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**MICRO AND SMALL SCALE AGRO-BASED INDUSTRIES IN THE CONTEXT OF
THE URUGUAY ROUND AGREEMENTS IN LDCS***

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* The view expressed in this document are those of the author and do not necessarily reflect the view of the Secretariat of UNIDO. This document has not been edited.

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Chapter 1

Where the problems lie

The largest difficulty facing the 48 Least Developed Countries (LDCs) is quite simply one of internal stagnation. This has been partly caused by heavy over-specialisation in too few types of economic activity to the detriment of industry and manufacturing. This is true in virtually all of the present LDCs except two -- Malawi and Ethiopia. In these two African states industry constituted around 60% of GDP by 1991. By contrast, basic subsistence agriculture constituted at least 30% of GDP in most of the other LDCs -- figures range from 30% on Guinea to 67% in Somalia.¹

Problems caused by the lack of industrial development in LDCs have been compounded by the fact that Governments have in the past made the mistake of intervening too much in the few sectors which already exist. The encouragement of state-owned industry has brought with it a number of market imperfections which have slowed growth. One such difficulty has been to try and develop industries in which the country has no obvious comparative advantage; which have received badly-directed and insufficient investment; and which are very wasteful. For instance, little attention has been paid to manufacturing, which is vital for long-term economic growth. Much of state-owned industry is also either purely-export oriented and, as a result, the earnings it generates do not go back into the rest of the economy; or provide no exports at all, offering few countries an export-led escape from debt problems.

Very large amounts of state subsidies and investment funds have been given to state industry in LDCs, often at the expense of private-sector, micro- and small-scale enterprises. Many local commercial banks have also shown overly-strong preferences towards state-owned enterprises (SOEs). This trend genuinely needs to be reversed to encourage further growth, as re-directing investment funding towards more dynamic parts of the economy, such as newly-privatised firms and small-scale, private-sector companies, has pulled other developing countries in parts of Asia and eastern Europe out of recession and into the fast lane of development.

While changing the structure of industry in LDCs could help eradicate economic stagnation and increase living standards, foreign trade conditions need to be altered to enhance economic performance. This has become particularly important since the conclusion of the Marrakesh Agreements during the Uruguay Round of GATT, which will open up the very vulnerable economies of the LDCs to the volatile world market.

Paying back the huge international debts accumulated in many LDCs during the 1970s and 1980s has proved a crippling burden to these delicate economies. Firstly, the debt burden is so high in some LDCs that repaying creditors has diverted valuable investment funds from basic development projects to merely service basic debt obligations. For instance, Guinea's debt-service ratio is a staggering 200% per year. Other LDCs in Africa and in Asia have debt-service ratios as much as 50-60% per year. Spiralling debt levels have also resulted in the

¹ UNIDO, PPD/IPP:REG

cutting off of most new external sources of finance. This has not prevented the purchase of modern technology and know-how from abroad, it has resulted in widespread import substitution, which has created further inefficiencies, as the LDCs have been forced to gear their output towards self-sufficiency rather than to international comparative advantages.

Although very fragile and far from stability², the LDCs have gone through a period of reform beginning in the mid-1980s. In order to reach a greater level of development and stability, the World Bank defines the way forward as:

- * getting macroeconomics policies right -- stabilising price changes, employment levels and the exchange rate;
- * encouraging competition by liberalising tightly-controlled parts of the economy;
- * using scarce institutional capacity wisely -- removing unnecessary government intervention in markets.

Many LDCs are far from these goals, but some have begun to make vital reforms. For example, a number of countries have enacted privatisation programmes, partially liberalised their exchange rates and lifted controls on a selection of prices. This paper examines these reforms in the light of the need to expand private-sector, micro- and small-scale industries in key sectors where many LDCs have obvious comparative advantages such as in agriculture, textiles and light engineering. It also briefly looks at public sector reform, particularly in terms of investment financing; and at the impact of the Uruguay Round of Agreements on future industrial development. This document contains a number of recommendations detailing how certain obstacles to industrial restructuring can be overcome and how this fits into the more general requirement for economic reform, as outlined in the UNIDO Industrial Action Programme.

² *The World Bank's definition of economic stability is as follows: annual inflation of less than 10%; very low budget deficits (generally less than 1-3% of GDP); and a competitive (market-determined) exchange rate.*

Chapter 2

Selected sectors and industry patterns

Establishing viable businesses in the most appropriate industrial sectors is of the utmost importance to the future development of the LDCs. In the past industry has either been concentrated in too few sectors or has been established in areas where there is no clear comparative advantage. Most LDCs have valuable resource bases in sectors such as agriculture, textiles, wood, tobacco and light engineering. Some of these sectors are already important parts of industrial sector, others require more development. Certain types of output - - such as basic food processing; textiles and leather-work; and the making of basic metal goods -- are already a staple of most LDC industrial sectors, though substantial work has to be done to make the most of these industries and to promote less developed areas, such as services.

Agro-industry

Agro-industry is potentially one of the most important industrial sectors for the LDCs. Agriculture, as a whole, is a very dominant part of GDP and several key sub-sectors could be developed from this important resource base. For example, the World Bank³ estimates that agriculture accounted for 35% of GDP, 40% of exports and 70% of employment in sub-Saharan Africa in 1994. Subsistence agriculture, for example, is over 30% of GDP and engages over 85% of the population in Chad and Malawi; and is around of 40% GDP and over 90% employment in Burundi. The importance of agriculture to these economies is further emphasised by the fact that many of the countries of this region obtain most of their export earnings on the rather turbulent coffee and cocoa markets. In Asia, the dependence on agriculture is as equally strong as in sub-Saharan Africa. In Bangladesh, agriculture accounts for 44-48% of GDP and 80% of employment, as it does in Myanmar and Bhutan. In addition, agricultural products already make up a high level of industrial output in the LDCs, for example in Nepal (see Table 1 below). It is, therefore, hardly surprising that much of the emphasis in future industrial policy should be directed towards agro-industry.

