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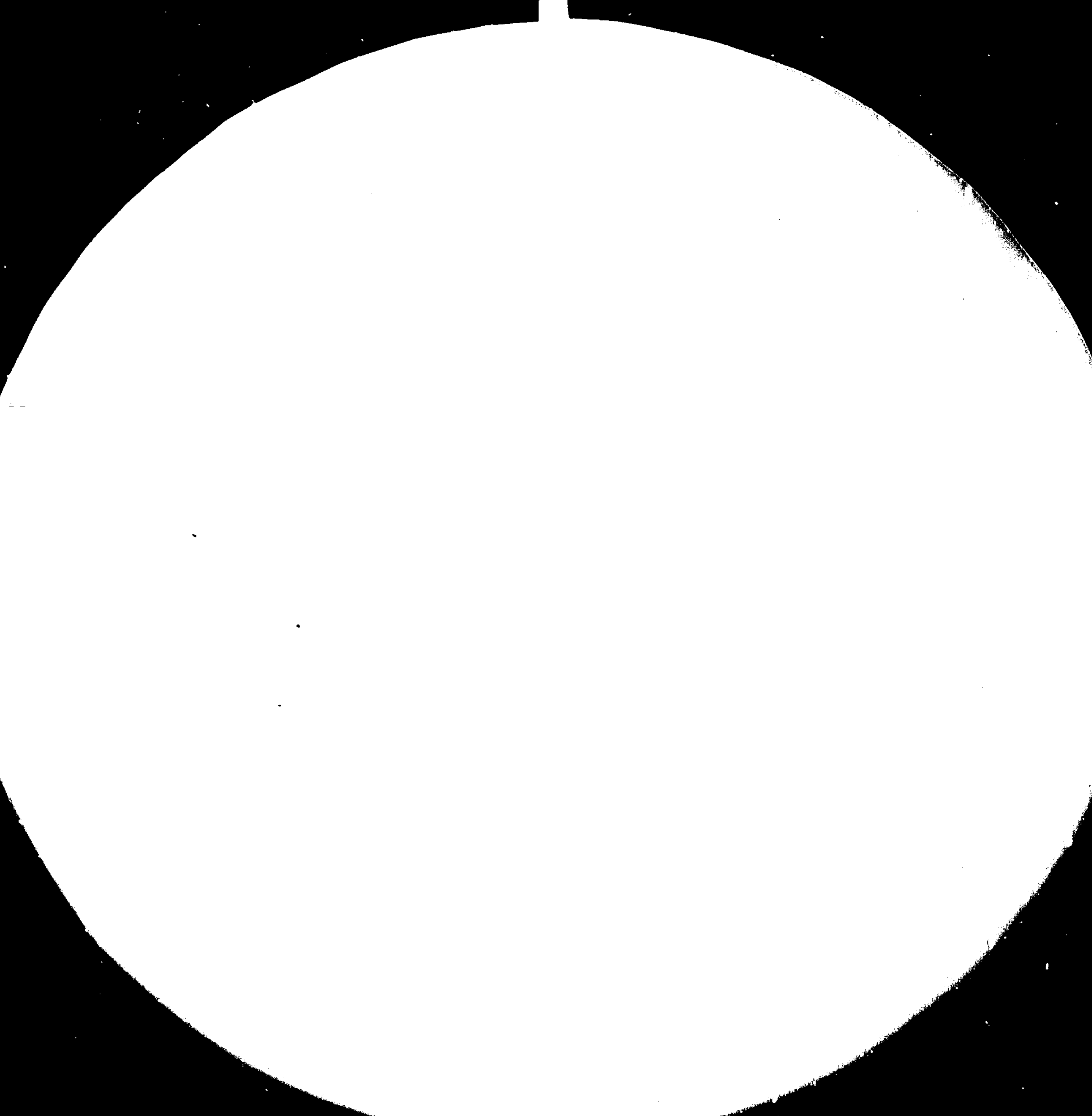

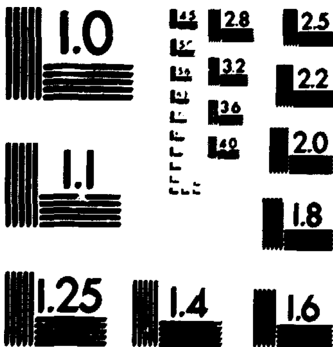

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INTERNATIONAL FINANCIAL FLOWS TO INDUSTRY: SOME SECTORAL TRENDS*

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2862

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** UNIDO consultant.

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Preface

This paper reviews recent trends in international lending to certain sectors of industry. This is in accordance with the Board's resolutions with respect to the work on industrial financing within the System of Consultations - "Work on industrial financing should be pursued with regard to each sector in respect of which Consultations had been scheduled".[1]

In order to provide some perspective on the sectoral trends of international industrial finance, a brief overview of the financial flows is presented in the introductory section. Given the diversity and confidentiality of much of the information, it was not possible to analyse overall trends in sectoral financing from both private and public sources of industrial finance. Instead, information available on lending trends by the World Bank and its affiliates has been used. There are two reasons for focusing on World Bank lending as opposed to other multilateral bodies: (i) it is one of the major co-financiers of development today and performs a lead role in international lending operations, and (ii) data relating to committed investment in industry are easily accessible and so provide a good starting point for the analysis. In addition, for many developing countries, it is the major external source of finance for industry.

(UNIDO Secretariat)

1/ See ID/B/L.318, 18 May 1984, Report of the Eighteenth Session of the Industrial Development Board, Agenda item 9, para. 10.

Background: Trends in industrial finance flows to developing countries

1. Trends in financing specific projects have to be seen against the background of the global economy in recent years. The last ten years have rather vindicated the persistence of business cycles - recession in 1974/1975 with slight recovery towards the late 1970s and from 1981 onwards, a recession that the world economy is yet to come to grips with. Restrictive monetary and fiscal policies adopted by industrialized nations in coming to grips with their own inflation have over time further aggravated the problem of structural adjustment and short-term economic management in developing countries. This has led to a prolonging of recessionary pressures in the developing world which, for some countries, have reached crisis proportions.

2. All this has tended to highlight the increasing interdependence of countries over time. One of the most distinctive features of this aspect of the inter-action between nations was the dominant role played by private capital flows in financing economic development, principally through the Euromoney market. This market grew approximately nine times between 1972 and 1981. Some countries, which had access to the market went in for heavy borrowing and due to the tightening of credit conditions, are now paying the price. Some developing countries, on the other hand, either did not or could not have access to the international financial market. On the whole, there were large global current account deficits and since 1973 medium-term private international bank lending and bond issues have financed two thirds of these deficits. This implied that the developed nations were themselves slowly becoming larger borrowers of funds in the financial markets. In fact, whereas in 1979 their share of total gross international borrowing was 48 per cent, it increased to 50 per cent in 1980 and 69 per cent in 1981.

3. Although international commercial bank lending to developing countries has been increasing, the real volume of private direct foreign investment has declined. Net direct private investment flows from OECD countries to developing countries were only about $10.2 billion in 1978, or $5.5 billion in 1973 values, compared with $6.3 billion in 1973.[2/] This was despite incentives and concessions made by many developing countries regarding laws

2/ IFC, Annual Report 1979.

governing foreign investment. Many governments attempted to make conditions in general more favourable for the inflow of foreign capital. Hence, this decline undoubtedly reflected unsettled economic and "political" conditions in the world economy.

4. The result of these two trends is that, since the very process of development involves imports of capital goods and services, the developing countries faced a double set back - slowing down of direct foreign investment and increasing competition in the international borrowing - lending environment. Further, because of the build-up of debt and also concern over the possibility of costly rescheduling procedures many private lenders felt that they had reached their lending limits to certain developing countries.

5. Thus, from a relatively "easy" position as regards the availability of funds, the poorer nations over the last couple of years have found themselves in a rather sorry plight. Their external positions have been considerably weakened by the astronomical foreign debt amassed and the austere economic adjustments imposed along with an acute lack of foreign exchange have drastically reduced the investment potential of their export-linked industries. Debt servicing (as a percentage of exports) in many countries has risen to 55 per cent, and in 1983, $11 billion more were paid out by developing countries as a whole than were received in new loans, representing a reverse flow of capital.

Sectoral trends in multinational lending to developing country industry

6. In the face of such economic malaise it would be interesting to consider the role played by the multilateral lending institutions - the World Bank with its affiliates in particular. When foreign capital is not forthcoming, lending/aid by multilateral institutions, though marginal for countries with relatively easy access to financial markets, provides the much needed breathing space to relax the foreign exchange constraint and exploit existing investment opportunities. Further, it also provides the necessary thrust to help spring an economy out of recession.

7. The inherent lumpiness of resources flows tied to specific projects prevents the categorization of lending operations by the IBRD, IDA and the IFC into continuous trends; however, in certain cases there is a clear shift away from or towards particular sectors. The dollar value in some cases has risen,

but if deflated by the price index to arrive at real flows, this increase is less clear. Moreover, in 1981/1982 total IFC investment actually fell, "a fact attributable to the lack of a few larger projects that could be realized due to the unattractive investment climate that prevailed in many developing countries throughout the year" (World Bank Annual Report 1982). It might be remarked also that during 1982 the investment climate in most developed countries was generally considered to be unattractive.

8. Moreover, the percentage change in total lending for the IFC, taking the previous year as a base, has declined constantly after 1978, i.e. the annual growth rate of IFC lending over time has not been maintained (Fig. 12).

9. As indicated in the attached charts, there has been a marked decrease in the proportion of funds directed to iron and steel (fig.13), fertilizers (fig.14), petrochemicals (fig.15), and manufacturing in general (fig.16). Lending to "agro-business and financial institutions have been proportionally higher. This reflects a policy of diversification by the IFC" (World Bank Annual Report 1982), i.e.there has been a swing away from the basic industries on which developing countries had previously placed such emphasis as a basis for industrialization and long-term development.

