

II. RESOURCE MOBILISATION IN A CHANGING CONTEXT

Sources of Development Finance

6. In recent years, the main thrust in the creation of new financial institutions has been at the regional and sub-regional levels. If carried too far, this trend could lead to increasing fragmentation into regional blocks. We see a danger, furthermore, that this fragmentation could be translated at the global level into an increasingly rigid division of the world into two camps - developed and developing, donor and recipient, active and passive. The dangers and indeed the untruth of such a crude division, for developed and developing countries alike, are perhaps more obvious in 1974 than they were at the beginning of the Second Development Decade.

7. We believe that the events of 1973 are part of a process leading to a fundamental change in the relationships between developed and developing countries, that these relationships have become more complex, and that a simple division between developed and developing countries will become less and less useful as a basis for strategy. An important element in these changing relationships is the current concern over supplies of raw materials, giving rise to a need for a reorganisation of relationships between supplying and consuming countries, and for improved ways of mobilising resources for the development of natural resources.

8. For development finance in general, Commonwealth countries draw on a wide range of external sources. The main types of source are briefly characterised in Annex VIII, and may be listed here as:

- (a) international development banks;
- (b) bilateral aid agencies;
- (c) development finance corporations;
- (d) export credit agencies;
- (e) overseas banks permanently represented in developing countries;
- (f) banks and other financial institutions offering services as intermediaries in the world's capital markets;
- (g) direct foreign investors.

We believe that the trend is towards increased rather than reduced diversity in the sources of capital for developing countries, and that necessity will drive developing countries to seek new sources in addition to those already available. We also believe that this could be a healthy trend, at least to the extent that it reduces developing countries' dependence on the resources, and therefore the preferences, of a small number of dominant development agencies.

9. Operationally, however, the trend towards diversity presents developing countries with two major problems:

- (a) the need to shop around more extensively in order to be sure of obtaining the most advantageous terms;

- (b) the complications that arise when capital from two or more sources has to be brought together in a single package.

10. Many developing countries gained experience in shopping around among aid agencies in the early 1960s, when aid was increasingly available from a number of relatively recent entrants into the field. But it was always a time-consuming activity, which imposed a considerable burden on the scarce administrative resources of the recipients. In the conditions of the 1970s, when there is less competition among the established donors, so that developing countries are having to explore sources of new and unfamiliar types, this burden is likely to be greater. The problem of comparing the true costs of alternative sources, also, is more severe, e.g. as between a bank which relies primarily on its lending margins and a bank which relies on a substantial commission at the front end of a loan that it has organised. There may be problems for the established donors, too, if they are faced with increasing uncertainty concerning other approaches that are being made to finance a project which they are themselves considering. It would seem both wasteful and risky to leave each developing country separately to acquire the extensive and detailed technical knowledge that the exploration of new sources requires.

11. Experience in putting financial packages together for complex projects is at present most heavily concentrated in some specialist merchant banks and banking consortia, the major inter-governmental development banks, and development finance corporations. Merchant banks and other commercial banks, however, are relatively inexperienced in the mobilisation of packages including concessionary finance, which is usually regarded as an inter-governmental responsibility; and mixtures of commercial and concessionary finance are likely to become increasingly common, e.g. where the exploitation of natural resources in a remote part of a country requires some concessionary finance for infrastructure. In the inter-governmental development banks, officials with experience of putting a mixed financial package together seem to be agreed that it is a difficult, lengthy and highly specialised task, which they tend to regard as subsidiary to their main task of direct financing of projects, using the resources of the banks that they serve. Generally speaking, inter-governmental development banks are reluctant to become involved in projects in which they are not the main source of finance, because of the complications that this introduces into the process of project appraisal and control. Development finance corporations, notably the International Finance Corporation, have been more energetic in seeking additional sources of finance, but here there are other problems, to which we return in paras. 14 and 24 below.