³ *Adjustment in Africa: reform, results and the road ahead*, World Bank 1993

Table 1

The production of selected manufactured goods in Nepal 1991/1992

Commodity (unit)	amount
Sugar (million tons)	55,265
Animal feed (million tons)	21,682
Vegetable ghee (million tons)	12,242
Soft drinks (thousand litres)	13,410
Beer (thousand litres)	12,329
Cigarettes (million units)	6,963
Synthetic clothes (thousand metres)	11,445
Jute goods (million tons)	17,639
Processed leather (thousand square feet)	6,892
Paper (million tons)	6,417
Soap (million tons)	20,903
Plastic goods (million tons)	4,885
Cement (million tons)	237,327
Steel utensils (million tons)	159
Agricultural tools (million tools)	453

Source: World Bank, Department of Industry of Nepal, Nepal Rastra Bank

In fact, raising the number of agro-processing possibilities could improve both domestic and foreign sales of agro-industrial goods; increase exports; stimulate the growth of new sub-sectors and related-business services; and create new capital.

Other key sectors

Much present economic activity in LDCs is based in agriculture. However, there are a number of other sectors which could prove vital to future economic growth and stability. These include textiles and garments; and light engineering and metal products. These industries make up far less of GDP than agriculture, but are essential for improvements in domestic living standards, as well as being a vital source of export earnings.

Textiles are important income generators in countries as far apart as Bangladesh (cotton and leather), the Central African Republic (textile and leather processing), Uganda (cotton production), Sudan (leather processing), Madagascar (textiles and garments) and Burkina Faso (general textile manufacturing).

Light engineering and the making of metal products have considerable potential in LDCs. These sub-sectors hold a wide range of products suitable for manufacturing in a wide range of less developed economies -- such as the making of industrial machinery and components for the domestic market; as well as machinery for agriculture. In addition, there is considerable potential for technology transfers between more developed parts of the world and the LDCs through component manufacturing for the car-making industry and the engineering

sector, as well as the making of castings and forgings. Countries which are already trying to develop metal-product and component production include Mauritania and Nepal.

Not only is there scope for economic development through agro-based industries, textiles and light engineering, the service sectors of LDCs require much-needed investment. It will be essential over the next few years to plough well-aimed funding into the upgrading of banking, telecommunications and postal services; as well into the other utilities to support other emerging parts of the LDC economies. There is also room to develop services, such as tourism, which can bring in substantial export funds and feed them back into the local economy. Two of the few LDCs which have capitalised on this type of service provision are Maldives and Gambia.

Industrial patterns

Industry makes up only a very small proportion of GDP in many LDCs. However, this sector has proved to be a constant drain on resources, particularly in the case of finance. There are a number of serious problems which are endemic in LDC industry such as low productivity; a lack of trained workers; the inability to mobilise finances effectively; an abundance of out-of-date technology; a lack of foreign investment and a very under-developed private sector.

Industrialisation in many LDCs began initially through natural resource extraction and through the partial processing of agricultural goods. Most of the products made in the LDCs were targeted at the world commodity markets rather than for domestic consumption. This meant that although industry started to earn export revenues, it became very vulnerable to changes in the world market and brought little money into the local economy. This lack of linkage was made worse by the fact that the products made in LDCs were sold virtually exclusively on the world's most volatile commodity markets. For example, uranium mining and processing in Niger declined sharply from 13% of GDP in 1980 to 8% of GDP in 1986 due to continuous falls in the world price for radioactive metals. Other LDCs have faced economic decline due to their reliance on sales into the world cocoa and coffee markets.

A second weakness within the present structure of LDC industry is its lack of modern technology. Many of the sectors which have come to dominate the productive sector are technologically-undemanding and are highly dependent on the abundance of cheap, local labour. The result has been that most of the profit made from these industries has been kept in the hands of a few foreign investors and of the government, while the low wages paid to many industrial workers have not allowed them to raise their standards of living. The low wages and living standards of industrial workers has had an impact on the rest of the economy, as there has been little income trickling back into other sectors such as services and agriculture.

One very strong feature of the industrial sector of many LDCs is that of state dominance. For example, over 60% of output in the cement, tobacco and agro-chemicals sectors in Nepal are produced by SOEs. This pattern is similar in sub-Saharan Africa. State-owned enterprises in many LDCs have become a severe burden on the public sector and on the economy as a whole due to their wastefulness. This is particularly apparent when it comes to financing, as state industries have often received disproportionately-large amounts of central budget

funding. In Burundi, for instance, net public sector outflows to industry are around 19% of the total state budget or rather 25% of gross expenditures (one and a half times the national education budget). This is very high when the fact that industrial production makes up only 15% of GDP is considered.⁴ The same applies to a host of other LDCs, which are literally pouring cash into the stagnant state sector -- in Mali, for example, public spending on industry was 18% of GDP in 1991-1992.⁵

The wastage created in public-funded industry has been further added to due to a lack of proper monitoring. Few countries audit state enterprises thoroughly enough and on a regular basis. The inability to monitor SOEs properly and lack management techniques has brought many enterprises to the verge of bankruptcy and has forced governments to dig deep into the public purse to maintain employment levels.

Despite the ever-growing problems facing LDC governments, many have been slow to deal with difficulties in industry. Some privatisation has taken place, though mainly on an ad-hoc basis rather than through the large-scale, tightly-co-ordinated programmes seen in other rapidly-developing countries such as the Czech Republic and Poland. Nevertheless, progress has been made and some sell-offs have resulted. One of the countries which has made the most progress towards the privatisation of state industry is Benin, which had divested 100 of the 120 SOEs present in its economy in 1989 by 1994. Some were privatised, others were liquidated. In Gambia, 28 enterprises were privatised between 1989 and 1992 and in Mozambique 216 were sold off between 1987 and 1993⁶. Another country with a progressive privatisation programme is Nepal. Several factories, such as Bhaktapur Brick & Tile, Bhirkuti paper Mill and the Bansbari Leather Factory were all sold off successfully in the early 1990s (see the box below for details of Nepal's privatisation programme). However, these sales of LDC SOEs are only the tip of an iceberg, as both these firms and those which still remain in state hands need major restructuring.