10. For the IBRD and IDA as a whole, lending in industry and development finance companies has declined proportionally in the period 1975-83 (figs.1 and 2). More specifically, there has been a shift away from iron and steel, fertilizers, building materials, and also some agro-based industries like food-processing and fisheries. Of them, iron and steel and fertilizers show a dramatic fall even in the total nominal dollar amount commited between 1975-1983 (figs.3 to 6).

11. However, in order to actually see a change in priorities or a break in the policy of investment in any particular sector, or how its development is viewed over time by finance agencies, a lot more specific information is needed as regards withdrawal from projects or the holding back of funds already commited. There are two problems here:

(a) Formal refusals are unusual and are not normally made public; and/or

(b) during the course of project preparation and loan application when projects are in the pipeline, developing countries learn if their projects will face difficulty in approval by finance agencies. During this process loan application withdrawals occur, but since it is normally a tacit exchange between the parties concerned, information is not usually disclosed.

12. Information on disbursements would solve the foregoing problem to some extent, but here again the sectoral level, data are not easy to come by. Hence the results presented here can be viewed as indicative only. Further they should be seen against the investment climate that existed to put them in their proper perspectives. (A note on this background is attached alongside).

13. Viewing the data available in some sense, as representative of other international development finance agencies, their role at best was conservative. It was in effect more geared towards stabilisation rather than long-term development, perhaps in view of existing institutional and legislative constraints, necessarily so.

Conclusions: Areas for international policy

14. To revive investment and prolong the economic recovery, many observers recognize that there has to be a move towards "appropriate" monetary and fiscal policies by the industrialized nations. Since, for an adequate recovery, both developed and developing countries require lower interest rates than currently obtaining, any further escalation of the level of interest rates would be disastrous. At the same time inflationary pressures should not be allowed to precipitate themselves.

15. When a developing country fights its ways out of recession, it always faces short-term liquidity problems. The road to recovery involves imports of those goods and services (i.e. spare parts, raw materials intermediates etc.) essential to the fruitful exploitation of existing production potentials and satisfaction of new investment opportunities. Recovery-linked demand for resources can cause serious problems to countries which, while on the path towards recovery, are already threatened financially. Hence, international commercial banks should continue net lending to prevent the lack of finance from becoming a biting constraint on recovery. In this they may also be

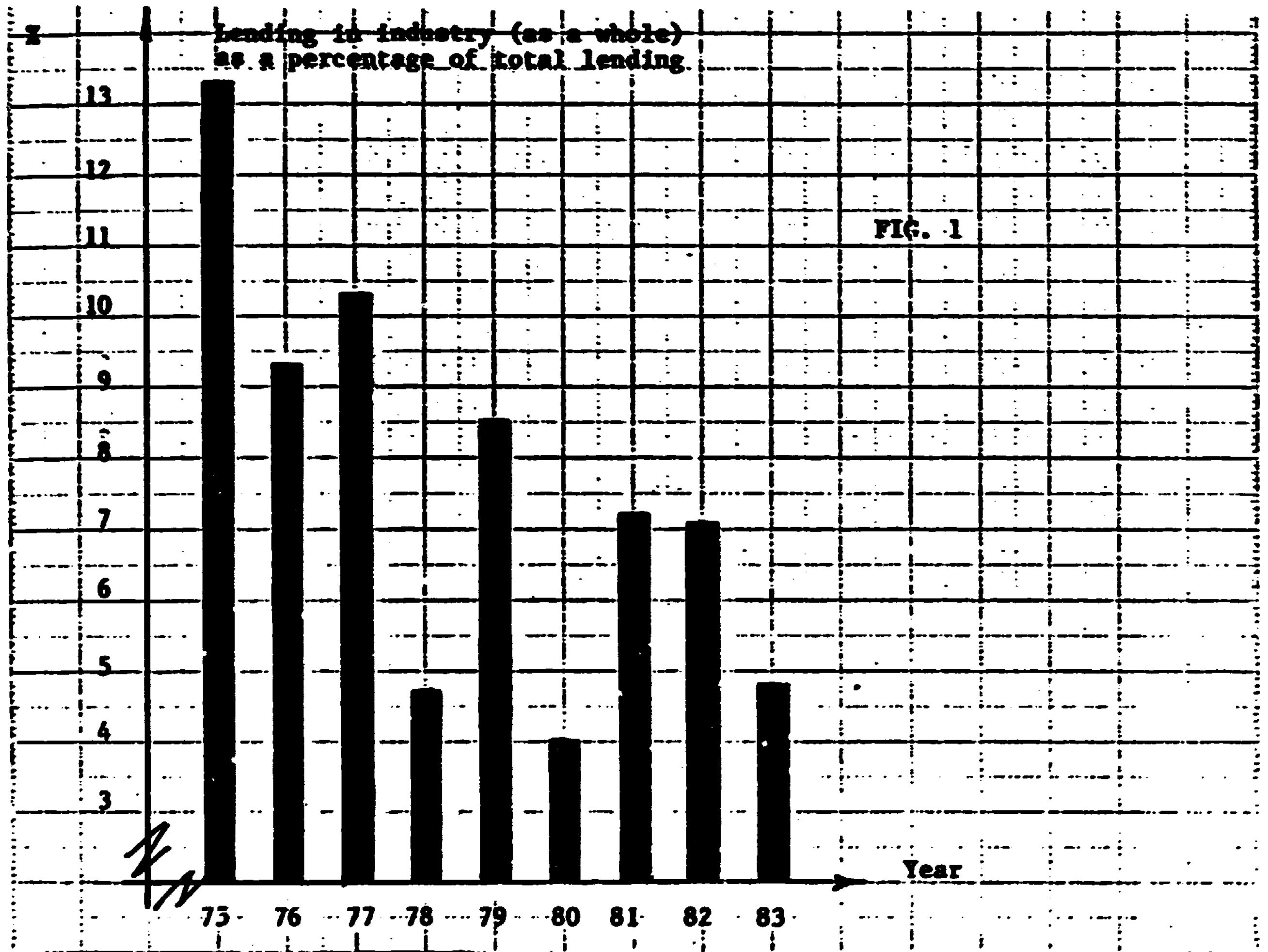
obliged to consider adjustments to interest charges, fund interest obligations, including capitalization of interest, stretch and repayment maturities, or some combination of the foregoing. (It is interesting to note that public discussion of the foregoing has recently become respectable.)[3/]

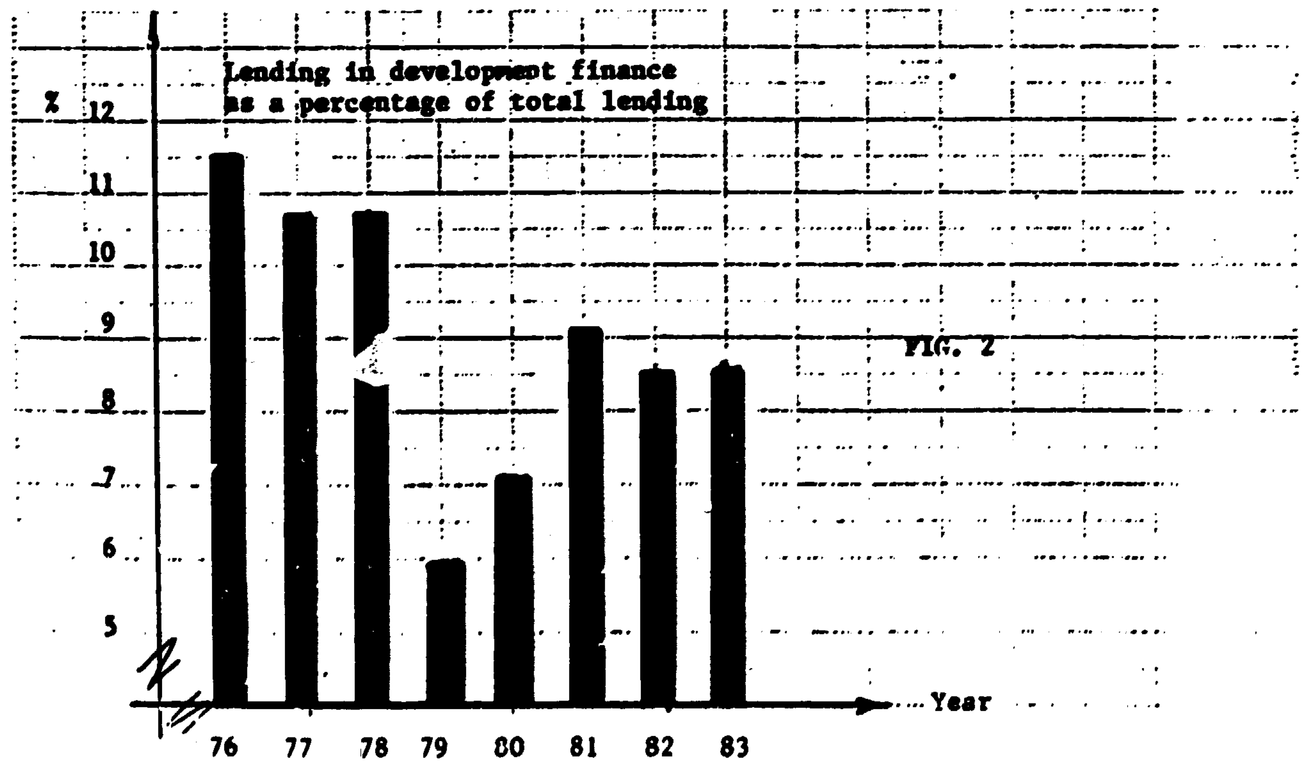
16. Further, the developing countries need to pursue appropriate adjustment policies to increase economic efficiency and enhance export potential. There should be a more determined and concerted effort towards structural change as well as a more cautious approach towards international commitments. Governments should be judicious in not losing sight of long-term objectives because of preoccupation with short-term economic management. Optimally, a "suitable" combination of both is of true order.

3/ But see ID/237 "Industry 2000: New perspectives", Chapter 2.