The Need for a New Intermediary

12. We believe that the ability of Commonwealth countries to take advantage of new and changing opportunities could be enhanced by the creation of an additional intermediary, specialising in putting the finance together from diverse sources in those fields which tend to be financed in this way. The case for such an intermediary seems to us to apply primarily but not exclusively to the directly productive sectors,¹ and particularly to the exploitation of natural resources. We have noted a widespread feeling that these sectors are not adequately covered by existing sources of development finance, a view which seems to have underlain, for instance, the incorporation of a special emphasis on increasing productive capacity in the creation of the Caribbean Development Bank.

¹ The term "directly productive sectors", as used here, covers manufacturing, mining and petroleum, and agriculture. For brevity, the term is shortened in the remainder of the report to "productive sectors".

13. Many developing countries have tried to promote their industrialisation through the mechanisms of an open market economy, relying both on foreign investors and on domestic private entrepreneurs. There have been some impressive successes in terms of increased aggregate output. Nevertheless, the strategy is being reconsidered in the light of two needs that have appeared:

- (a) a need for new types of agreement between foreign investors and their local partners, which will give confidence to both sides, and will give confidence to governments that they remain in effective control of the development of their countries' resources;
- (b) a need to improve the internal distribution of the gains, in terms of employment creation and increased incomes for the mass of the people.

It seems likely that many governments will try to meet these needs by increased public intervention in the productive sectors, irrespective of political ideology, and that this will happen even in countries that continue to welcome foreign investors as partners in joint ventures. It may be difficult, however, to match this process in the mobilisation of finance, and in the development of the specialised skills required in financial negotiations. An intermediary performing the functions outlined in para. 12, therefore, could fulfil a particularly useful role as bank to the state as entrepreneur. To fulfil this role adequately, an intermediary would have to meet two basic conditions:

- (a) that it should be committed to its primary clients, since a superficially neutral intermediary may quickly lose plausibility when confronted with doubts about whom it "really" represents;
- (b) that its acceptability to potential sources of finance should be solidly based on respect for its financial integrity and its business capacity.

14. One severe problem that has arisen in countries in which the public sector is seeking increased participation in productive enterprises, to which the proposal of the Government of Jamaica, for instance, was addressed, is the mobilisation of adequate venture capital. An intermediary of the type envisaged could contribute in three ways to solving this problem:

- (a) it could help in finding, assessing and introducing an appropriate foreign partner, having regard to such factors as the relative merits of different technological processes;
- (b) as a bank seen to be committed to the interests of the host country as its client, it could act for the host country in financial negotiations, and could help in organising its equity stake on a sound financial basis;
- (c) within limits, at least in relatively small enterprises, it could help with the initial financing of the host country's equity stake, perhaps with a loan to be repaid on some sort of production payment basis -

a function which at present sometimes falls to the foreign investor, with unsatisfactory results for both parties.

We would see dangers, however, for a new institution which had the direct provision of equity capital as its major function. The experience of development finance corporations has repeatedly shown that the performance of this function has two results:

- (a) heavy and continuing involvement in the management of enterprises in which the corporation has invested, which diverts staff resources from the identification and organisation of new investment opportunities;
- (b) a loss of flexibility in the corporation's balance sheet.

Neither of these results is compatible with the functions outlined in paras 12 and 13.

15. Several of us were able to recall cases from our own experience, in which projects had failed to come to fruition because of the lack of an intermediary capable of assembling all the elements essential to the launching of a project, rather than because of defects in the projects themselves. Similarly, in discussing the first draft of our report informally in our own countries, several of us found that our proposals were welcomed as meeting real and substantial needs, especially by national development finance institutions. Most important in our view is the fact that an intermediary of the kind that we envisage was seen as being sufficiently flexible to meet the special and differing needs of different countries. Furthermore, developing countries' need for sound assistance and advice in their relationships with sources of commercial finance is implicit in the concern that has been expressed in a number of annual reports of existing international financial institutions. Full assessment of demand would require detailed and comprehensive exploration of the views of individual Commonwealth governments, and of government agencies such as national development banks. This exploration would be addressed to the questions that we raise in Section V, and to more detailed development of our proposals in Section VI. If these proposals are welcomed in principle, we suggest that the necessary further exploration could be done under the aegis of the Secretary-General.