⁴ *Figures for 1991 from Private sector development and accelerated growth of industrial enterprises in least developed countries*, UNIDO, April 1995

⁵ *Mali: Public expenditure review*, World Bank, June 1995

⁶ *op cit.*, UNIDO April 1995

Privatisation in Nepal

The privatisation programme under way in Nepal is typical of the type of sell-off programmes being conducted in other LDCs. Several factories were privatised in the period 1990-1993, with 14 more slated for privatisation during 1994 and 1995. Features of the programme were

- * All of the sales were conducted through tenders, except in the case of the Bhaktapur Brick and Tile Factory, where only the machinery and equipment was available for sale and the government held on to the factory's land holdings.
- * Up to 30% of the shares in each enterprise entering the programme were made available to the employees through government financial support schemes so that they could maintain an interest in the factory in which they worked.
- * A number of older employees were encouraged to take voluntary retirement with compensation at the time of the factory sale to reduce over-manning.
- * Other private sector developments, such as the development of micro- and small-scale enterprises have been encouraged by the programme.

Source: World Bank, 1994

Although the LDCs have made positive steps forwards through privatisation, this process has brought with it a number of problems. Firstly, there is a lack of clarity concerning the definition of the term privatisation. In Ghana, for instance, a publicly-owned vegetable oil factory was classed as being privatised recently, although it was sold to another state-owned firm and, thus, stayed in state hands! Another difficulty is re-training the management of newly-privatised companies to work in a more market-oriented manner and not to expect government bail-outs any moment they might get into financial difficulties. Thirdly, privatisation generally increases unemployment rates, as has been seen in eastern Europe (for example, Poland's employment rate in mid-1995 was over 15%⁷) and can lead to long-term financial misery for newly-laid off workers if there are no jobs to be found elsewhere in the economy.

In other words, although privatisation is probably one of the most effect ways to restructure existing state firms, it should not be embarked upon by itself. While the establishment of privatisation programmes has started to ease the burden industry is placing on the state sector and on the economies of the LDCs, it is not enough just to sell-off existing firms and expect everything to work out smoothly. New companies need to be created to ensure increased domestic competition and provide better linkage between industry and the rest of the economy. One of the most effective ways to ensure this is to encourage the development of a small-scale industrial sector to grow in parallel with the restructuring of existing industrial firms.

⁷ *EIU Business Report Poland, Quarter 3, 1995*

Chapter 3

Micro- and small-scale industries

Encouraging the growth of micro- and small-scale enterprises has proven to be an important part of economic transition in many parts of the developing world, most notably in south-east Asia and eastern Europe -- for example in the Czech Republic, Poland, Romania and Vietnam. Such dynamism cannot be ignored by the LDCs, as the combination of privatisation with micro- and small-scale industrial development is producing positive results in other developing nations.

At present, micro- and small-scale firms constitute only a very small part of the industrial sector, something between 5-20% in most LDCs such as Laos, Benin and Guinea. This amount of small, private-sector businesses needs to be expanded to improve growth prospects and living standards. While, in principle, it is not hard to establish the need to encourage micro- and small-scale industrial development, the present lack of growth of this sector indicates that there are a number of fundamental problems facing small businesses in LDCs. The business climate in many LDCs is harsh to say the least. The list of difficulties facing micro- and small-scale businesses is long, though the most typical problems include:

* **Registration difficulties:** Registering a micro- or small-scale enterprise can be a lengthy process, fraught with bureaucracy and requiring high registration fees. Entrepreneurs can not only be loaded down with large amounts of paperwork, but may also have to seek special permission to set up their firms from local ministries. While it may be appropriate to demand special permission to establish a business in certain highly sensitive parts of the economy, for example in the defence sector, having to file for permission to establish a small firm in very single part of the economy may prove detrimental to general development. It was for this type of reason that the government of Nepal removed the requirement to get ministerial approval of all but a few types of small businesses in 1992. Other LDCs will need to follow suit if they want to take advantage of rapid small-business growth in the future.

* **Price restrictions:** These prevent the sale of goods at their market price and can make the setting up of small businesses unviable as controlled prices are often below market rates and thus affect profitability. A case in point is the sale of petroleum-based goods in west Africa. Not only do price controls discourage the retailing of petroleum-based goods by private firms, they act as a strong disincentive to potential small-scale producers of goods derived from petroleum, such as plastics, paints and other commodities.

* **Labour restrictions:** Present labour practises make it difficult to run small businesses in LDCs. Current labour legislation is very protective of industrial labour rights and is highly inflexible. There is an urgent need to remove restrictions in the hiring of staff, such as the demonopolisation of state employment agencies. In addition, many entrepreneurs face difficulties in dealing with collective lay-offs, as in some countries this requires ministerial approval. Wage settlement procedures are also cumbersome in many LDCs. For example, in Mali the government still sets a legal minimum wage for most vocational employment categories which must be adhered to by all firms.

* **Monopoly restrictions:** The number of state-owned monopolies in LDCs is high. Not only are there monopolies in the production sphere, which automatically mean the exclusion of small enterprises from a particular line of business, but there are also large sales monopolies and trade monopolies in many less developed states. The inability to freely negotiate prices and sell goods on to retailers is a strong disincentive to producers wanting to participate in the domestic market and prevents the strengthening of linkages between different sectors. Other entrepreneurs face the dilemma of dealing with trade monopolies, because of which governments restrict access to trade licences and foreign currency only to the state sector.