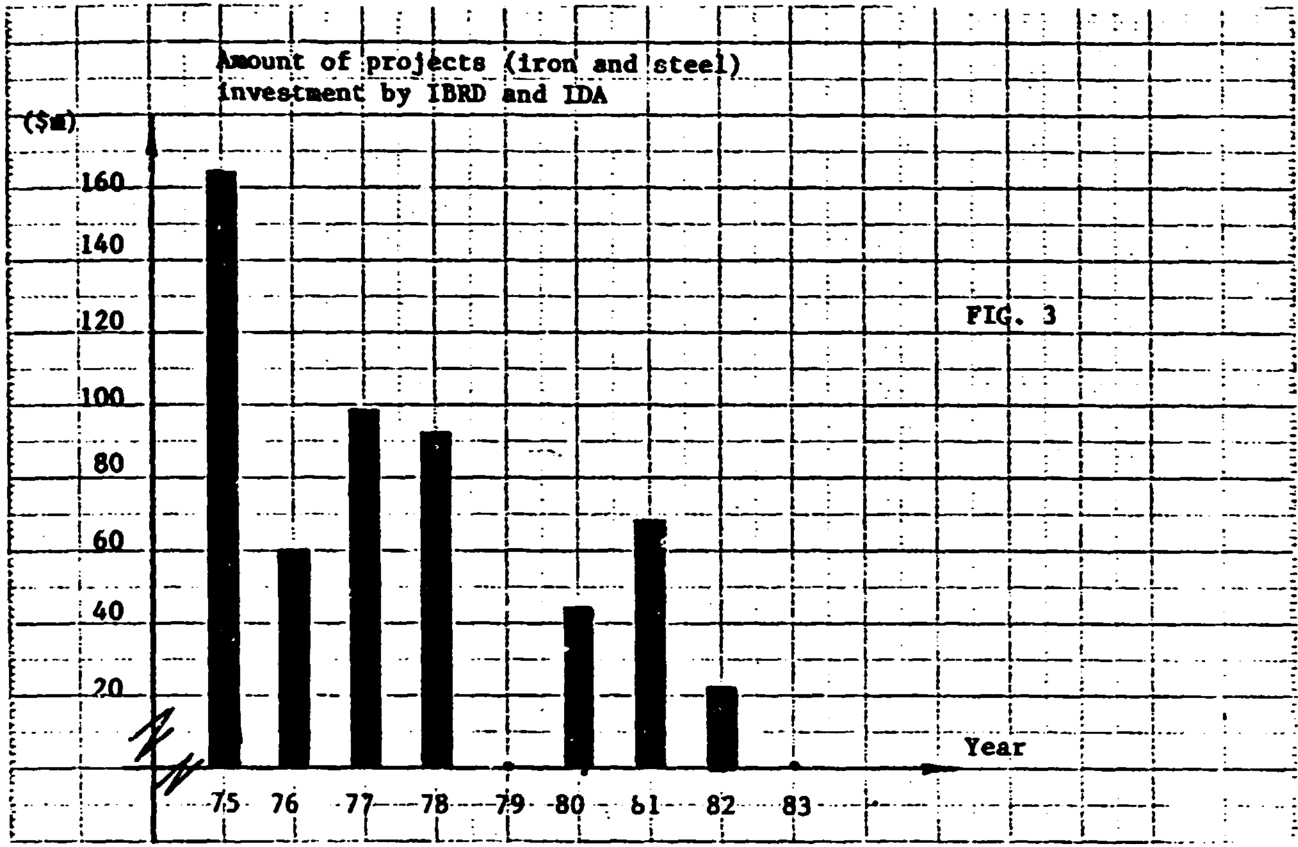
Appendix 1

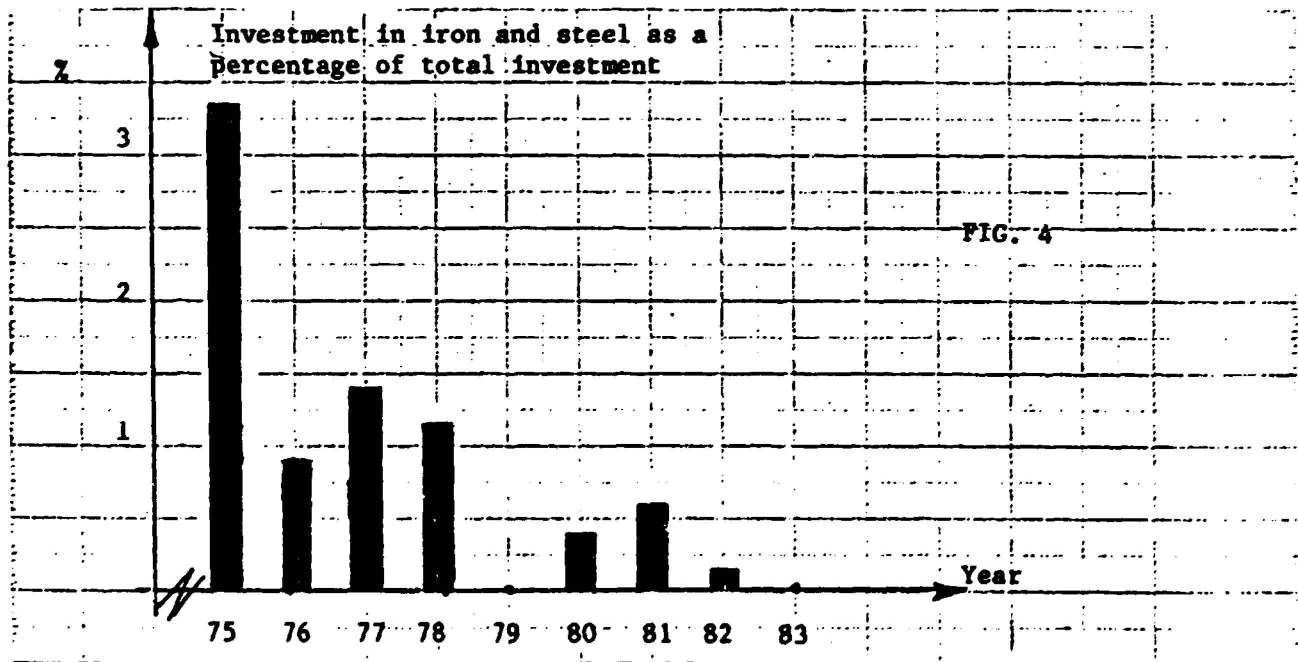
AGGREGATE ANALYSIS
IBRD AND IDA





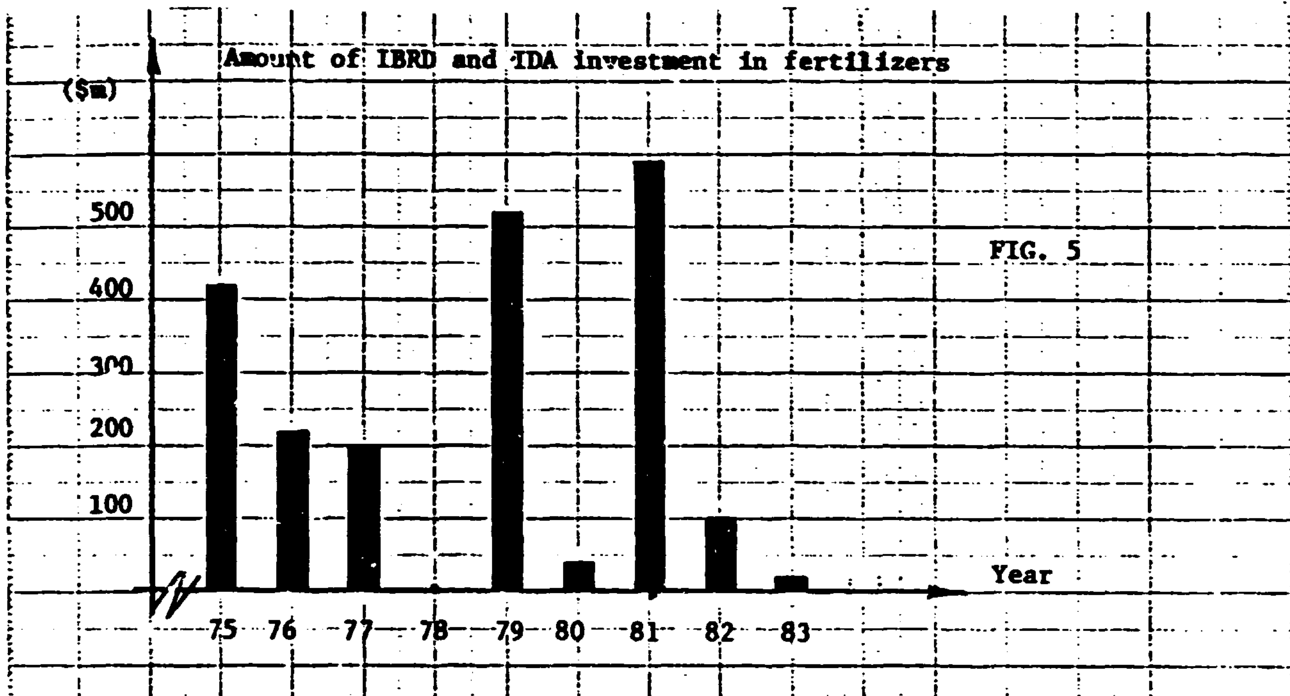
IBRD and IDA
Iron and steel

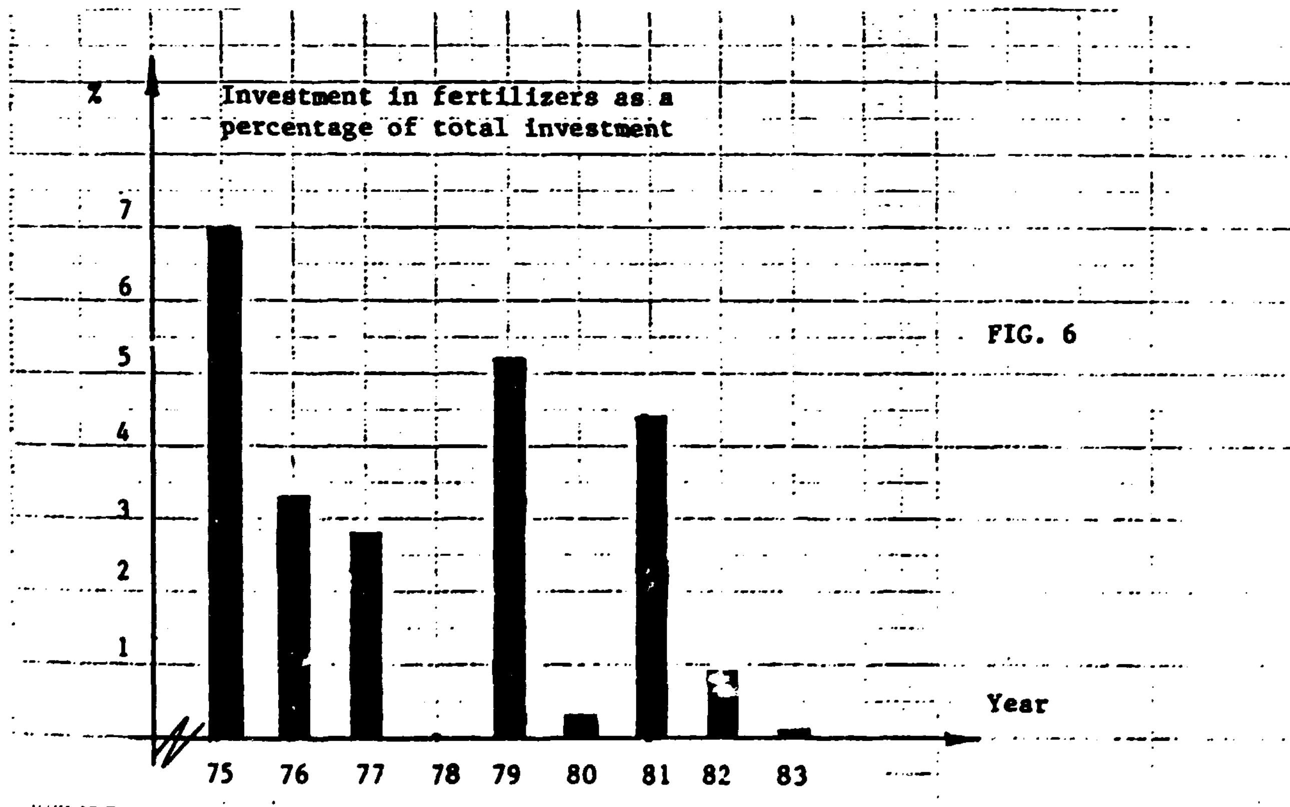




Figures 3 and 4: Investment in iron and steel has fallen rather sharply between 1975 and 1983, both in absolute dollar term as well as in proportionate terms.

