq, Bangladesh, India, Pakistan, Southern Yemen and Sri Lanka). Among mineralogical research, exploitation and processing most concerned iron ore (e.g. in Algeria, Iran, Nigeria, Tanzania, Pakistan, Sudan and Sri Lanka); copper (e.g. in India, Congo, and Afghanistan): phosphorous (e.g. in Egypt, Tunisia, Iraq and most recently also in Morocco); and coal (e.g. in India, Iran, and Nigeria). Very often the USSR supported projects which were not particularly favoured by Western aid donors, for example, in the case of the Indian steel plants Bokaro and Bhilai; the phosphorous exploitation and processing projects in Tunisia, and the oil and iron-ore research in Sri Lanka.[1/] In most cases at least a part of the development assistance and supply of capital goods and equipment was repaid by the recipient developing country on a barter basis through deliveries of goods. This was done either in the form of so-called buy-back agreements as in mining and oil projects, and in those concerning the steel plants in India, or through supplies of major export commodities such as exports of cotton in the case of the Aswan High Dam in Egypt. Particularly with respect to oil and also with respect to Egyptian cotton, those barter-like supplies from developing countries have been largely used by the USSR to earn hard currencies in Western markets or to fulfill obligations resulting from barter-like agreements with other developing countries.[2/]

In contrast to USSR development assistance, Chinese aid is more concentrated on immediately productive projects. In Africa, Chinese development assistance concerned mainly smaller-scale projects for light industry or agriculture. Sometimes also assistance in the medical sector was given. In contrast to Soviet and Eastern European development assistance, which particularly since the middle of the 1960s has been rather export-oriented, at least to some extent, with the intention to supply the donor markets, Chinese aid projects are designed more for import-substitution. Consequently, the famous Tanzania-Zambia (Tanzam) railway project represents an exceptional case in Chinese development assistance, local costs were equally covered on a barter-like basis. That is,

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1/ See, for a more detailed explanation, the case studies on Egypt, India, Sri Lanka and Tunisia, carried out in the frame of the research project of the OECD Development Centre "The Development Impact of Barter in Developing Countries" by I. Outters-Jaeger, op.cit.

2/ Concerning USSR oil re-exports see among others the article by H. Bischof, "Erdöl in der kommunistischen Entwicklungspolitik": Monatsberichte, Entwicklungspolitische Aktivitäten kommunistischerländer, Forschungsinstitut der Friedrich-Ebert-Stiftung, Mai 1974.

the arrangements provided for imports of Chinese goods to the recipient country, which should be sold in the local market in order to cover with the proceeds local costs arising with the different projects.

2.2 Barter-Related Investment Mechanisms in Economic Relations Between Sino-Soviet Bloc and Developing Countries

As already mentioned, Sino-Soviet Bloc development assistance is largely barter-based. That is, the supply of plant and/or investment goods and related technical know-how, as well as technical assistance granted with it, is usually repaid either on a direct barter basis through deliveries of goods, or on a barter-like basis in local currency through clearing accounts, of which the deposits are to be used for purchases of goods in the recipient country. Table 1 reviews various bilateral agreements on economic and technical co-operation between Sino-Soviet and developing countries, which imply financing of imported industrial plant or equipment and related technical know-how on a barter or barter-like basis. As previously pointed out, these agreements constitute only the general frame for the economic relations to be established between the two partner countries. Their indications with respect to the different projects, the credits and their repayment, have thus in general merely an indicative character. However, as far as could be seen from the supplementary protocols and contracts, in cases where repayment on a barter or barter-like basis was provided for, this was generally carried out in the same way as suggested in the initial agreements; the only exception being more detailed additional arrangements in additional protocols and trade and payments agreements.