* **Access to funding:** The lack of availability of credit for the development of micro- and small-scale businesses has also stunted their growth. Most official commercial and government lending is directed at the state sector, leaving little cash for investment in new private companies. Other unofficial sources of finance are sparse and hard to mobilise (see the following chapter for more details).

* **Taxation:** Few LDCs give tax breaks to newly-established micro- and small-scale businesses, exposing them to the same level of taxation as well-established state-owned firms. Corporate income tax rates in many LDCs are relatively high due to the need to finance the central budget, which subsidises SOEs -- i.e. the private sector is taxed to fund the state sector. For example, corporate income tax revenues in Nepal were NR1,468.3 million in 1992/93 or rather 25.8% of total central budget revenue. Most of this revenue went to subsidise loss-making SOEs -- NR1,293.7 million worth of direct public sector subsidies went to industry and mining in 1992/93, according to the Nepalese Ministry of Finance. This is over 88% of total corporate income tax revenue for the year.

* **Other restrictions:** Most of the problems faced above are common to all LDCs with few exceptions. However, some LDCs have made establishing and running small-scale businesses even more difficult than average through very-specific legal procedures. In a small number of countries there are what is termed as "economic sabotage" laws, which mean that entrepreneurs' actions could be interpreted as illegal if they do not conform to very specific norms.

All of the above are very serious disincentives to the development of micro- and small-scale businesses in LDCs, as well as to newly-privatised (formerly state-owned) companies. They also require fundamental changes in the way many LDC economies are run and can only be remedied, if there is the political will to deal with them, over a considerable period of time before positive results can clearly be seen. Nevertheless, it will be essential to reform the following:

- * pricing policy -- to make it more market-oriented;
- * foreign trade laws to give small businesses access to international markets;
- * the bureaucracy -- to allow the easier creation of micro- and small-scale businesses and rid the economies of the LDCs of monopolies;
- * and the banking sector -- to garner the capital needed to achieve longer-term growth.

Chapter 4

Financing micro- and small-scale enterprises in LDCs

The availability of adequate financial resources is essential to the promotion of micro- and small-scale enterprises in LDCs, as well as to the future of newly-privatised, former state firms. Both these types of companies need access to many different sources of capital including:

- * **Foundation capital** -- the funding required to permit registration of a business as stated in local company laws. This "ground capital" must be at least the minimum required to start a business as stated in local law. If not even the minimum foundation capital as stated under local law cannot be successfully raised by an entrepreneur, he or she cannot open a business.
- * **Working capital** -- the money required to conduct day-to-day business and to keep a company's cash flow healthy. Restricted access to working capital, which generally takes the form of short-term loans of less than one or two years, can create liquidity problems for small firms, particularly if the financial system itself is weak. Ultimately, the inability to access working capital can result in bankruptcy.
- * **Investment capital** -- the capital needed to buy new machinery and equipment, invest in training programmes, conduct modernisation and expand rapidly-developing businesses. In most economies this type of capital is generally only available once the micro- or small-scale firm has established a reliable track record and commercial lending bodies, such as banks, have enough reliable information to determine whether the business involved will be a medium- and long-term success.

All three types of funding are essential to rapid private-sector development. However, not all types of capital are available in many LDCs either formally or informally because of the lack of accumulated savings and because of poor financial resource management. Mobilising the local savings pool and encouraging the agglomeration of those resources will significantly improve credit-making potential in LDCs. These new holdings could then be used to create new capital -- provided credit-giving bodies understand how to lend money to their clients.

Formal sources of finance

The formal finance sector in LDCs consists of central budget funding; foreign aid and grants; and commercial bank loans. Most of the capital created through these three sources goes to state-owned industrial enterprises rather than to the small-scale private sector. The inability to raise capital through formal sources is stunting the development of micro- and small-scale enterprises in LDCs and is starting to hurt these economies as a whole.

State budget funding

Very large slices of the state budgets of many LDCs go directly to subsidise loss-making state companies. In recent years, pressure has been put on the LDCs to reform public expenditure patterns and cut direct subsidies to state-owned firms as part of more general fiscal reform programmes suggested by the World Bank and IMF, though with very mixed results. The

government of Mali is typical of many in LDCs which have tried to cut public spending on industry during the early 1990s, but still have large outgoings. Public spending on SOEs may have gone down from 25% of GDP in 1987, but was still at a high as 18% in 1992.

While some cuts in public spending on state sector industry are being made, very little of the funding saved is used for micro- and small-scale enterprise promotion. It would be foolish to argue that the state should subsidise small businesses rather than state-owned firms, but state funds can be used to provide the following kind of services to small companies:

- * legal advice on how to set up and run a business;
- * lower-cost land and property organised either in run-down industrial areas or on special development sites in undeveloped regions;
- * better infrastructure, such as better roads, postal services, telecommunications and public transport; and
- * better sewage, electricity, water and waste disposal systems.

The provision of such services does require quite large amounts of cash and could only be achieved in many LDCs on a long-term basis. However, improvements like better telecommunications and electricity supplies will benefit the rest of the population, as well as the small businesses themselves.

Commercial bank loans

Commercial bank funding is as oriented to the state sector as is state budget funding of industry. In Guinea, for example, over 90% of commercial bank loans were given to SOEs during the early 1990s, despite the fact that SOEs made up only 25% of GDP. This trend is disturbing as the primary source of commercial investment funds in most developed economies for private sector development comes through savings, which are deposited with financial institutions such as banks, which in turn gather the savings made and use them to make commercial investments. This is not the case in many LDCs for the reason that few commercial banks are willing to lend funds to high-risk, small-scale entrepreneurs when they can make loans to lower-risk state-owned enterprises -- most SOEs are considered lower risk for the simple reason that if they default on a loan the central budget will bail them out. The unwillingness to give credit to new private sector customers is compounded by the fact that few bankers in LDCs have been trained properly to assess risks and are, thus, unable to judge whether or not an idea is viable.