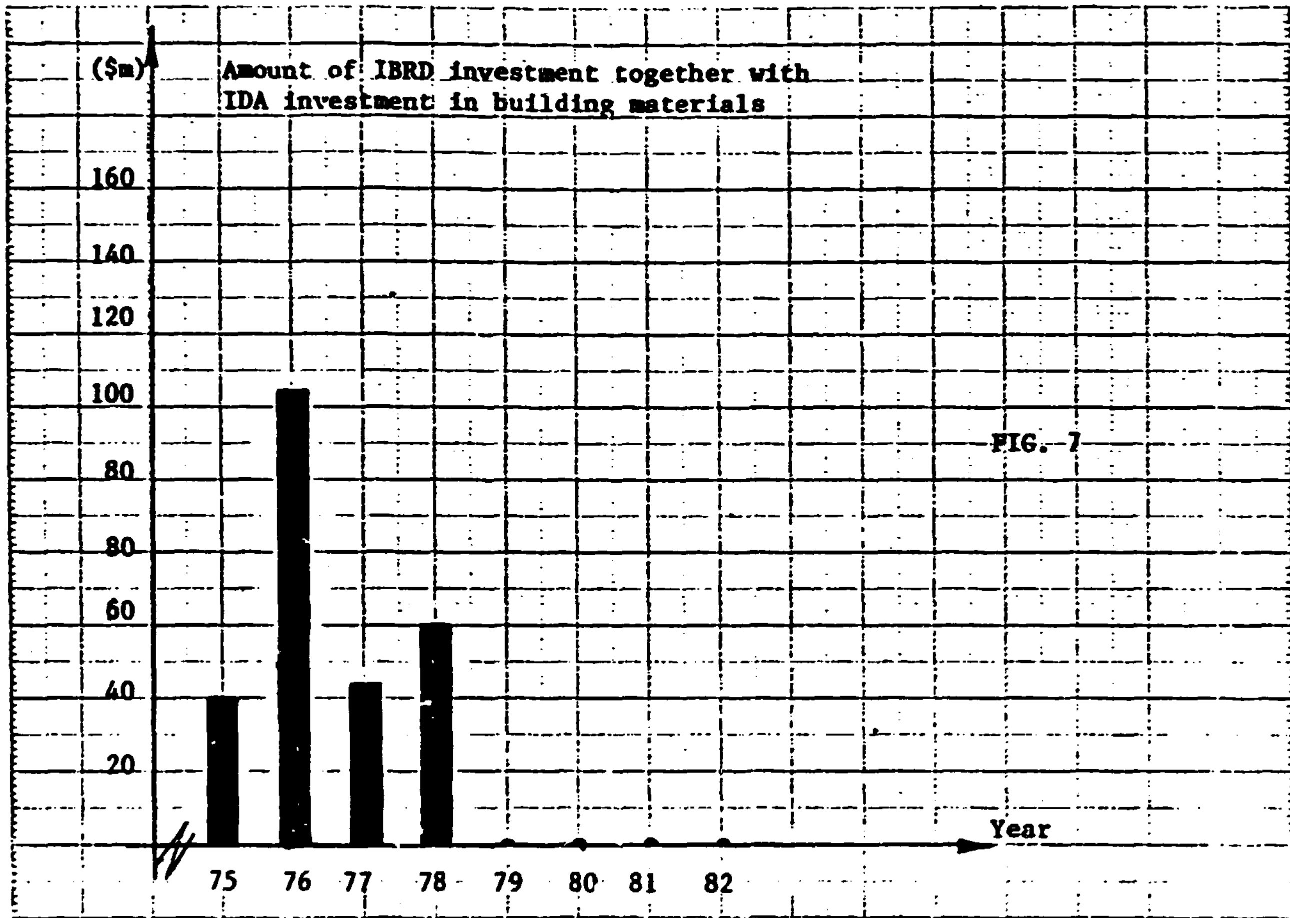
IBRD and IDA
Fertilizers

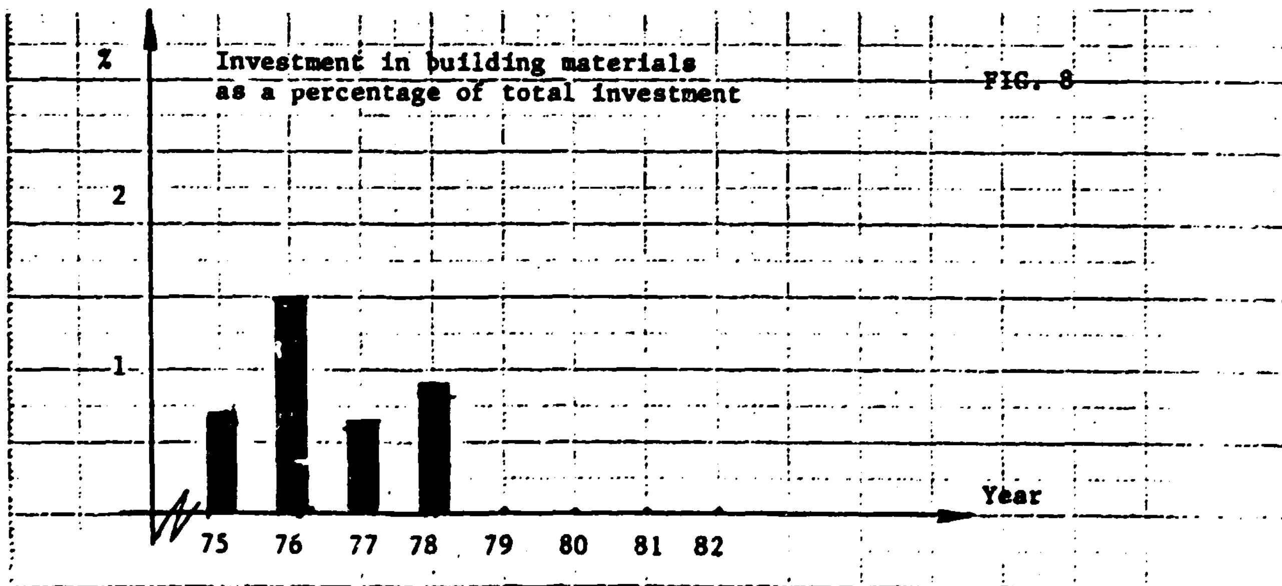




Figures 5 and 6: The fertilizer industry has shown decline in absolute dollar terms between 1975 and 1983, with a peak at 1981. The percentage of investment going to fertilizers on the other hand was greatest in 1975 and has declined since.