Many of the agreements quoted in Table 1 provide in a general way for the repayment of development assistance and supply investment goods through deliveries of goods - without specifying the goods to be supplied by the recipient country. (See, for example, Brazil's agreements with Czechoslovakia of 1973 and 1974, as well as its protocols with Czechoslovakia of 1976, and Poland of 1976, and the agreements between Afghanistan and USSR of 1956 and India and Czechoslovakia of 1959 and 1964.) In several cases mention is made that the goods to be supplied for repayment are indicated in the respective trade agreements and related annual protocols (see Agreements between Algeria and USSR of 1972 and between Algeria and the P.R. of China of 1963, 1964 and 1975, as well as the agreements between Czechoslovakia and Egypt 1960-73). Frequently, the respective trade agreements and protocols were concluded in parallel to the respective agreement on economic and technical co-operation, as was the case between Iran and Czechoslovakia in 1969 and between Afghanistan and the USSR in 1968. These arrangements represent clearly examples for the interdependence of trade and development assistance in Sino-Soviet Bloc countries' relations with developing countries. Sometimes also is mentioned that the necessary individual transactions or phases of the different projects, which will have been arranged in individual contracts between state trading institutions or other organisers of the contracting partner countries, are to be carried out on a barter basis (see, for example, the agreement between Rumania and Egypt of 1965). In fact, this seems to be more frequently the case than mentioned before in the general agreements and protocols, since there

is a general preference in Eastern European countries and in the USSR to deal with developing countries on a direct barter or on a compensation basis in order to save scarce foreign exchange for imports of high priority goods mainly to be obtained from Western Europe or North America.[1/]

In contrast to the cases indicating in a general way that repayment of development assistance and supply of investment goods should occur through deliveries of goods from the recipient country, which we have just described, in a large number of agreements the major products foreseen for these offsetting exports are indicated. This was, for example, the case in the agreements, quoted in Table 1, between Brazil and the Peoples' Republic of China of 1975, between Algeria and the USSR of 1968, and between India and Poland in 1968. Mostly, these exports involve major export commodities. Thus, for example, nearly all of Egypt's agreements and protocols on economic and technical co-operation with Sino-Soviet Bloc countries provided for exports of raw cotton; in particular, development assistance was granted by the USSR in context with the construction of the Aswan High Dam, largely repaid by Egypt through deliveries of raw cotton to the USSR. In India's offsetting exports to the USSR, tea has played an important role, and in the agreement between Colombia and the USSR of 1977, coffee is designated as the major commodity of the offsetting exports. The bilateral agreements on economic and technical co-operation between the oil-producing countries such as Algeria, Afghanistan, Iran and Iraq, and Eastern European countries and the USSR, have largely provided for oil and natural gas exports to the donor countries, in particular to the USSR (see different agreements in Table 1). In other cases a large part of the offsetting exports consisted of important minerals. Frequently the raw materials just mentioned represented output of the development assistance projects themselves. Thus, co-operation in oil prospecting, exploitation and processing of Algeria, Iran, Iraq and Afghanistan with Eastern European countries and, in particular, with the USSR, have almost always involved exports of oil or natural gas in order to offset, at least partly, the assistance and related imports from the donor country. Similarly geological research for minerals and mining projects have generally implied exports of minerals, e.g. of iron ore from Brazil, Algeria, Iran and Pakistan and of phosphorous from Iraq, Egypt, Tunisia and Morocco.

1/ See, among others, J. Wilcynski, "Problems of East-West Trade", and also, I. Outters-Jaeger, "The Development Impact of Barter in Developing Countries", op.cit., as well as the case studies on India, Egypt and Sri Lanka carried out in the frame of this project of the OECD Development Centre.