The Commonwealth's Comparative Advantage

16. In this context, the Commonwealth's frequently cited virtues of diversity of membership, relatively easy communication and flexibility of response are not negligible. The Commonwealth has already developed some interesting techniques, notably in technical assistance, for making the distinction between donor and recipient less rigid. The experience thus gained provides a useful starting point.

17. The argument against translating that experience into financial terms has been that the number of Commonwealth countries capable of providing financial aid is smaller than the number capable of providing technical assistance. According to this argument, Commonwealth developing countries, while they may draw heavily on other Commonwealth countries for technical assistance, have to look to channels which draw on a wider range of sources to meet their financial needs. Figures for aid to Commonwealth countries are given in Annex VI. Bilateral aid from Commonwealth developed countries is

about one-third of total aid to Commonwealth recipients as a group from DAC member countries and multilateral agencies. Even this proportion represents a significant concentration of effort. That it is not larger is simply a reflection of the imbalance between developed and developing countries in the Commonwealth membership.

18. Australia, Britain, Canada and New Zealand have a combined GNP equivalent to 13 per cent of the total GNP of DAC member countries. Their combined aid programmes are equivalent to 15-16 per cent of total aid from DAC member countries. Commonwealth developing countries, in contrast, account for 45 per cent of the total population of developing countries, excluding China, North Korea and North Vietnam, and they are the recipients of about 25 per cent of total aid from DAC member countries and multilateral agencies.

19. So long as discussion is confined to the established framework of multilateral and bilateral aid, to the established sources of aid, and to established relationships, it seems to us that this imbalance in Commonwealth membership cannot be lightly dismissed. In a world of rapidly changing relationships, however, the Commonwealth has a special advantage. Precisely because the scope for action along familiar lines may be constrained by the imbalance in Commonwealth membership, the proponents of any Commonwealth initiative are forced into an effort to re-define relationships, and to identify new opportunities which existing institutions, with an established code of practice developed over a number of years, might overlook. In this context, the diversity of Commonwealth membership, which includes relatively advanced developing countries as well as some of the least developed, becomes one of its greatest strengths. There is strength, also, in the fact that its membership is exclusive as well as inclusive, a circumstance which requires its members, in all their diversity, to consider what binds them as well as the differences in their viewpoints.

20. In a financial context, one element of Commonwealth relationships which seems to us to have considerable substance is the propensity to make use of the services of the City of London. For historical reasons, a Commonwealth country will normally have a higher propensity to use the City of London for its overseas financial business, in preference to one of the other major international financial centres, than would a non-Commonwealth country in the same region and with the same characteristics. That this continues to be so is only partly attributable to historical reasons. A more substantial reason, it seems safe to assume, is that Commonwealth countries continue to find the services of the City of London useful. It seems to us that no discussion of intra-Commonwealth financial relationships can afford to overlook the existence of this solid asset. An instrument which facilitated more efficient use of this asset, to the benefit of Commonwealth developing countries, might realise within the Commonwealth that ideal of a mutually advantageous relationship which has hitherto figured more prominently in the rhetoric of development cooperation than in its reality. While this report concentrates on the mobilisation of capital, and hence on the needs of developing countries, it is clear that better use of the market is to the advantage of developed countries also, in terms of the common interest of all countries in the maintenance of orderly conditions in the market, in the promotion of trade, and in the promotion of a climate for investment which ensures an equitable and secure distribution of returns.

21. Some indications of the scope of London as an international financial centre are given in Annex VII. In particular, Annex VII underlines the significance of London's emergence as the main centre of the Eurocurrency market. Commonwealth developing countries, of course, are not the largest users of London's financial services. One other group of users which is of special relevance to a discussion of development finance, in a context of changing international relationships, consists of those countries which have newly acquired or greatly increased surpluses, few of which are in fact Commonwealth members. But Commonwealth developing countries do have some measure of special access to London, notwithstanding the erosion of discriminatory regulations in their favour, by virtue of their long-standing connections.