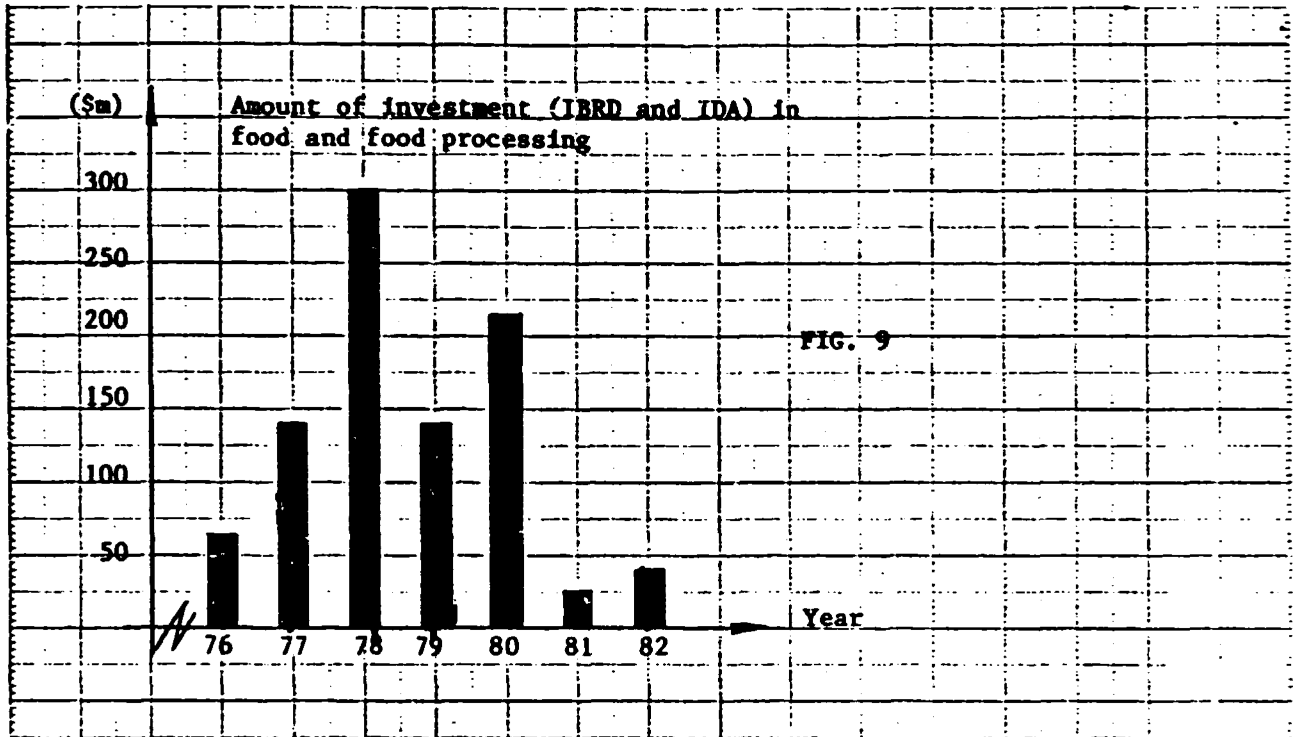
IBRD and IDA
Building Materials

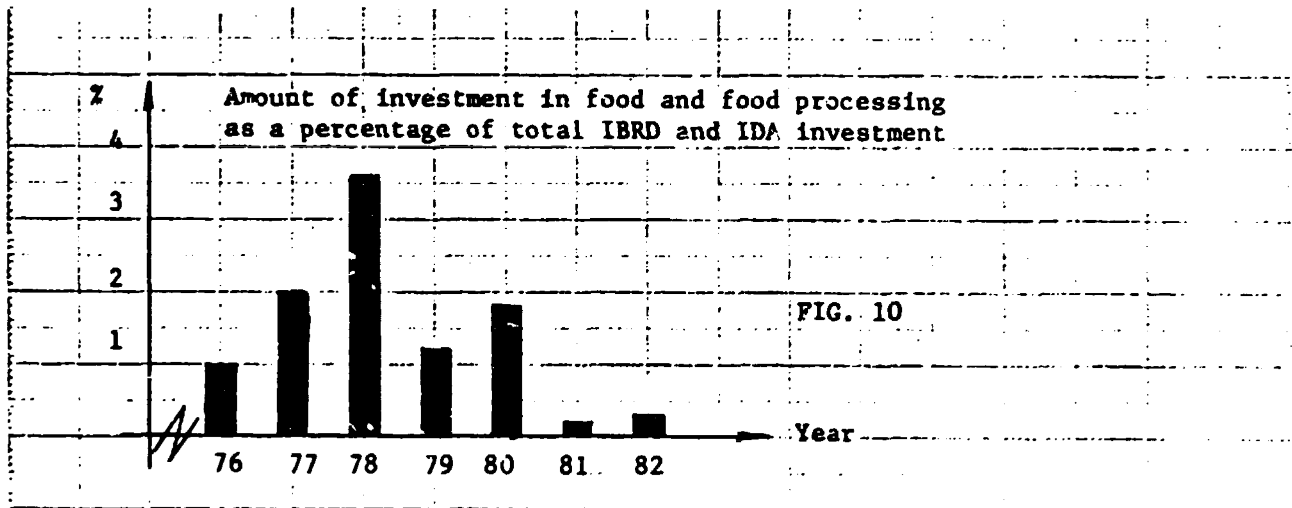




Figures 7 and 8: Investment in building materials in dollar as well as percentage terms dropped off completely after 1978 and has been negligible since.

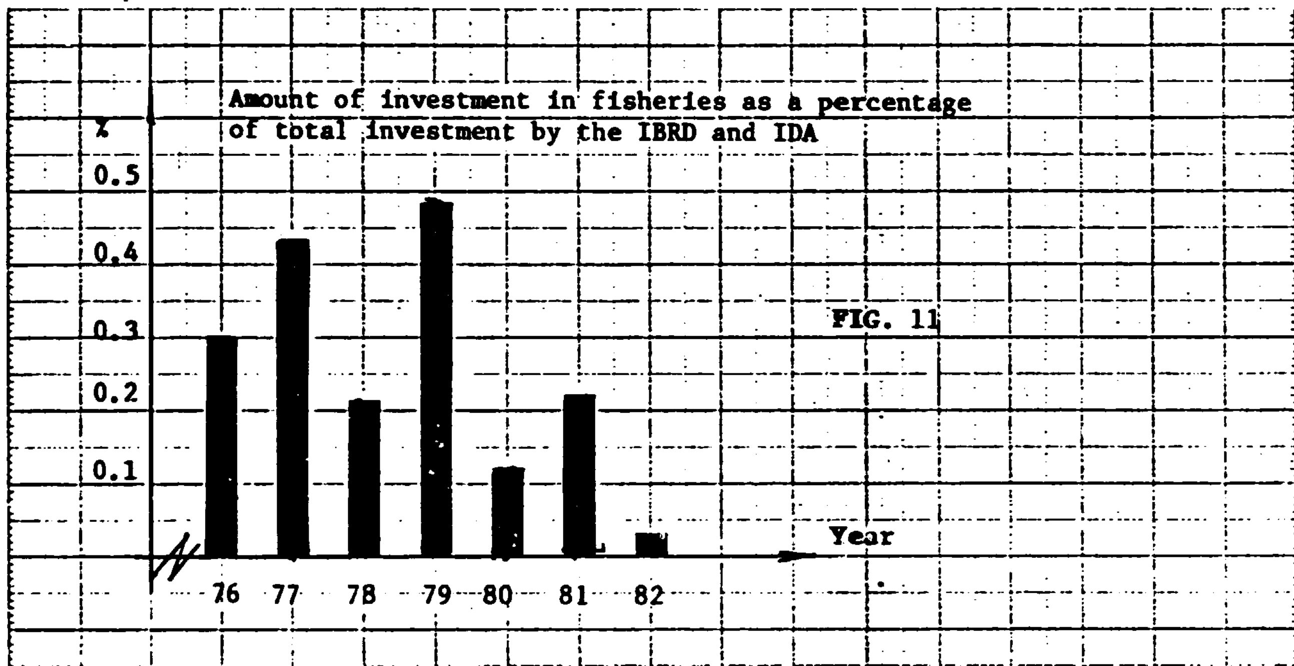
IBRD and IDA
Food and food-processing





Figures 9 and 10: Investment in food and food processing peaked in 1978 and has declined since in absolute dollar as well as percentage terms.

IBRD and IDA
Fisheries



<u>Figure 11</u>: Involvement in fisheries has not been significant throughout, but even so has shown a distinct downward trend with respect to the percentage of total resources devoted to it.

AGGREGATE ANALYSIS
IFC

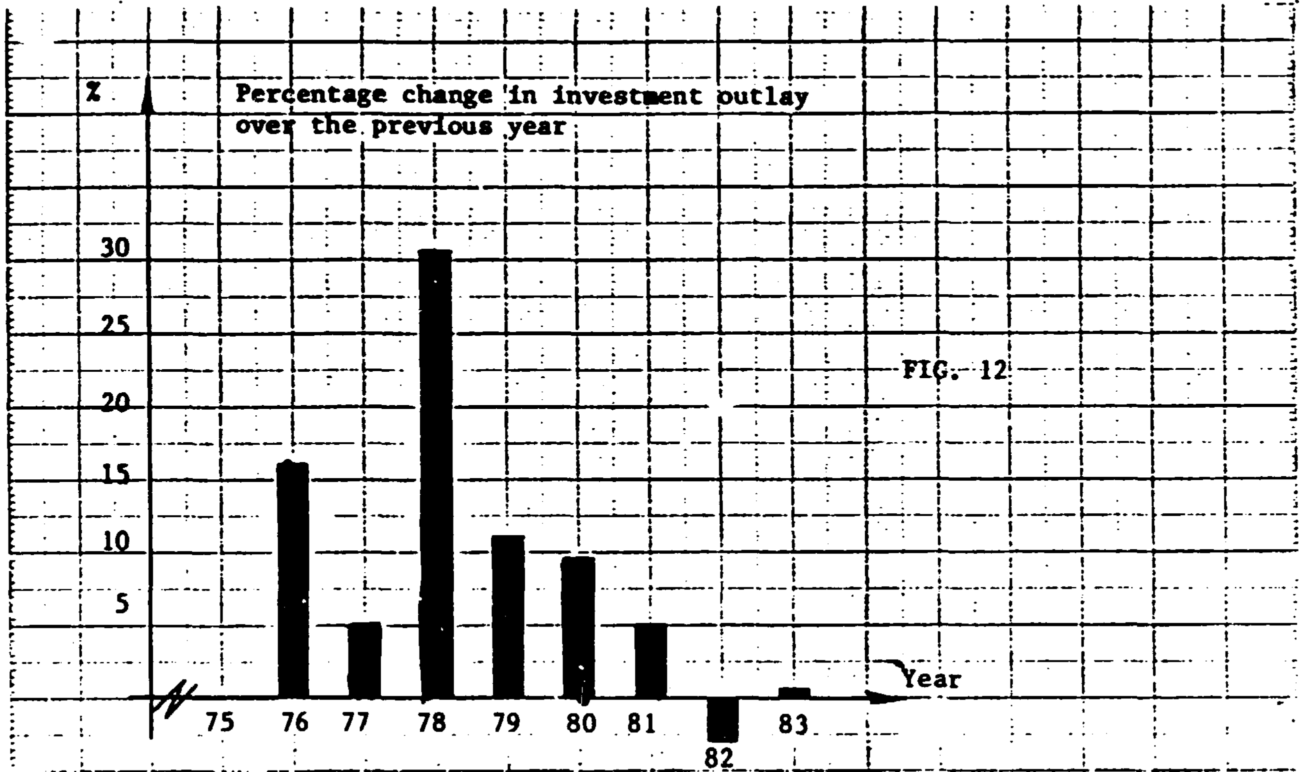


Figure 12: Percentage change in total investment, taking the previous year as base, has fallen rather sharply since 1978.