Getting access to commercial bank credit is one problem. Making credit available to any potential customer in an LDC banking system is another. The commercial financial systems of the LDCs require urgent reform as they have failed to mobilise local savings; allocate financial resources efficiently; offer a means of diversifying financial risks; and provide services to facilitate trade -- all of which are essential to promote stronger industrial and economic growth.

The weaknesses of the banking sector are of particular concern in sub-Saharan Africa, where

bank deposits were on average less than 15% of GDP in the early 1990s.⁸ The lack of savings in sub-Saharan economies has stemmed from low savings ratios, which averaged at around 8% in the late 1980s compared with 20% in India and 33% in south-east Asia⁹; poor banking practices, which gave savers little confidence in placing their funds in local banks; negative interest rates, for example the real interest rate in Rwanda was -9.9% per year and in Sierra Leone -30.7% per year in 1990-1991 according to the International Monetary Fund¹⁰; and a high general level of poverty. The economic crisis of the 1980s and early 1990s has also had a negative effect on the commercial banking systems of much of sub-Saharan Africa due to the large amounts of unpaid debts which enterprises have incurred which are blocking the financial system. In addition, many so-called "commercial" banks are, in fact, government-owned and do not operate on a proper commercial basis. For instance, the state is the major shareholder in four out five of Burkina Faso's largest commercial banks, none of operate on a purely on commercial criteria.

Reforming the banking system and getting it to respond better to the needs of small-scale businesses will greatly improve private sector development prospects. Some reforms to the commercial banking sector have already been enacted, such as putting ceilings on lending or re-capitalising local banks, though this has not eradicated its weaknesses. Madagascar and Mauritania have gone the furthest of the sub-Saharan LDCs to reform the commercial banking sector by liberalising interest rates, restructuring banks and privatising state-owned commercial banks. However, neither country has gone as far as liquidating any unviable banks or finance houses. The only African LDCs which have taken this step are Rwanda, Guinea and Senegal. In Asia, the Caribbean, the Middle East and Pacific, bank reforms in LDCs are even further behind those which have been completed in most of sub-Saharan Africa.

International aid and credit

Very little external financing is available to the majority of LDCs, as a result of debt crisis of the 1980s. Many of the poorest countries of the world are its biggest debtors, which have been unable to either service their present debt obligations or pay back the original amount owed. For instance, Mali had a very high debt-service ratio of 68% in 1991/92. Guinea has even bigger problems as its debt-service obligations were running at 200% in the early 1990s. The inability of many LDCs to service and pay back their debts has effectively cut off most forms of international aid and credit from both international institutions, such as the International Monetary Fund and World Bank, as well as from commercial sources, with a small number of exceptions -- for example, Mali received external financing equivalent to CFAF105.6bn in 1994¹¹.

The limited amount of foreign aid and credit available to LDCs is generally directed at the

⁸ *Adjustment in Africa: reforms, results and the road ahead*, World Bank, 1993

⁹ *Op cit.*, World Bank, 1993

¹⁰ *IMF figures from Adjustment in Africa: reforms, results and the road ahead*, World Bank, 1993

¹¹ *Mali: Public expenditure review*, World Bank, June 1995

achievement of macro-economic stability, rather than at small business. Some funding is provided by the likes of UNIDO for technical assistance during the economic reform process, though larger and more micro-economically-oriented sources of funds need to be brought into the LDCs before small businesses really start to benefit from foreign economic assistance.

Informal sources of financing

Most micro- and small-scale enterprises do not raise capital through the banking system or via the government as few small-scale firms have high levels of savings and collateral. Furthermore, the actual procedures needed to be followed to get a bank or government loan can be very complex. Complying with the terms and conditions required to fulfil loan obligations can be hard, if not impossible, due to the lack of information in less developed economies. Furthermore, many banks and government organisations have already developed strong preferences towards certain types of borrowers, such as well-established state firms, due to habit. As a result, many entrepreneurs have turned to less formal types of borrowing arrangements to finance their businesses.

The informal economy in many LDCs is large. It is hard to estimate the actual size of such undeclared incomes, though in a recent survey conducted by UNIDO on households in Senegal and Dakar, informal savings were around 16% of total household incomes, twice the average official savings ratio¹². Most of the informal income generated in LDCs takes the form of transfers of goods, services and money through brotherhoods, religious organisations, work on family farms and gifts at ceremonies. It is through these means which many entrepreneurs in LDCs start their micro- and small-sized enterprises and it is in the informal sector that many private-sector businesses stay in fear of high taxation and other state intervention (see the Chapter on micro- and small-scale industries for further problems facing small-scale entrepreneurs in LDCs).

Attempts have been made to harness informal sources of financing and convert them into financial co-operatives throughout the developing world to try and bring economies into the open. These schemes have worked in some places and not in others. In Romania, for example, farmers and small-scale entrepreneurs have been encouraged quite successfully to form credit unions to either lease or buy farm equipment or certain types of factory machinery and office equipment and share them among themselves. Similar experiments have taken place in LDCs, one example of which is Malawi, which has tried to harness its large informal savings pool through the creation of Smallholder Agricultural Credit Administrations, but with very mixed results. Mali is another LDC with experience of trying to harness its informal economic resources to make them function better and within the formal sector. Its experience is discussed below.