22. The preceding paragraphs have been concerned with the Commonwealth's comparative advantage as a framework within which to establish a new financial institution and to develop new relationships. Another argument of a more political nature which needs to be considered - though it is clearly beyond our capacity to carry it to a conclusion - concerns the extent to which Commonwealth member countries see the case for a new institution of some substance and utility as a practical application of their more general commitment to the principles of Commonwealth cooperation.

The Capacity of Existing Institutions

23. The functions outlined in paras. 12 and 13 would be different from and additional to those of the Commonwealth Development Corporation. The CDC has accepted the logic of para. 14, to the point that 65 of the 233 companies in which it has investments, including 32 which are CDC subsidiaries, are directly under its own management. Our impression is that the factors that have made this possible include, among others:

- (a) its derivation of its money relatively cheaply from a single major source which simplifies control as well as reducing its balance sheet problems;
- (b) a structure which allows it to accept a long-term managerial commitment to the projects that it selects;
- (c) a coherent staff team built up over a long period, with relatively little turnover.

We do not think that it would be easy to sustain these features in an international corporation, and we believe that there are strong arguments against seeking change for change's sake in a corporation which, after a long and difficult initial period, is generally regarded as performing rather well the role that it has developed for itself.

24. The functions that we envisage are rather closer to those of the International Finance Corporation, and indeed the experience of the IFC, and its way of tackling the problems it has encountered, figured prominently in our own discussions. Apart from the general tendencies of development finance corporations mentioned in para. 14, we see three principal difficulties that might prevent the IFC from performing the functions we have in mind.

First, the IFC's articles place it firmly in the private sector.¹ It does not exist to assist the state as entrepreneur except as a minority participant, and we do not see how this function could be combined with its primary role. Secondly, even if this difficulty could be overcome, a membership of 98 countries is an impediment to the growth of close and continuing relationships with client governments. Thirdly, the fact that more than 75 per cent of its capital is subscribed by developed countries means at the least that it must remain neutral as between foreign and domestic investors, whereas what is required for the functions outlined here is an institution committed to the interests of its primary clients (see para 13 above).

25. We have also considered whether the intermediary role could not be equally well performed by existing Commonwealth banks and other London banks with experience in developing countries, thus avoiding the need for a new institution. There are some signs that this is already happening - e. g. the successful offer by Kleinwort Benson to act for the Government of Hong Kong in the financing of the Hong Kong underground, which was announced during our first round of discussions. We assume that this type of business will expand, but we also assume that the main business of these banks will continue to be with their established clients, and that there will be a growing role for a bank that works primarily or even exclusively for clients in developing countries. Furthermore, circumstances arise in which developing countries will get the most favourable terms by allowing contractors and their associated banks to compete in securing the best export credit terms, while they would do better to have a single bank going to the market on their behalf to finance the down payments and other elements which export credit cannot cover. In this situation a clear division of responsibility would be beneficial.

1. Article One of the IFC's Articles of Agreement states:

"The purpose of the Corporation is to further economic development by encouraging the growth of productive private enterprise in member countries, particularly in the less developed areas, thus supplementing the activities of the International Bank for Reconstruction and Development ... In carrying out this purpose, the Corporation shall:

- i. in association with private investors, assist in financing the establishment, improvement and expansion of productive private enterprises which would contribute to the development of its member countries by making investments, without guarantee of repayment by the member government concerned, in cases where sufficient private capital is not available on reasonable terms;
- ii. seek to bring together investment opportunities, domestic and foreign private capital, and experienced management; and
- iii. seek to stimulate, and to help create conditions conducive to, the flow of private capital, domestic and foreign, into productive investment in member countries.

The Corporation shall be guided in all its decisions by the provisions of this article."

26. Another possibility that we have considered is the more modest performance of the intermediary role by a technical assistance team operating as financial consultants, perhaps under the aegis of the CFTC. All those whom we consulted, however, emphasised that any institution which was not putting resources of its own into the loans it was promoting would get a very sceptical response. We conclude that the functions outlined require a bank equipped with sufficient resources to give convincing backing to its promotional activities, even though its own participation in the loans that it put together could normally be quite small.