IFC - IRON AND STEEL

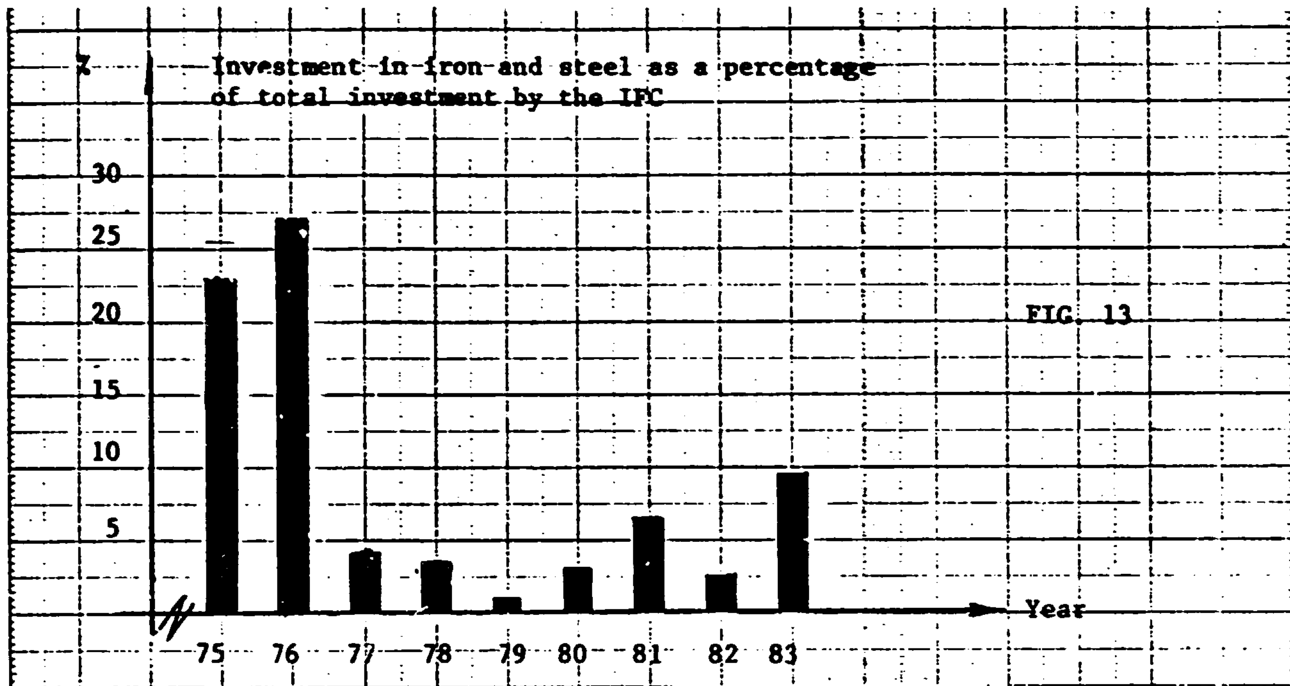


Figure 13: Investment in iron and steel as a percentage of total investment has declined to almost a third between 1976 and 1983.

IFC - FERTILIZERS

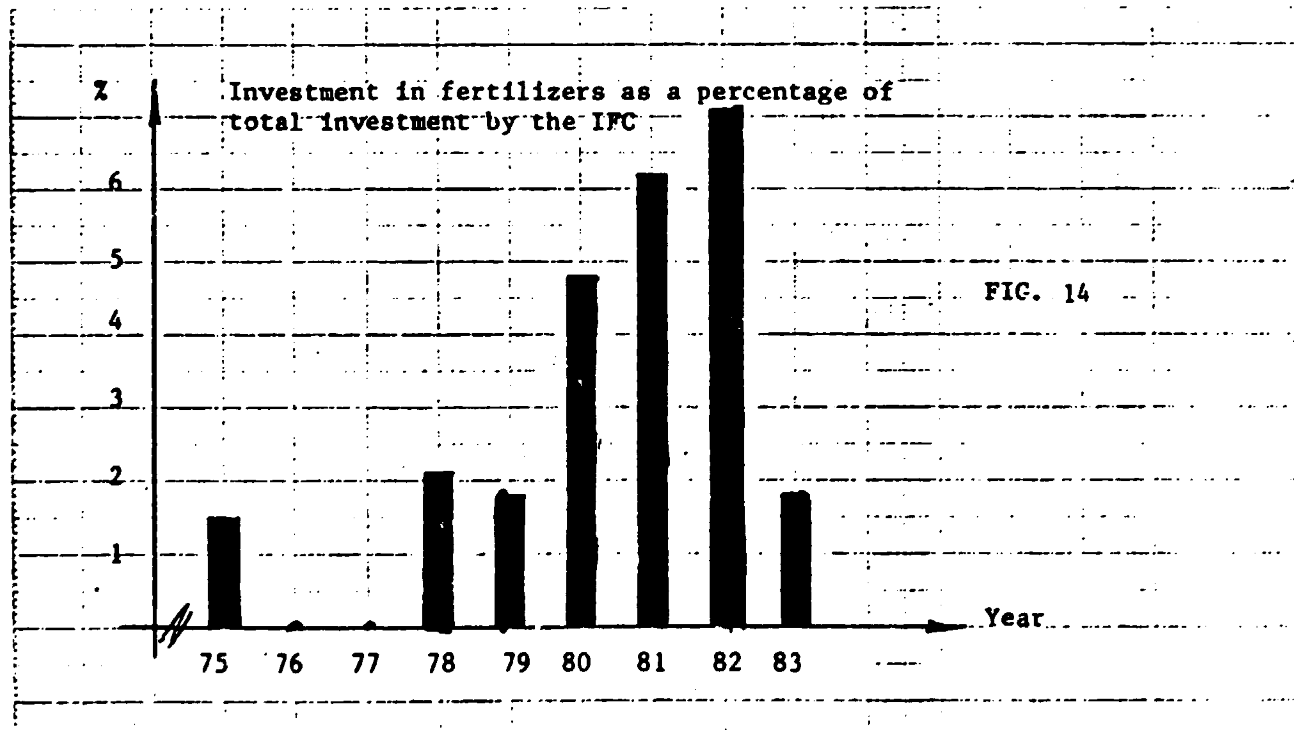


Figure 14: Investment in iron and steel as a percentage of total investment has declined to almost a third between 1976 and 1983.

IFC - CHEMICALS AND PETROCHEMICALS

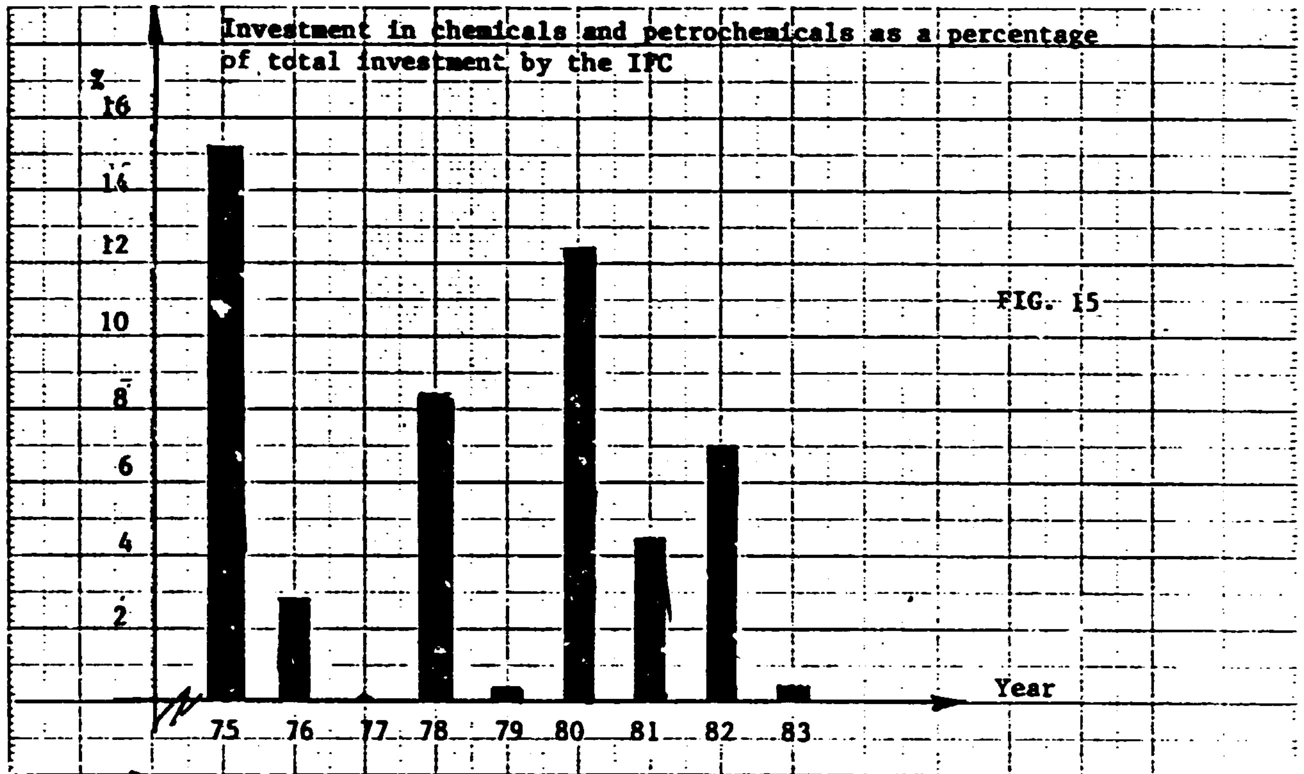


Figure 15: Percentage investment in petrochemicals fell sharply from almost 16 per cent in 1975 to less than one quarter of 1 per cent in 1983.