TABLE 1: Selected Bilateral Agreements on Economic Co-operation Between Centrally Planned Economy Countries and Major Developing Countries Implying Barter-Related Investment Mechanisms

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
Afghanistan	USSR	28.1.56	Earliest Agreement on Economic Co-operation	Agriculture Irrigation Hydro-electric power Airports Industry Mining Oil industry	Total 134.4 mill. US $	2 per cent p.a. interest 30 maturity years 8 years grace period Repayment in 22 equal annual instalments	Repayment through deliveries of goods from Afghanistan
		(a) 16.10.61 (b) 6. 2.68	Agreements on Economic and Technical Co-operation in accordance with 2nd and 3rd 5-year plans	Oil industry Chemical industry Geological research	(a) Total 177 mill. roubles (b) Total 177 mill. roubles	2% p.a. 12 maturity years	Repayment through deliveries of goods from Afghanistan according to parallel concluded trade and payments agreement and related protocols, in particular through exports of natural gas
		19.5.72	Agreement on Economic and Technical Co-operation during the 4th 5-year plan period 1972-77	Oil refinery Roads Geological research Hospitals	114 mill. roubles		– [illegible] mill. roubles are to be repaid in 30 years through deliveries of natural gas; – the rest to be repaid during longer period according to trade and payments agreement through deliveries of goods.
Algeria	Democratic Republic of Germany	16.3.70	Agreement on Industrial complex Médéa	Industrial complex Médéa	14.2 mill. US $ + 111.3 mill. mark for supply of equipment	10 maturity years	To be repaid partly in resulting output

Table 1 (continued)

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
Algeria (cont'd.)	USSR	(a) 27.12.63 (b) 3.7.64 (22.7.68	Agreement on Economic and Technical Co-operation Protocol)	(a)-Feasibility studies - geological research - industrial projects (b) Steelworks Annaba	(a) Up to 100 mill. US.$ (b) 127.7 mill. US.$		- Repayment in local currency into special (clearing) account, which may be used for purchases of Algerian goods at world market prices or be converted into convertible currency on mutual agreement - partial repayment in exports of iron ore
		28.12.68	Long-term Agreement on the supply of technical assistance and equipment up to 1975	Investment goods for agriculture industry infra-structure mining			Repayment through deliveries of Algerian goods, in particular wine, crude oil, non-ferrous metals, etc.
		(a) 14.2.72 (b) 27.2.76	Protocols on Economic and Technical Co-operation	(a) Equipment for extension of metallurgical complex El Hadjar, Coking plant (USSR supplies coke) etc. (b) Assist technically 100 projects e.g. - iron ore exploitation Gara Djebilet - complex for heavy machinery - desalination plant - energy production			Repayment through deliveries of goods according to Trade and Payments Agreements and related Protocols, in particular through wine, crude oil, citrus fruits, steel plates, mercury, lead and zinc concentrates. Exports are partly resultant output of USSR Development Assistance projects

Table 1 (continued)

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
Algeria (cont'd.)	Rumania	29.3.68	Agreement on Co-operation in mining industry	Oil prospection & exploitation, geological research			Payment for deliveries of oil drilling equipment from Rumania through exports of iron ore
		31.12.71	Protocol on Economic and Technical Co-operation	Oil drilling and technical assistance		Participation in costs Alg. Sonatrach 75%; Rumanian Geomin. 25%	Payment in deliveries of 1.1 mill. tons of iron ore and 500,000 tons of crude oil
	Peoples' Republic of China	(a) 9.10.63 (b) 25.12.64 (c) 7.5.75	Agreement on Economic and Technical Co-operation	(c) Agricultural development projects	(a) Loan: 250 mill.francs, Supply credit 250 mill. francs	Interest free	Repayment through deliveries of goods according to parallelly concluded Trade and Payments Agreements
Brazil	Democratic Republic of Germany	(a) 22.10.59 (b) 28.5.61 (c) 17.3.62 (d) 1.11.68	Agreements for financing of Economic Co-operation between Deutsche Noten Bank and Banco Nacional do Desenvolvimento Economico	(a) Supply of complete plants and equipment			(a) To be paid by exports of Brazilian goods (coffee, tobacco, sisal, nuts, oranges, wood, hides and skins) which are bought with deposits in local currency from clearing accounts
	Peoples' Republic of China	23.6.75	Agreement on supply of raw materials for Brazilian pharmaceutical industry				In exchange for Brazilian goods, i.e. sugar, soja beans and iron ore.
	Czechoslovakia	May, 1973 May, 1974	Agreement on co-operation in setting up a hydro-electric power plant	Supply of equipment for hydro-electric power plant, tools, textile machinery, cement works	40 mill. Swiss francs		To be repaid in Brazilian goods, in particular coffee and iron ore
		17.9.76	Protocol on Economic Co-operation				