Mali has a large informal economy created through local "tontines". In an attempt to harness the resources of the tontines and other informal socio-economic groups, credit unions known as Groups d'Interet Economique (GIEs) were established to act as non-bank financial

¹² *Reconciliation and convergence: private sector development and productivity*, UNIDO, 1994

intermediaries with the assistance of the European Development Fund from 1987 onwards¹³. GIEs were designed to offer their members medium-term credits, through the creation of a joint savings and collateral pool, which would allow members to apply for either credits within the size of the individual GIE's savings pool or securitised by group savings and collateral from other financial institutions such as local banks and the European Development Fund. To set up a GIE, entrepreneurs in Mali have been required to:

- * participate in a monthly savings plan, which mobilises equal amounts of savings from each group member; and
- * use the savings they have made as a form of guarantee for loans to be made to group members by outside institutions. The initial contribution to the GIE's credit fund is 10% of the GIE's combined annual income.

Once a GIE has been established its members are entitled to apply for credit. Usually one project is granted a loan once the initial 10% payments have been made by all the GIE members, other credits to other members becoming available when 30% of the initial loan is paid back. This should reduce loan delinquency, as other members of the GIE force borrowers to pay back into order to get further credits for their own businesses.

In practice, the Mali GIE experiment has proved only a partial success due to problems in getting long-term commitment from group members. This has been particularly evident as regards savings, as few members of all of the initial GIEs were willing to save on a long-term basis. While the results of the GIE programme do not necessarily sound overly encouraging, there has been some positive progress made in encouraging entrepreneurs to initiate the savings and borrowing process. In other words, the programme was able to mobilise informal tontine savings at least on an initial basis in over 830 GIEs across Mali and increase access short-term access to credit.

Looking closely at the experiences of Mali, several lessons can be learnt which could be applied to other LDCs wanting create more formal forms of credit unions from informal means. There is a strong need to focus on what the individual will receive from joining a credit union or financial group. These financial benefits also need to appear within a reasonable amount of time once the initial conditions for joining a credit union have been met -- i.e. credit unions should not be swamped by bureaucracy. This has proved to be critical factor in the failure of some of the GIEs in Mali. Of 33 GIEs interviewed by UNIDO which have been taking part in the Mali experiment, 19 (58% of the total) had not been able to get cash from outside sources within the promised time.

A second lesson from the Mali experiment is the need to build savings and create credit mechanisms based on genuine common economic interests. Common interests and dependency on other members of the group played a vital factor in the success or failure of the Mali GIEs. Over 85% of the successful GIEs were composed of individuals with common activities or where the success of each individual influenced the group both in terms of credit availability and more generally. Furthermore, over 70% of the GIEs which were able to saving on a regular basis had close common interests.

¹³*Op cit.*, UNIDO, 1994

A further issue is the necessity to insist that members have both significant and equal stakes in the pool of capital created. In Mali, where participation levels have been lower in GIEs, they have been less successful. The initial 10% guarantee has been found to be too low to cover loan losses. Furthermore, many members without loans stopped contributions to the savings fund after the first credit was granted, unbalancing stakes in the credits which had been extended. Expanding the numbers of members in GIEs could also be a solution to this problem, as the higher the number of members the easier it becomes to garner savings and promote better credit mobilisation facilities.

Many of the less successful GIEs in Mali lacked discipline when it came to loan repayment and making regular savings contributions. In Romania, a high number of credit unions have failed for the same reasons. It is, therefore, necessary to create effective savings incentives and develop strong sanctions for loan repayment in credit unions and other types of organisation which mobilise informal savings. In less formal organisations, such as tontines, susus and rotary savings clubs, there are large amounts of strong self-discipline imposed on members. Perhaps, by creating tough penalties and by developing credit unions with stronger common interests, this lesson can be learned in more formal organisations.

On a more general level, it is widely recognised that there is a large informal sector in many LDCs, which not only contains high levels of unmobilised savings, but also large amounts of other unregistered forms of capital, goods and services. Getting the informal sector to come closer to the formal economy, particularly in the case of micro- and small-scale enterprises, without creating huge disincentives is one of the biggest challenges facing LDC governments wanting to promote future growth and wealth creation.

Foreign investment

Foreign investment is a small, but important, element required for industrial development in LDCs. Attracting foreign investment can bring a number of critical benefits to less developed economies. Firstly, injections of foreign capital can significantly improve job prospects for local employees, raise production levels and contribute to future growth and wealth. Foreign investors also usually bring in new equipment and technology; a higher grade of managerial skills; and other know-how, such as intellectual property.

While foreign investment can bring very visible benefits to LDC economies both in terms of capital inputs and technology transfer, levels of foreign investment are generally low because of the poor business environment. Low real incomes and a heavy dependence on subsistence farming make market demand in many LDCs low. In addition, foreign investment rules are unclear or unfavourable in many LDCs, particularly concerning profit repatriation and investment guarantees. Foreign investors also face problems such as challenging giant local monopolies, hiring labour in a restrictive labour market and most of the other problems encountered by local small-scale entrepreneurs. Poor infrastructure and a lack of businesses services and good-quality banking services contribute to the hesitance seen in many potential foreign investors.

One way to promote foreign investment prospects in LDCs is to create a special foreign investment programme, such as in Laos, Bangladesh and in other LDCs. These types of programmes generally offer tax incentives, such as reduced corporate income tax payments;

special guarantees concerning the availability of land and infrastructure; and access to special free-trade and investment zones. However, even in countries such as Laos which have established special foreign investment incentive packages and programmes, it is unlikely that foreign direct investment levels will grow as quickly as they have in places like south-east Asia and China, where economic conditions are markedly better. Nevertheless, encouraging foreign investment will bring benefits to LDCs, particularly if investors are encouraged to link their activities with the rest of the economy. This can only be achieved through mobilising internal resources more effectively and creating a more competitive business environment.