IFC - GENERAL MANUFACTURING

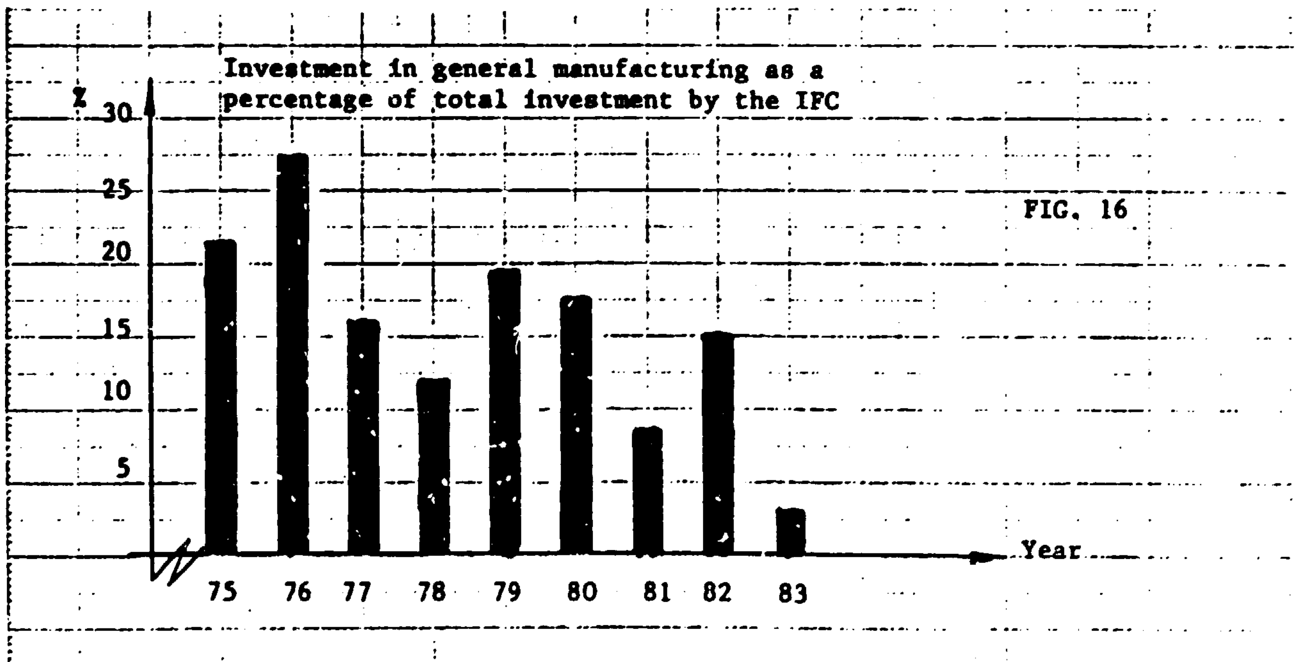


Figure 16: Percentage investment in general manufacturing (including textiles, durable consumer goods, "light" machinery etc.) has shown an almost constant decline between 1976 and 1983 to reach a rather low level of 3 per cent.

Appendix 2

A BACKGROUND TO THE SECTORAL TRENDS:
SALIENT CHARACTERISTICS OF THE WORLD ECONOMY IN 1975-1980 AND 1981 ONWARDS

1975-1980

1. The mid seventies were marked by a strong recession in the world economy. The introduction by major industrial countries of fiscal and monetary policies to control inflation had caused the growth of economic activity to decline considerably. In the wake of this came the oil price adjustments of 1974 and 1978 which further complicated the problems of a world economy already grappling with inflation, unemployment and imbalances in world trade and payments.

2. The recession after a lag affected the developing countries, mainly through its impact on exports of primary commodities. The prices of agricultural commodities, other than food items, began to weaken in early 1974 and then moved sharply downwards, being quickly followed by the prices of minerals, metals and industrial raw materials. In addition, due to price inflation in the developed world, essential imports like manufactures, machinery, industrial equipment in general became more expensive. These trends, broadly speaking, entailed a worsening in the terms of trade for the developing countries and consequently a weakening balance of payments' position.

3. Some developing countries, however, were able to sustain their levels of economic growth by borrowing on external markets. Even though a large part of this borrowing was directed towards covering deficits on current account, some was channelled into productive investments. As a result, a real average annual GDP growth rate (albeit uneven) of around five per cent was maintained in the seventies.

4. This unevenness among developed and developing countries and lack of vigour and sustained momentum that characterized previous economic recoveries, reflected, to a large extent, the disappointing behaviour of capital investment. The economic upturn in the developed countries, for example, had to depend heavily on the revival of consumer expenditures, since there was a marked lack of dynamism in investment. Certain capital goods industries

suffered from overcapacity though uncertainty about the future was perhaps the most important reason for this behaviour of business investment. Fears about inflation, coupled with memories about the rapid sequence of adverse economic events of the early 1970s, tended to undermine confidence.

5. New direct foreign investment became progressively more sluggish as the deepening recession, with its effects on export markets, and the continuing inflation of investment costs, threatened the viability of projects. In some cases projects at an advanced stage of preperation were either cancelled or postponed.

6. Net direct private investment flows from OECD countries to developing countries, for example, were only about $10,200 million in 1978 or $5,500 million in 1973 values, compared with $6,700 million in 1973. This decline reflected the unsettled economic conditions since the early seventies and also in part the delays in many planned investments in export oriented mining mentioned earlier.

7. The area in which there was noticeable growth during the recession was in the flow of international private capital from commercial banks to developing countries. Since 1973 (at least up to the mid 70's) lending by commercial banks has been the second largest single resource flow to developing countries, after official development assistance, which itself comes from a variety of bilateral and multilateral agencies. This was aided by the relatively liquid position of major international banks. Among the factors which contributed to liquidity was the channelling of a major part of savings of some oil-exporting countries to domestic and international money markets. Another factor was the slack in investment which was associated with the recession and of the strong tendency of corporations to strengthen their balance sheets by reducing short-term debt.

8. Euro-markets specifically continued to make an important contribution to the process of international payment adjustment. Total publicized Euro-currency medium-term credits in 1975 amounted to $21 billion, whereas Euro-bonds revived to a total $8.5 billion, four times the 1974 level. However, only very few developing countries, principally Mexico, had access to the Euro-bond market on any significant scale.

9. Hence the need to finance balance of payments distortions due largely to the oil price adjustments combined with a fall of direct foreign investment, led developing countries to borrow heavily on private markets. Gross new borrowings in 1978 were 80 per cent above the 1977 level and in 1979 over 70 per cent of gross new loan committments to developing countries were from private international sources.

10. However, even till the late seventies, developing countries had not "overborrowed" to any significant extent. The increased borrowing and the build-up of external debt since the early 1970s were supported by growth in their GNP and exports over the same period. While external debt increased from a level of around $90,000 million at the end of 1972 to $250,000 million at the end of 1977, the ratio of debt to GNP increased only marginally, from slightly above 16 per cent to just over 19 per cent. Meanwhile the even faster growth of the total exports of developing countries contributed to a slight decline in their debt servicing to exports ratio from around 16.5 per cent in 1972 to about 15.5 per cent in 1977.

1981 onwards

11. Sustained by the momentum of their earlier economic performance and growth-oriented policies, many developing countries were able, in 1980 and early 1981, to maintain their growth rates of GDP and exports at or near earlier levels despite quite adverse conditions in world trade and financial markets. The escalation of fuel and some other import costs were none the less reflected in generally severe balance of payments problems for most oil-importing countries within both the developing and industrialized worlds. These difficulties were compounded by depressed conditions in industrial nation markets for developing country exports and by higher costs and greater volatility in international financial and exchange markets.

12. During late 1981 and early in 1982 the economies of the developing countries were again heavily influenced by the poor economic performance of the major developed countries which continued to labour under the combined yoke of deepening recession, increasing unemployment, high interest rates, and continuing inflationary pressures.

13. Compared to an average annual increase in GNP of 5.1 per cent in the 1960s and 3.3 per cent in the last decade, industrial country growth was only about 1.1 per cent in 1981. The developing countries as a group performed only slightly better with a combined growth rate of about 2.2 per cent in 1981, significantly below the annual average of about 5 per cent during the previous decade.

14. A major problem stemmed from the difficulties of servicing external debt in the 1980s during a period of heavy balance of payments deficits and more difficult conditions in private international markets. In 1980, the maintenance of growth was achieved at a cost of a 55 per cent increase in the combined current account deficit of the oil-importing developing countries. This deficit approached $70,000 million, more than that of the industrialized countries, even though it was incurred on a volume of trade less than one quarter as large. It represented close to 5 per cent of the GDP of oil-importing developing countries in 1980. Nevertheless, it is important to recognize that this sum financed imports of goods and services largely from the developed world.

