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FINANCE

FOR

THE

DEVELOPING
COUNTRIES

Respectfully,
Richard L. Kitchen

1970 CAPITAL EXPENDITURE

1970 CAPITAL EXPENDITURE

ASSISTANT SECRETARY

Finance for The Developing Countries

Richard L. Kitchen

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for Developing Countries,
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Introduction

This book is concerned with the financing of development at both the macro- and micro-levels. Given the fungibility of finance the two levels cannot readily be separated, but micro-, or project-level finance generally tends to be subservient to macro-financial considerations. At the macro-level government monetary and fiscal policies generally determine the terms and availability of finance for projects. In addition, savings (or available finance) is given as national income less consumption; any 'gap' between savings and investment is identical to a trade gap between exports and imports. Both need to be financed by capital inflows from abroad. The prevalence of the recipient government guarantee in external financing means that project risk is often subservient to country risk. However good a project looks, it will have difficulty in attracting foreign finance if the country's financial position is not perceived to be sound.¹

Such a view is certainly not unanimously subscribed to. An oft-repeated remark is that development depends on the identification of 'good' projects, and well-prepared feasibility studies of 'good' projects will enable finance to be found readily. In other words, there is never a shortage of finance for developing countries, only a shortage of well-prepared 'bankable' projects. This view has frequently been aired by diplomats and bankers involved in North-South discussions, but suffers from two other weaknesses as well as the 'country risk' argument. First, it ignores constraints which may impinge on the financing institutions, notably that banks' capital/asset ratios may be low, and that they (and other agencies) may face a constraint in the borrower's debt/equity ratio. Secondly, it ignores the point that the quality of a project depends upon the terms of financing, notably the interest rate and the maturity, and risk. The acceptability of a project depends, therefore, upon the rate of return being above the risk-adjusted discount rate. If the interest rate rises, a project may move from being above the cut-off line to below the cut-off line. Liquidity is a second crucial test for project acceptability. A shortening of maturity may easily turn a 'liquid' project into

an 'illiquid' one. There might have been times in the 1970s when the financial markets were extremely liquid that there was more finance available than projects to finance. However, this cannot be said to be generally the case, and the international financial conditions of the early 1980s serve as a sharp reminder that funds are not always available in abundance.

The term 'finance' itself merits some explanation. *The Dictionary of Modern Economics*² gives the following definition:

Finance Narrowly interpreted it signifies *capital* in monetary form, that is in the form of funds lent or borrowed, normally for capital purposes, through financial markets or institutions. But in common parlance the term is applied to funds from almost any source, used to undertake any kind of expenditure.

Finance should be distinguished from money. The latter is a particular type of financial asset which is generally accepted in exchange. Other financial assets cannot generally be used in this sense, although many are readily marketable, and can therefore be exchanged for money. The basic definition of money (M1), is currency plus current account bank deposits. These short-term assets form only a part of the financial markets discussed here. With 'finance' we are mainly concerned with longer-term instruments of assets and liabilities, whereas monetary instruments are short-term. This befits one of the preoccupations of the book, the financing of projects, which requires long-term finance. However, as the definition of money is broadened to include time deposits, savings deposits, and other assets, it embraces instruments which increasingly overlap with what is meant here by 'finance'. The book is not only concerned with financial instruments (apart from money M1), but equally with the institutions and markets which mobilize them.

The perception of the need for this book grew from two independent sources.³ First, my experience of teaching development finance on the M.Sc. course and on post-experience courses at the Project Planning Centre convinced me that there was a need for a single book which covered the ground. Secondly, working on industrial financing with UNIDO has shown me that there is a need to present an overall picture of development finance to civil servants, politicians, and diplomats, and for financial professionals such as development bankers, as well as to students. The book is aimed, therefore, both at students and professional readers. I have attempted to blend together financial theory and knowledge of workings of financial markets and institutions, in order to try to show the relevance of one to the other.

This book does not, generally, attempt to be prescriptive. The wide variations included under the overworked term 'developing countries' prohibit generalized prescriptions. Each government and organization will have its own policy objectives which will largely determine its financial strategy. Therefore prescription, especially by a north European, would be presumptuous. However, I have not let that inhibit me from drawing my own general conclusions from the analysis; a book without some views would be very dull. My conclusions generally lead me to favour the development of money and capital markets, with regulation and supervision but with limited

controls. I prefer the use of government revenue and company equity capital, rather than debt, especially foreign debt. I favour the increased securitization of debt, both domestic and foreign. I incline towards a policy of moving towards financial independence rather than dependence on foreign aid and debt. I would tend to support the growth of the private sector (and privatization) rather than government dominance of the economy. However, whether I would keep all my general inclinations when faced with a specific country would depend considerably on the social, economic, and political conditions prevailing in that country.

Although some 80% of investment in developing countries is financed by national savings, domestic financing does not occupy 80% of this book. The financial markets and institutions in developing countries vary considerably from country to country, which limits the extent to which one can discuss them in aggregate, or at a certain level of generalization. However, these countries all face the same international markets and institutions, and therefore they all face broadly similar conditions in external financing. As international financing is therefore a subject which finds a common interest among most developing country readers, and also in non-developing countries, I have given it a prominence beyond its quantitative significance in financing economic development.

The first three chapters of the book are concerned with basic principles and theory. The theory relates largely to domestic capital markets, but some capital market theory relates also to international finance. The two themes of capital market theory and financial repression will recur throughout the book. Chapters 4–6 are concerned with the mobilization of domestic finance, and Chapters 7–9 with external financing. Chapter 10 is concerned specifically with project financing, while Chapter 11 considers a number of the recent proposals to improve development financing. The broad scope of the book inevitably means that some subjects are treated superficially, but I hope that provision of ample references will help the dissatisfied reader to deepen his knowledge elsewhere.