Chapter 5

The Uruguay Round of Agreements and the loss of preferential treatment for products and commodities from LDCs

The economies of the LDCs were very protected from external shocks and received a high level of export privileges from the 1960s to the 1980s. The concept of LDC trade protection was originally designed to help infant industries in LDCs get off the ground and to limit the damage caused external price shocks. However, the same protectionism has done little to promote industrial growth in the LDCs, as it has restricted competition and allowed the misallocation of resources. There is a growing conventional wisdom which states that high levels of protectionism should be replaced by freer trade to stimulate economic regeneration. The desire to free world trade and reduce restrictions was the main resolve behind the Uruguay Round of Agreements of the GATT, during which most LDCs lost much of the preferential treatment given to their goods previously. However, while the desire to promote international competition could result in good longer-term effects on LDC economies, it exposes them to previously unseen levels of competition and economic shocks, which could have devastating short-term results that could crush such fragile economies.

While it is true that greater exposure to the world market and increased international competition could prove the greatest incentive to parts of LDC economies, the initial results of the Marrakesh Agreements from April 1994 are likely to be a reduction in the competitiveness of LDC products on the world market, particularly on the highly-volatile commodities markets for cocoa, various metals and other unprocessed commodities. Poor foreign trade results could deepen the present LDC recession.

Although short-term prospects do not bode well for many LDCs, there are ways of building up the economic strength to make the best advantage of the post-Marrakesh world order through trade reform, the promotion of new types of industry and through carefully-thought out political tactics

Trade reforms and the Uruguay Round of the GATT

There is no doubt that the present high level of trade restrictions in LDCs need to be cut to promote economic growth. The lack of freedom to import and export is seriously hampering private sector development. There are a wide range of barriers to free trade in LDCs ranging from import and export licences; tariffs and other types of customs duties; restricted access to foreign currency; and other non-tariff barriers such as limits on the transfer of intellectual property. These barriers need to be removed, slowly but surely, to allow more flexibility within LDC economies.

Import restrictions can be split into two groups: short-term import restrictions, such as the limiting of access to hard currency for the purchase of imports, and longer-term restrictions, such as the imposition of tariffs and import licensing. These tight controls have resulted in a general stagnation of trade and economic growth levels and in increased smuggling.

A number of LDCs have already been tackling the problem of import restriction reform for

several years, though the need to create a new system has become paramount since the Uruguay Round of GATT was concluded in 1994. While some progress in import liberalisation has been made, however, it has generally been very timid. Several countries have attempted to reduce the effects of short-term import restrictions, primarily by granting better access to foreign currency for import purposes. Ghana is an example of a country which has increased access to foreign currency. The government initiated radical reforms in the foreign exchanges system in 1983, which involved a complete overhaul of the way the exchange rate was set. The old foreign exchange system was based on a centrally-fixed exchange rate, which was very over-valued when compared with the informal (market) exchange rate. The government and the National Bank devised a currency auction system, which would allow demand and supply dictate the exchange rate and the purchasers of foreign currency.

However, the Ghanaian system which developed still allowed bidding at different exchange rates during the same market session, creating large market distortions. In addition, while more players were generally allowed to enter the foreign exchange market through the new system, some were still excluded and were also not permitted to retain all of the foreign currency they earned from exports.

Zambia has also enacted foreign exchange reforms. It has used a different method of foreign exchange reform to Ghana, which has allowed more retention of export earnings for the purchase of imports. Known as the "own funds method", the Zambian initially allowed companies throughout the country to purchase imports from their own retained export funds. The economy-wide limit on own-fund imports was up to \$100 million per year. However, more recently, the Zambian authorities have cut the maximum level of own-fund imports to \$7 million per year. This was because allowing enterprises to purchase goods in a parallel currency did not meet longer-term economic objectives, it was used basically to assist devaluation.

Tariffs

Countries which have tried to reduce import tariff levels and other long-term trade restrictions include Ghana, Rwanda and Tanzania. During the 1980s, Rwanda reduced its maximum tariff rate on imports from 270% to 100%. Tanzania has reduced its maximum tariff rate from 120% to 40%. Tariff rates in Ghana presently vary between only 10-30%.

Lowering tariff rates does not necessarily open up an economy to greater levels of imports, however, as they are not effective unless tariff structures are rationalised. A growing number of LDCs have attempted to rationalise their tariff systems by reducing the number of tariff rates, by getting rid of ad hoc exceptions and by applying rates according to more systemic criteria. Countries which have followed this path include Burkina Faso, Ghana, Mali and Senegal. Few, however, have actually lowered the average tariff rate, though they may have reduced the maximum and minimum tariff rates -- for example Rwanda, and Tanzania as described above. In fact, instead of making the customs duty and tariff system simpler through reform, some countries have raised the average level of tariffs over recent years, something the Uruguay Round Agreement is intended to stop.

While lower tariff rates could improve longer-term trade prospects, reducing customs levels

too far may threaten central budget revenues in many LDCs, as over 20% of public sector revenues come from tariff payments¹⁴. In other words, trade reform could create a potential conflict between the opening up of LDC economies to competition from abroad and finding sources of central budget funding. In light of these potential conflicts, LDCs need to create a more flexible customs system able to accommodate conflicting national and international goals, rather than just lower customs rates, to cut economic rents and reduce domestic economic distortions.

Import licensing

Import licensing restrictions are the other main long-term import barrier imposed by LDCs. Several nations have tried to reduce licensing restrictions, such as Tanzania and Zambia, though few have been successful in creating a more flexible import environment. One method which has been used to reduce the number of licensing rules is the open general licensing (OGL) system, which allows the liberalisation of most kinds of imports, but places a number on lists which grant them automatic licenses and access to foreign trade up to a given level. The authorities in question would then gradually expand the number of items on the OGL list and remove items from the "negative list" of products forbidden to enter the country without a licence. The advantage of the OGL system is that creates a list of import automatic licences which are available with guaranteed foreign currency backing in a quick fashion.

In practice, however, the usage of OGL systems has produced patchy results. For example, only 10% of all imports were on Zambia's OGL list in 1989. However, by 1992 95% of all import items were part of the OGL system, excluding oil and fertilisers. By contrast, Tanzania still had a large negative licensing list in 1991, despite beginning OGL style liberalisation in 1987.

