III. TASKS FOR A COMMONWEALTH INVESTMENT BANK

31. In the preceding section, we have made a case in general terms for a bank that would act primarily as an intermediary on behalf of governments and public enterprises in Commonwealth developing countries, supporting them in their relations with external sources of concessionary and commercial loans. The purpose of this section is to set out some major tasks to which it might address itself, in certain specific fields.

32. A Commonwealth Investment Bank, as it might be called, would need to develop the general skills required for project-financing in the productive sectors - i.e. manufacturing industry, mining and agriculture. Apart from these general skills, as exemplified, for instance, in the financing of large-scale industrial projects, the Bank would need to develop specialist skills related to the tasks associated with particular problem areas. In identifying some of these skills, and the tasks for which they are required, it is not our intention to preclude other operational areas that the Bank might enter. Our purpose is simply to specify some major problems for the resolution of which a suitable instrument appears at present not to exist.

33. It is noteworthy that the lack of such an instrument has already been felt by certain non-Commonwealth countries. An argument along the lines of the preceding section seems to have been an element in the establishment of an International Investment Corporation for Yugoslavia and in the intended establishment of a Euro-Latin American bank. For the reasons given in paras. 19-21, a bank or corporation of this type established within the Commonwealth would have special advantages.

34. As an instrument for facilitating developing countries' access to capital markets, a Commonwealth Investment Bank would need the skills required for operating in Eurocurrencies. Recent events have given rise to a general re-examination of the Eurocurrency market, giving added urgency to the need for an instrument which will promote orderly and prudent use of this market on the part of developing countries. According to one assessment, announced Eurocurrency borrowing by developing countries in the year November 1, 1972, to October 31, 1973, was $6,500m.[1] It was estimated that total borrowing by developing countries in the Eurocurrency market was perhaps double that amount.

35. There are some obvious dangers in this trend. At current rates, such borrowing is expensive, and can be rendered much more expensive:

(a) by wrong assessments of future parity movements, which can outweigh the effect of interest rates [2];

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1. Rothschild Intercontinental Bank, Annual Report, 1973, p.7.

2. Ibid. pp.9-11. The cost in sterling terms of borrowing certain Eurocurrencies for six months is estimated as having ranged from -12% to +71% in 1973.

(b) by borrowing through channels in which additional costs are imposed, or through persons and institutions of uncertain worth.[1]

In spite of these dangers, it seems unrealistic to believe that developing countries will deny themselves access to such a large source of funds. From their point of view, borrowing on this market has the advantage of giving greater freedom of action, since it normally carries fewer conditions than are associated with lending on concessionary terms. Where it is used as an alternative to tied concessionary loans for capital and semi-capital goods, the extra cost of borrowing on the market, if knowledgeably and skilfully used, may be largely offset by savings on price and a more advantageous choice of equipment.

36. The dangers of borrowing in the Eurocurrency market are most likely to be avoided by those banks which have a continuous and large-scale involvement in it, and which have therefore developed the required specialised skills. These banks have become increasingly involved in raising general-purpose loans for the relatively few developing countries that are regarded as creditworthy, and, more widely, in the mobilisation of project finance for countries which cannot borrow simply on the basis of their overall financial strength. The main function of a Commonwealth Investment Bank in this field would be to identify, maintain close relations with and facilitate the business of those reputable banks which can plausibly take a lead position in the syndication of Eurocurrency loans. It would not normally take a lead position itself, though it would often need to take a small participation in whatever financing it arranged, in order to inspire confidence.

Mining and Petroleum

37. The mineral assets of developing countries may remain unexploited or under-exploited for any or all of four main reasons:

(a) an adverse assessment of political risk on the part of mining companies;

(b) the location of mineral deposits in remote areas, involving uneconomic infrastructure costs;

(c) failure to find a satisfactory contractual resolution to the conflict between developing countries' legitimate desire to control and to derive the benefit from their own assets and the desire of mining companies to earn what they regard as a fair return on investment of an inherently risky nature;

(d) failure to mobilise the very large amounts of capital required.

A Commonwealth Investment Bank could make a useful contribution in all four respects, as set out in the next four paragraphs, and in doing so could provide a service of value both to the countries in which minerals are located and to the principal consumers.

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1 Since these additional costs tend to occur at the front end of the repayment schedule, e.g. as enlarged fee and commission, they have a disproportionate impact on the discounted stream of repayments.

38. Mining companies are increasingly unwilling to commit their own resources to what they regard as areas of high political risk. It seems to be generally agreed that an additional intermediary on the side of developing countries, with a stake of its own in the development of new mines, could have a steadying effect. In particular, it could help in the working out of a mutually acceptable understanding, giving the mining companies a reasonable assurance of the future security of their operations. We note that there have been cases in which failure to reach a satisfactory understanding, and hence failure to develop a new mine, appears to have been attributable to the lack of an intermediary which the developing country concerned felt it could trust completely as having its interests at heart.

39. Assessment of political risk has driven mining companies to look at high-cost but allegedly low-risk areas in developed countries. One result of this is that deposits which were previously regarded as uneconomic because of infrastructure costs may now be worth reconsidering, especially if the host country, as a partner in the venture, can reduce the cost by securing concessionary finance for the infrastructure element. If this trend materialises, mixtures of concessionary and commercial finance will become increasingly common, posing a complex problem in coordination.