Other Functions Considered

27. In addition to considering alternative instruments for performing the functions outlined in paras. 12 and 13, we have also considered other financial needs, and possible institutions to meet them. Of the types of institution that we considered, the main ones are:

- (a) a development bank;
- (b) a development corporation;
- (c) a general purpose concessionary fund, or "soft window";
- (d) an export credit facility.

Our terms of reference required us explicitly to consider the last of these. Our reasons for rejecting it are given in the next paragraph. Our reasons for giving a lower priority to the other three than to the creation of a bank designed along lines rather similar to those of a project-oriented merchant bank are implicit in the arguments of paras. 12-14 and 16-21. They are essentially functional, and relate to the Commonwealth's comparative advantage. In terms of additionality, we believe that a bank with the functions suggested could achieve larger gains to developing countries, in the forms set out in para.5, than any plausible institution of types (a), (b) or (c) above. In reaching that conclusion, we do not mean in any sense to dispute the case for a larger flow of concessionary funds from developed to developing countries, which would be a factor in the creation of an institution of any of these three types. Because this is a crucial issue in the creation of any new financial institution for developing countries, our general views on it are set out in the concluding paragraphs of this section.

28. The question of export credit for developing countries' exports falls into two parts. First, there is the question of conventional 180-day credit for normal trade. Here, there does not seem to be a major problem, and we would commend measures such as those taken by the Government of Jamaica, which are set out in Annex IX for illustrative purposes. Secondly, there is the question of medium-term credit on terms which enable developing countries with productive capacity in the capital goods sector to compete with developed countries in what has recently become something of a "credit race". Here, we would broadly endorse the argument of the Orion Bank Study, which can be summarised as follows:

- (a) The main claims on such a facility would be made by a rather small number of Commonwealth countries.¹
- (b) The sums involved in financing the "extra cost" of

1. Op. cit. paras. 44 - 46.

subsidising medium and long-term export credit are small in relation to export earnings. 1

- (c) The provision of these sums from external sources might raise disproportionate political issues in terms of the reaction of exporting interests in the principal donor and lending countries. 2

On the basis of this argument, we also endorse the principal conclusion of the Orion Bank Study, to the effect that the burden of financing medium and long-term credit "can best be mitigated or offset by appropriate recourse to international money and capital markets". 3 We attach particular importance to the third of the arguments cited above. To be of real help, an externally financed export credit facility would need to be additional to existing sources of concessionary funds. We believe that Commonwealth developing countries will encounter fewer problems, and will achieve a greater addition to their resources, if they pursue such an addition by other means, enabling them to divert their own resources thus saved into financing their exports in the manner suggested by the Orion Study. This conclusion, however, relates specifically to an export credit financing or re-financing facility. We note the need identified in the Orion Study, for technical assistance in the fields of export credit finance and credit insurance. We also note that the question of providing an international guarantee facility for export credits is under study in the World Bank.

29. A bank performing the functions that we envisage would be very active in organising development financing packages in which existing sources of concessionary finance are a component alongside loans on commercial terms. It is possible, also, that circumstances will arise in which bilateral agencies will ask it to administer concessionary funds on their behalf, either as parallel financing or as funds in trust, for which it would require the appropriate powers. In addition, a situation might arise in which bilateral agencies were anxious to associate themselves more closely with its operations. To provide for this possibility, the articles could be drafted in a way which would facilitate the incorporation of a soft window at a later stage.

30. The case for more resources for developing countries on concessionary terms seems to us unquestionable. A decision to make such resources available through Commonwealth channels depends ultimately on the political will of member countries, which we are not qualified to assess. If the will to establish a Commonwealth soft-loan instrument does exist, however, we still think that it should initially be kept quite separate from a bank performing the functions that we have in mind, at least until its reputation and image as a sound commercial organisation are firmly established.

1. Ibid. paras. 22, 23 and 48. Even for India, the principal country involved, it was calculated that the annual "extra cost" of financing a 3 per cent margin between the terms of market borrowing and of subsidised credit would take ten years to reach £3.6m.

2. Ibid. para. 18.

3. Ibid. para. 54(b)