Export promotion

Developing export promotion programmes is one way to encourage new sources of trade badly needed by LDCs adapting to the post-Uruguay Round world market. The basic principle behind export promotion programmes is to allow the growth of exports through market forces by taking away impediments to growth. This means giving traders better access to foreign currency; eliminating export licensing requirements and export monopolies; as well as facilitating exporters' access to inputs and capital. Through giving incentives to a wider range of domestic producers to export, as well as liberalising the country's domestic economy, the LDCs may be able to improve the efficiency of the industries on which it relies to bring in export revenues and possibly to create other competitive industries that the very limited number of markets in which they presently compete on a world-wide basis.

New industries and the Uruguay round of the GATT

Substantial changes need to be made to not only the trading systems of LDCs after the Marrakesh Agreement was finalised in April 1994, the new openness expected to be achieved through the liberalisation of the world trade regime and the end of much of the past

¹⁴ *Developpement du secteur prive et acceleration de la croissance dans les PMA*, Charles Vellutini

protectionism has go hand-in-hand with other reforms. In the case of the LDCs, much of the current economic structure will find it hard to adjust to the increased exposure to world market fluctuations which will result from the implementation of the Uruguay round of GATT. The lack of flexibility can not only be seen in the current trade regulations system, which needs to be modified substantial to fit into the new more open world economic framework, but within industry itself.

It is highly unlikely that the large, inefficient and inflexible state-owned enterprises which dominate the industrial sector in most LDCs will be able to adapt to the present round of changes in time to make a positive impact on LDC economies. These enterprises have been used to being very protected from international competition and have been used to certain trade privileges, such as better access to foreign currency than their private-sector competitors, which will be eroded during the next few years. Furthermore, as the LDCs loose their tariff privileges in export markets there is no guarantee that they types of goods and commodities they produce now will be competitive later.

It is more likely, however, that more flexible smaller private sector producers will adapt to the post-Uruguay round world faster that SOEs and, thus, should be allowed to compete along side larger state-owned and newly-privatised firms in both domestic and world markets. Micro- and small-scale enterprises have the following advantages over state-owned enterprises in the new, more open trade environment:

- * A higher degree of flexibility. It is easier for smaller-scale producers to adjust to international market changes than for larger, less dynamic state-owned enterprises.

- * Better export potential. The rapid development of the small-scale business sector has brought many of the less developed countries of eastern European, such as Albania, Bulgaria and Romania, out of recession. Smaller-scale enterprises have found very competitive niches in both the European and north American markets for a wide range of goods made virtually exclusively by small enterprises.

The main disadvantage of opening up the economy to rest of the world and re-orienting industry towards the small-scale private sector is that if there is a downturn in demand on the world market, the economy is more vulnerable to recession than if it is more protected and has a less market-oriented productive sector. While this may be true, smaller, more flexible production units generally bounce back from recession faster than larger, less flexible units, due to their quick adaptation possibilities. At this stage, with many LDC economies in such dire straits, this may sound unpromising, though if changes are not made, the situation could end up far worse.

World politics and the Uruguay round of the GATT

The initial reaction to the Marrakesh Round of Agreements in 1994 in many circles has been one of deep concern as regards LDC development. The loss of privileges the enactment of the Uruguay Round could, as discussed above, destroy large parts of the LDC economies. While this is a very sensitive issue, the LDCs are not without the political leverage to deal with any potential balance of payments crisis caused by rapidly-increased levels of imports. For instance, several of the east European countries which have just become members of the

GATT and have Europe Agreements with the European Union have used import surcharges to stem import growth to prevent huge balance of trade and balance of payments deficits from developing, after initially opening up their economies to more trade.

A typical case is Hungary, which developed a serious balance of payments deficit in 1994 of over \$2 billion. The Hungarian authorities approached the GATT and the European Union to allow them to impose the present 8% surcharge, which affects all items except basics such as medical equipment and children's' foods. The Slovak government has successfully used a 10% import surcharge to keep down import levels since 1993. The country had a tiny \$40 million trade deficit in mid-1995.

It may be possible that LDCs can follow these examples of learning to open up the foreign trade environment and then use selected, low-rate tariff barriers to stem imports into their economies on a short-term basis. This depends, however, on how well the LDCs can enact most of the preliminary conditions of the Uruguay Round, as without initially allowing foreign-made goods in, they will not be able to ask for special treatment.

Conclusion

Developing and restructuring the micro- and small-scale enterprise sector in industries where LDCs have an obvious comparative advantage will prove vital to future growth, especially in the light of the Uruguay Round of GATT. Not only will increases in the numbers of micro- and small-scale enterprises create greater diversity in LDC economies, but they will also:

- * Encourage greater domestic competition. This can be achieved through the establishment of micro- and small-scale businesses and through the privatisation and restructuring of SOEs;
- * Provide better forwards and backwards linkage between industry and the rest of the economy. Many small businesses will be establishing themselves in sub-sectors or in services related to existing industries, rather than always mimic present industrial patterns. Allowing the creation of such sub-sectors will encourage linkage between primary sectors -- mainly agriculture and mining -- and the rest of the economy;
- * Replace inefficient and illiquid state-owned enterprises which are no longer economically viable through competing them out of business; and
- * Respond faster to changes in the world trade system.

In order to achieve better small-scale sector growth, LDCs need to:

- * Improve legislative conditions for the establishing of small, private businesses. This includes easing registration rules and allowing small businesses to compete in formally monopolistic markets;
- * Increase the amount of finance available to small-scale entrepreneurs by cutting state budget expenditure on SOEs, reforming the banking sector and developing more alternative means of finance;
- * Eradicate price controls; and
- * Enact trade reforms to allow better access to foreign markets.

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