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
Brazil (cont'd.)	Poland	1973	Agreement on Economic Co-operation in mining and other industries	- steel industry - coal industry - agricultural machinery factory - railway development			
		(a) 18.4.73 (b) 20.12.76	Agreements on supply of raw materials (2 parallel contracts)		130 mill. US.$		(a) Brazil supplies 5.5 mill. tons iron ore against 4 mill. tons coal from Poland (b) Brazil supplies during 10 years: magnesium, kaolin and iron ore to Poland against deliveries of coal from Brazil
		26.2.76	Protocol on Economic and Technical Co-operation and on supply of equipment	Supply of equipment for projects and of chemicals	1.6 mill. US.$		To be repaid in Brazilian goods, in particular soja beans and cakes
	Rumania	29.10.74	Protocol on supply of industrial equipment	Supply of machinery and industrial equipment from Rumania			To be repaid through deliveries of Brazilian iron ore to Rumania
Colombia	USSR	5.9.77 (5.1.78)	Agreement on Economic and Technical Co-operation (Protocol)	- Hydroelectric power stations - Irrigation projects	Total credit 290 mill. US.$ Machinery supplied from USSR 100 mill. US.$ + commercial credit 40 mill. US.$ (5 years). (sub-supplier Westinghouse)	4.5% p.a., period of repayment 10 years	To be repaid by Colombia in exports of goods, in particular coffee and other agricultural products, but also in industrial products

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
Egypt	Bulgaria	23.10.65 24.12.70 9.3.73	Agreements on Economic, Technical and Scientific Co-operation	Agriculture food processing	12 mill. US.$ 25 mill. US.$	2.5% p.a. 8 years period of repayment from date of final delivery of equipment	Repayment in Egyptian pounds through clearing account
	Peoples' Republic of China	21.12.64 (19.1.69) (Renewal up to 1985)	Agreement on Economic and Technical Co-operation	(1965-68) to finance imports of complete plants, (including 3 years plant operation), equipment, raw materials and technical assistance	345 mill. Swiss francs	Interest-free, repayment in 10 equal annual instalments	Repayment in goods and/or in currency upon Chinese request
	Czechoslovakia	(a) 15.6.60 (b) 21.3.62 (c) 10.3.65 (d) 2.3.73	Agreements on Economic and Technical Co-operation (Protocols and contracts up to 1970)	Supply and installation of complete industrial plants, power stations, sugar refinery, metallurgical projects	(a)(b) & (c): Total = 47 mill. £ sterling; (d) = 40 mill. £ sterling	2.5% p.a. interest, local costs to be financed by Egyptian Government	Repayment in goods within the framework of the trade and payment agreements in force. In case of termination of agreements, repayment into special account
	Democratic Republic of Germany	(a) 29.8.58 (b) 1.3.65 (c) 26.11.70	Agreements on Economic and Technical Co-operation (supplemented by Protocols up to 1974)	30 industrial plants	Total 32.5 mill. £ sterling	2.5% p.a. interest, local costs financed by Egyptian Government	Repayments in Egyptian pounds into a special account of which deposits would be transferred into ex[illegible] clearing account for use in the [illegible] of existing trade and payment agreement