The increasing pace of events in world financial markets means that a few aspects of the book will have already been overtaken by events before it is on the bookshelves. The integration of the major securities markets of the world suggests that the benefits of international diversification may be diminishing. It remains to be seen to what extent third world debt and equity markets become caught up in the present rush for change. Also, the recent sharp decline in oil prices and interest rates up to April 1986, suggests a significant shift in the supply for demand for funds in international financial markets, and changing prospects for several debtor countries and creditor banks. The more optimistic prospects for growth in the North may also help developing country exports, and thereby relieve the strain caused by debt services requirements.

Inevitably in a work such as this I have drawn extensively on the research results of others, and it is to them that I own my main debt. I am also

indebted to many people working in the field who over the years have taught me a great deal. Mention of selected individuals tends to be invidious, and I certainly do not wish to embarrass them by association with my errors and naive judgements. However, as a minimum I should mention Vic Richardson of UNIDO, and formerly of Bradford University, who kindled my interest in development finance, and over the years helped it to grow. Dr Nicholas Bruck of EDI, the World Bank, and Professors John Hunter (Michigan State University), Donald Lessard (MIT) and John Samuels (Birmingham University) commented helpfully on my initial outline. Thanks, too, to Professor Samuels for reading and commenting helpfully on a rather scrappy draft. They are not responsible, though, for the errors. I owe a great deal too to the library staff at the Project Planning Centre—Sheila Allcock, Carole Scanlon, and Jill Allsop—who have cheerfully handled my frequent requests for obscure and imprecise references; to the secretarial staff at the Project Planning Centre, notably Jean Hill, Elizabeth Dada, and Sue Mackrill, who with equal cheerfulness typed and reproduced the manuscripts; and to Michael Coombes, Irene Cooper, Wendy Hudlass, John Carden and Jane Miller of John Wiley who have guided this book into its final form. Finally, thanks are due to my wife and children for continued encouragement and curiosity.

NOTES

1. A UNIDO Consultation Meeting on Industrial Financing concluded that 'it is recognised that projects that are entirely viable on their own may be denied financing because they are located in countries with serious balance of payments problems. In such cases the assessment of country risk is at variance with project risk.' (Report on the First Consultation on Industrial Financing, Madrid, Spain, 18–22 October 1982).
2. *The Dictionary of Modern Economics*, ed. D. W. Pearce, Macmillan Reference Books, 1981.
3. Although the book is about finance, profit was not one of these perceived needs. I am reminded of Byron's couplet:
 'Oh Amos Cottle, for a moment think,
 What meagre profits spread from pen and ink'
 (Lord Byron, *English Bards and Scottish Reviewers*).

Abbreviations

AfDB	African Development Bank
AsDB	Asian Development Bank
BIS	Bank for International Settlements.
CAPM	Capital asset pricing model.
CCCE	Caisse Centrale de Coopération Economique.
CDC	Commonwealth Development Corporation.
CMEA	Council for Mutual Economic Assistance.
CMT	Capital market theory.
DAC	Development Assistance Committee.
DFC	Development finance company.
DFI	Direct foreign investment.
EEC	European Economic Community
EIB	European Investment Bank
FAO	Food and Agricultural Organization (of the United Nations).
FIR	Financial interrelation ratio.
GAB	General arrangement to borrow.
GDP	Gross domestic product.
GNP	Gross national product.
IDB	Inter-American Development Bank.
IBRD	International Bank for Reconstruction and Development.
IDA	International Development Agency.
IFAD	International Fund for Agricultural Development.
IFC	International Finance Corporation.
<i>IFS</i>	<i>International Financial Statistics.</i>
IMF	International Monetary Fund.
IRR	Internal rate of return.
ITC	International tax comparison.
KfW	Kreditanstalt für Wiederaufbau.
LIBOR	London inter-bank offer rate.
MDI	Multilateral development institution.

MM	Modigliani and Miller.
NIC	Newly industrialized country.
ODA	Official development assistance.
OECD	Organization for Economic Cooperation and Development.
OPEC	Organization of Petroleum Exporting Countries.
RADR	Risk-adjusted discount rate.
SCBA	Social cost–benefit analysis.
SDR	Special drawing right.
SSE	Small-scale enterprise.
TNC	Transnational corporation.
UN	United Nations.
UNCTAD	United Nations Conference on Trade and Development.
UNCTC	United Nations Commission on Transnational Corporations.
UNESCO	United Nations Educational, Scientific, and Cultural Organization.
UNIDO	United Nations Industrial Development Organization.
VAT	Value-added tax.

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Chapter 1

The Basic Principles of Development Finance

1. INTRODUCTION

For any appreciation of finance it is important for the reader to have a grasp of the basic principles. These are few in number, but do not always lend themselves to succinct definitions, which perhaps is why the definitions which appear in glossaries and dictionaries of terms do not give a full understanding. Therefore the first chapter is given over to describing these principles. For greater clarity of exposition they are divided into three groups: concepts, financial processes, and the mechanisms which apply the concepts and undertake the processes.

The basic *concepts* of finance to be considered are:

- Risk
- Return
- Security

The basic financial *processes* of importance are:

- Mobilization
- Intermediation
- Maturity transformation
- Risk transfer
- Financial deepening and financial repression

The financial *mechanisms* are:

- Institutions
- Instruments
- Markets

It is immediately clear that there exists some degree of overlap between these three categories, and also some close interrelations between some of