15. The effect of slow growth in developing countries was compounded by the resistance of interest rates to the downward pressure that could be expected to accompany sluggish economic growth. Although restrictive monetary policies in the industrialized countries succeeded in reducing inflation rates, the persistence of high interest rates accentuated the external debt burden for those developing countries that borrow from international financial markets. The real rate of interest (i.e. nominal interest rates less rate of inflation) on US dollar funds increased from an already high 5.6 per cent in 1980 to 7.4 per cent in 1981, and Euro-currency interest rates rose in 1979 to levels well above inflation and have broadly remained so since. In the early months of 1982 these high real rates persisted. As a result of higher real and nominal interest rates, oil-importing developing country payments of interest on medium- and long-term external debt increased by about $10,000 million from 1980 to 1981, accentuating the already serious balance of payments difficulties many of these countries are experiencing; combined current deficits, excluding official transfers, increased from $70,200 million in 1980 to $82,300 million in 1981.

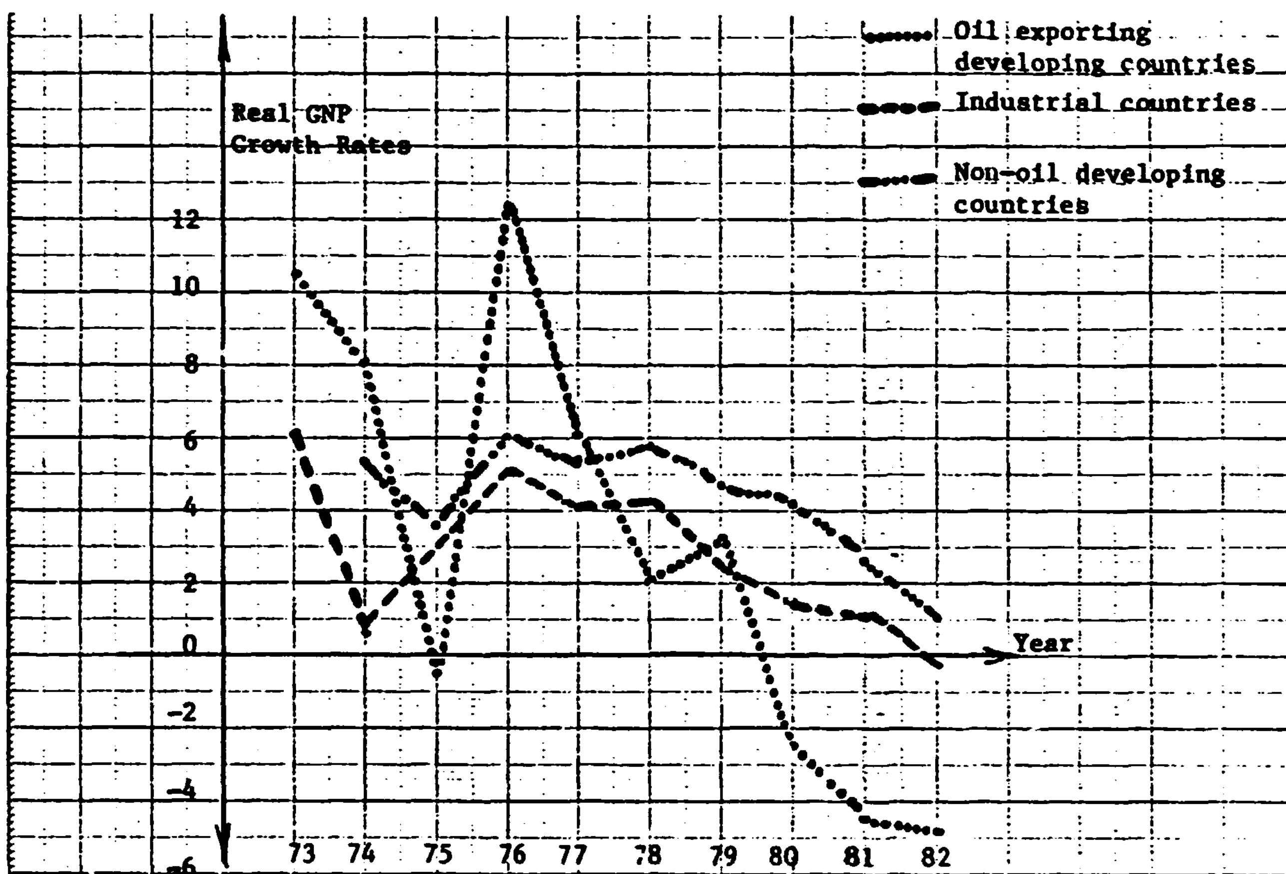
16. There was, hence, an increase in the borrowing requirements of developing countries. Private capital, to a certain extent, again responded to these requirements. Net disbursements of medium- and long-term loans from private financial sources increased more than 30 per cent between 1980 and 1981 to $44,400 million, after evidencing a decline in absolute terms between 1979 and 1980. Private direct investment also increased sharply, growing from about $10,000 million in 1980 to $13,400 million in 1981, which represented a gain of 34 per cent. Net disbursements from official sources grew by 11 per cent in 1981, totalling $37,200 million. Thus, the role of private capital increased even further constituting almost two thirds of total net external capital flows to developing countries in 1981 compared to less than 60 per cent the year before.

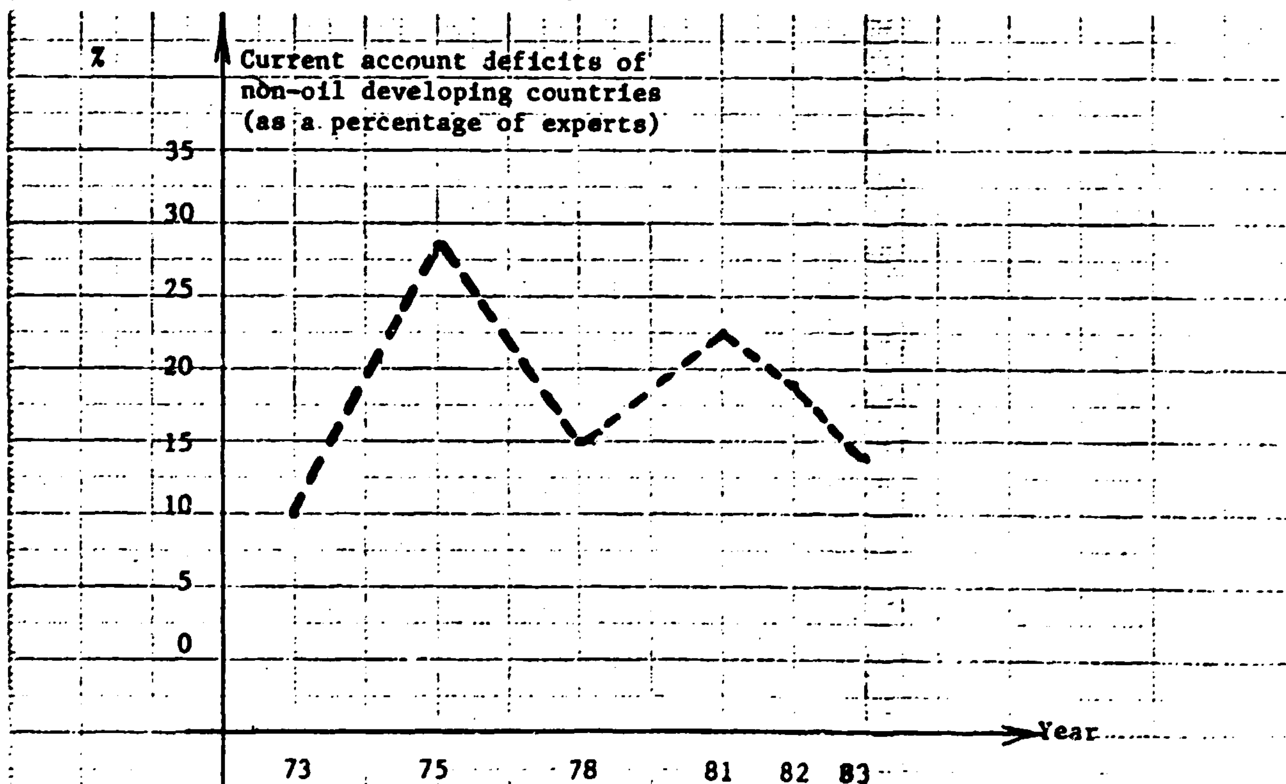
17. In 1982, the situation began to change. Both domestic investment and foreign private investment in the developing countries declined. Depressed demand left many developing country industries with excess capacity, and many firms with weakened financial structures as well as a shortage of internally generated funds to finance new investment. Such factors, coupled with exchange rate and balance of payments uncertainties, dampened the flow of foreign private investment as well as the demand for exports.

18. In addition, repayment difficulties arising from heavy past borrowing, coupled with concern about costly rescheduling procedures caused many private lenders to reach their lending limits to developing countries. In fact in 1983 the net resource flow to developing countries was negative to the order of US$11 billion.

19. Adjustments made by the developing countries and the picking up of demand in industrial countries set the stage for some recovery in 1983/84. GDP in the world economy grew by about 2 per cent though this was concentrated in developed and centrally planned economies. Developing countries, on the other hand, experienced little or no growth at all.

20. In retrospect, it seems clear that circumstances conspired to complicate even further the already difficult problem of economic development. Developed country markets were made sluggish by low growth and contradictory policies directed at containing inflation while increasing protection; the escalation of energy costs imposed new burdens on domestic growth and external payments; and prospects for official development assistance were discouraging. Together, such factors added up to a bleak landscape for development. Even when economic activity did pick up in the industrial countries, its transmission to developing countries was aborted due to the financial constraints inherited from the previous phase of the cycle. Should these constraints not be alleviated over a relatively short term in the future, the sustenance of economic growth in the industrialized countries may not have its desired impact on the developing world. This would inevitably derail the "engine of growth".





Note: Jagged lines show the discontinuity of the functions. Values are normally "year end" values and rates between two years are not, at any point, necessarily what is depicted here.