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
Egypt (cont'd.)	Hungary	(a) 19.10.62 (b) 7.2.66 (c) June, 1977	Agreements on Economic and Technical co-operation	Supply of complete plants, machinery and equipment, spare parts and technical assistance for food industries, food storage, railway development, light industry, ship-yards	Total (a) + (b) = 25 mill. £ sterling; (c) = 1.6 mill. US.$	Balances in special account 2.5% interest p.a. (10 maturity years)	Repayment through special account, to be used to finance current Hungarian payments to Egypt
	Poland	(a) 5.7.62 (b) 7.12.64 (c) 27.7.67	Agreements on Economic and Technical Co-operation (supplemented by Protocols up to 1975)	For imports of capital goods and equipment covering 20 industrial activities	(a) + (b) total = 60 mill. US.$	2.5% interest p.a.	Repayment through deliveries of goods, in particular of cotton, in accordance with existing trade and payments agreement
		7.12.64	Agreement on supply of mining equipment and machinery		30.0 mill. US.$		Repayment through deliveries of phosphate
		Dec. 1966	Agreement on Aluminium work	Installation and supply of complete aluminium works + provision of raw materials for it	19 mill. US.$		Repayment over 10 years in resultant output
	Rumania	1[illegible].4.65 (valid from 26.2.66 to 26.2.78)	Agreement on Economic and Technical Co-operation (supplemented by various protocols up to 1977)	Industrial projects in: metallurgy building ceramics petroleum		Outstanding balances each year bear 2.5% interest p.a. Local costs to be financed by Egypt	Repayment in deliveries of iron ore, phosphates and [illegible] soda [illegible]; - [illegible] account [illegible] for [illegible] [illegible] - [illegible] .A. to [illegible] Egypt- [illegible]

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
Egypt (cont'd.)	USSR	(a) 29.1.58 (b) 22.9.64 (c) 1971	Agreements on Economic and Technical Cooperation (supplemented by various protocols and contracts up to 1976)	- Cooperation in 65 projects - geological research and mining - metallurgical engineering - oil industry - machinery - steel works - electronic, chemical, pharmaceutical, textile and food industries - hydro-electric power stations USSR supplies: - machinery and equipment + technical know-how - technical assistance - training	(a) 700 mill. roubles = 175 mill. US.$	2.5% interest p.a. Period of repayment: 12 years Local costs to be financed by Egypt	Repayment through deliveries of goods (in particular cotton) in accordance with existing trade and payments agreement in force, or in convertible currency
		(a) 27.12.58 (b) 27.8.60	Agreements on Economic Aid and Assistance for the construction of the Asswan High Dam (supplemented by a large number of protocols and contracts)	(a) first phase (b) second phase up to termination	(a) 400 mill. roubles (b) up to 900 mill. roubles = 225 mill. US.$	(a) Period of repayment: 12 years, starting 1 year after first phase but not later than 1.1.64 2.5% interest p.a. (b) 12 years period of repayment, beginning 1 year after termination 2.5% interest p.a.	Debt servicing payments in special account, which will be used for purchases of Egyptian goods (mainly of raw cotton) or be converted into convertible currency. If costs should exceed the loan, the overdraft may be paid by Egypt through deliveries of goods in accordance with existing trade and payments agreements

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
Egypt (cont'd.)	USSR (cont'd.)	3.9.67	Agreement on Research in oil prospecting		40 mill. roubles (44.4 mill. US.$)	2.5% interest p.a. 12 maturity years	Repayment through deliveries of oil from Egypt
India	Czechoslovakia	24.11.59	Agreement on Economic and Technical Co-operation in the frame of the third 5-years plan (1961/62 - 65/66)	Industrial plants	48.5 mill. US.$	2.5% interest p.a. 9 maturity years 1 year's grace period	Repayment through deliveries of Indian goods
		(a) 11.5.64	Agreements on Economic and Industrial Co-operation	(a) Extension of rural industrial plants (b) Extension of all industrial plants set up with Czechoslovakian aid (c) Steel industry - Energy industry - Fertilizer production - Research institutes - Electrification of railway - Mixed companies in third countries	400 mill. In.ks. (a) = 34 mill. US.$ (140 mill. Rs. for spare parts) (c) 300 mill. Rs.	2.5% interest p.a. 12 maturity years 3 maturity years	Repayment through deliveries of goods

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
India (cont'd.)	Poland	(a) 7.5.60 (b) 1.4.66 (c) 27.11.68	Agreements on Economic and Technical Co-operation, Protocols up to 1975	(a) Coal mining and processing - tool machine factory - aluminium works - grain silos (b) Industrial co-operation in complementary production to increase bilateral trade (c) Co-operation in coal mining	(a) About 30 mill. US.$	(a) 2.5% interest p.a. 8 years period of repayment	Repayment through deliveries of Indian goods, in particular oil cakes and iron ore
	Rumania	(a) 3.4.68	Agreements on Economic and Technical Co-operation (supplemented by various protocols up to 1976/78)	- Processing and refining of oil - chemical and petro-chemical industry - fertilizer production - supply of ships - co-operation in supply of industrial plant to third countries		2.5% interest p.a.	Repayment in local currency in special clearing accounts, which is used for purchases of Indian goods, in particular iron ore and steel products
	USSR	2.2.55	Agreement for setting up the steelwork Bhilai (Protocols for extension [illegible]/74)	Steelwork Bhilai, comprising coking plants, furnaces, steel casting plants, etc.	[illegible]60 mill. roubles (= 137.5 mill. US.$)	2.5% interest p.a. Period of repayment 12 years	Repayment in result- and output

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
India (contd.)	USSR (contd.)	(a) 9.11.57 (b) 13.6.59 (c) 12.9.59 (d) 10.12.66	(a) + (d) Agreement on Co-operation in setting up industrial plants (b) Supplementary Agreement (various other protocols and contracts) (c) Credit Agreement to support third 5-year Plan	- Heavy machinery - mining machinery - glass factory - steam power plant - coal processing - pharmaceutical industry (c) Among others: Extension of Steelworks Bhilai and heavy trading plant Ranchi - oil and natural gas prospecting and exploitation	500 mill roubles (= 125.5 mill. US.$) (c) 1.50 mill. roubles (= 375 mill. US.$)	2.5% interest p.a. 12 years period of repayment	Repayment in Indian rupees, which USSR will use for purchases of Indian goods or/and convert into £ sterling
		(a) 25.1.65 (b) 20.2.70	(a) Agreement on co-operation in setting up the Steelworks Bokaro (b) Agreement on extension of Steelworks Bokaro (Additional Protocols 1973 & 1976)	Steelworks Bokaro among others: - coking plants - furnace plant - cold and hot rolling mills - various plants for materials (b) Extension of Steelworks Bokaro up to 1976	190 mill. roubles (= 211.1 mill. US.$)	2.5% interest p.a. Period of repayment 12 years	Repayment in Indian rupees; the USSR will use deposits for purchases of Indian goods, mainly resultant output, and/or convert them into £ sterling

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Commitments Credit Volume	Terms of Credit	Method of Repayment
India (cont'd.)	USSR (cont'd.)	5.4.76 18.6.76 11.8.76 10.9.76 19.12.76 April 78	Agreement and Protocols and Contracts concerning Industrial Co-operation and supply of Indian investment goods and raw materials to third countries	-Metallurgical equipment and steel equipment to Turkey - USSR projects in Bulgaria, Turkey and Cuba - equipment for USSR projects in Iraq, Iran, Libya, Algeria and Nigeria - 4 cranes for nickel-complex in Cuba - co-operation in heavy engineering for steelworks in Egypt and Turkey, India supplies technical know-how as well as prefabricated construction material			

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Credit Volume	Terms of Credit	Method of Repayment
Iran	Czechoslovakia	(a) 29.1.66 (b) 2.5.68 (c) 12.3.69	Agreements on Economic and Technical Co-operation (The agreements have been supplemented by various Protocols and contracts up to the beginning of the 1970s)	Supply of: complete plant and equipment for industrial projects in -machinery -hydro-electric power -metallurgy -ceramics -sugar factories -chemicals -cement works	(a) 15 mill. US $ (b) 200 mill. US $ (c) 200 mill. US $	10 years maturity (a) 2.5% interest p.a. (b) 2.5% interest p.a. 12 years maturity (c) 2.5% interest p.a. Period of repayment 12 years	(a) Repayment through deliveri of goods from Iran (b) Parallel to the Protocol were concluded: - a 5 years Trade Agreement, particularly in order to arrange the deliveries of 15-20 mill. tons of crude oil from Iran during 1970-80; and a -Payments Agreement (c) Repayment through deliveries of crude oil (20 mill tc tons) during 12 years
		1.12.76	Agreement on Economic Co-operation	Multiangular co-operation, construction of natural gas pipeline to Western Europe			Transit payments through deliveries of natural gas
	Rumania	(a) 25.9.65 (b) 24.1.68 (c) 18.3.67	Long-term Agreements on Economic and Technical Co-operation (supplemented by numerous protocols and contracts up to 1976)	(a) Supply of machinery, equipment and other materials (b) Mainly for agriculture (c) Mainly for industry	(a) 100 mill. US $ (b) 10 mill. US $ (c) 31 mill. US $	2.5% interest p.a., partly 10 year maturity, partly 8 year maturity	(a) + (c) Repayment through deliveries of crude oil; accounting in US $ through clearing accounts, which shall bear an interest of 2.5% p.a. (b) Repayment through deliveries of crude oil (in supplement to quotas in Trade Agreement)

Developing Country	Centrally Planned Economy Partner	Date	Kind of Agreement	Projects	Credit Volume	Terms of Credit	Method of Payment
Iran (Cont)	Rumania (Cont)	8.8.66	Agreement on Economic Co-operation in production of tractor assembling plant	Supply of complete plant and equipment and parts for assembling as well as of technical assistance			Repayment through deliveries of oil
		(a) 24.1.68	Agreements on Economic and Technical Co-operation	(a) Woodworking industry, supply of equipment and machinery and technical assistance	(a) 10 mill. US $		(a) Repayment: 20% in resultant output; 80% in deliveries of crude oil
		(b) 3.9.69		(b) Industrial plants + technical assistance	(b) 100 mill. US $	2.5% interest p.a. 8 - 10 maturity years	(b) Repayment: 85% through deliveries of crude oil; 15% in industrial goods from Iran
	USSR	(a) 27.7.63 (b) 13.1.66 (c) 15.4.67 (d) 22.6.68	Agreements on Economic and Technical Co-operation (Supplemented by numerous protocols and contracts up to 1976)	Dams + hydro-electric power stations -fisheries -grain silos (a) Extension of steelworks at Isfahan, geological research and well-mining projects.	(a) 35 mill Roubles (=38.89 mill. US $) (b) 260 mill. Roubles (=288.9 mill US $) (c) 160 mill. Roubles (=177.8 mill. US $)	(a) 3.6% interest p.a.; 12 years period of repayment (b) + (c) 2.5% interest p.a. repayment in 12 years	(a) Repayment in local currency, which may be used for purchases of Iranian goods or converted into convertible currency, costs for assistance in fishery projects and construction of grain silos to be repaid through deliveries of fish, certain fishery products, metals, wool, cotton a.a. (b) Repayment in local currency to be used for purchases of natural gas, cotton, raw wool and other specified products or converted into international currencies. (c) Apart from before mentioned deliveries, also repayment in deliveries of crude oil. (d) Repayment in local currency, which will be used for the purchase of Iranian natural gas, lead, zinc, oil and industrialised products or converted into international currencies