40. Because of the size and complexity of mining projects, the mechanisms by which returns are distributed between mining company and host country have to be negotiated to meet the circumstances of each special case. The need for assistance to developing countries in this respect is widely recognised. There have been occasions on which contracts have had to be renegotiated after some years, to secure more equitable terms. The process which leads to such renegotiations can generate much ill will on both sides. It would clearly be preferable if a mutually acceptable contract, with some chance of enduring as such, could be negotiated in the first instance.

41. The development of a new mine is typically financed on a development production payment basis, repayments being geared to the proceeds of a long-term sales contract. Governmental participation introduces an additional party to the contract as a complicating factor. There has been some discussion of the extent to which current practices in mineral financing need modification to take account of uncertainty over the problems to which this new situation may give rise. While the mining companies themselves seem to have adopted a more flexible position on the question of government participation, and while some of the banks that we consulted expressed a preference for government participation, or even government control, on the ground that in the long run this gives greater stability, the general view seems to be that new financial instruments will have to be developed. We are not qualified to judge the strength of the technical arguments in this discussion, but it appears to us at least that a need will arise for a bank which has a special competence in the techniques of mineral financing for developing countries, and which will therefore take a lead in developing new financial techniques if they are indeed required.

Agricultural Production

42. International development agencies have recently given greatly increased attention to agriculture. It is a sector which remains problematical for big international lenders, because of the multiplicity of small final borrowers, the element of local cost, the inappropriateness of the conventional capital/recurrent distinction, and vulnerability to highly

complex non-financial factors - administration, social organisation, climatic risk, etc. In view of the extent to which these problems are recognised, and of the intensity with which solutions are being sought, it seems likely that the main thrust for the new initiatives which are undoubtedly needed will come from existing institutions. The functions that we have already outlined, however, would clearly give the bank a role in putting together agricultural projects of an organised commercial nature.

43. As envisaged, a Commonwealth Investment Bank would be especially well equipped to assist in the organisation of agricultural processing projects. When agricultural processing is in the hands of an established company with experience in this field, the financing of new projects is relatively simple. It is becoming increasingly common, however, for governments to take the view that new processing projects should be established in the public sector or as joint ventures, in order to control, and to retain the income from, this development of their natural resource base. Another reason given is the need to ensure, through the mechanism of government participation, that the benefits of this increased income are distributed widely among small-scale agricultural producers, and are not confined to a small minority of private entrepreneurs who already have the capacity to save and invest. A Commonwealth Investment Bank could help governments to attain these objectives by organising the venture capital of such projects on a sound basis. Without such help, governments may be driven to adopt one or both of two strategies:

(a) keeping the total equity small, in order to minimise its own cash contribution while retaining overall control;

(b) seeking the assistance of the foreign partner in financing its own equity stake, e.g. with an agreement under which the foreign partner accepts deferred payment out of the earnings of the project.

Neither strategy is wholely satisfactory. The first can result in severe under-capitalisation. (Cases of debt/equity ratios as high as 20:1 have been reported to us.) The second introduces ambiguities into the substance of partnership, which constitute a potent source of future misunderstanding. Additional problems arise if the foreign partner responds to this unsatisfactory situation by seeking a management contract in preference to an equity stake, which can result in reduced commitment to the project and a loss of tax revenue.

44. The Bank's activities in manufacturing industry, also, could provide useful support for agricultural development. In particular, we note that fertiliser projects typically involve a mixture of concessionary and commercial finance, which gives rise to situations for which the Bank is explicitly designed.

45. More generally, the possibilities in agriculture would require further study after the Bank had taken shape.

Small-Scale Industries

46. Development agencies with experience in the promotion of small-scale industries seem to be agreed that success in this field requires close and continuing support during an extended initial period. This suggests

that the task of promoting small industries lies primarily with national development agencies, or at least with agencies that are strongly and extensively represented in the field, since a local presence is necessary for assessment in personal terms of the degree of entrepreneurial commitment, assistance in working up an idea into a viable proposition, assistance in the acquisition of basic business skills, such as book-keeping, and early warning when the small business man's vulnerability to short-term problems is getting him into difficulty. Compared with national development banks concerned with the promotion of medium and large-scale industries, agencies for the promotion of small industries have been relatively little used by the major international lenders as financial intermediaries, because of a prevalent assumption that their main need is technical assistance. Yet such agencies do need financial support in the performance of their role, in association with technical services, which suggests that a Commonwealth Investment Bank could fulfil a useful purpose in a relatively neglected field of international development cooperation.

General Purpose Borrowing

47. The needs in relation to general purpose borrowing are not confined to those countries which are sufficiently creditworthy to go to the market. In addition to helping creditworthy countries to organise their borrowing as cheaply as possible, a Commonwealth Investment Bank could play a useful role in helping countries to assess and compare the true worth of the services offered by commercial banks and other private intermediaries, even in countries of limited borrowing capacity.

Other Areas Considered

48. The other areas that we have considered fall mainly under the heading of invisibles. In particular, we have looked at three areas in which it is frequently argued, notably in the context of Unctad debates, that the dominance of developed countries imposes an unnecessary strain on developing countries' foreign exchange resources. These are:

(a) insurance;

(b) shipping;

(c) tourism.

We do not believe that simply building up developing countries' capacity in these three areas provides an adequate solution to the problems that arise. In insurance, we see no easy way of avoiding the cost of re-insuring in one of the established insurance markets. Both in shipping and in tourism, we note that considerable efforts have already been made, and that in the light of experience many developing countries are now reconsidering their policies. We would draw attention to the possibility of expanding the functions of the CFTC in these fields, to assist developing countries in making discriminating use of the facilities that are available, but we are not convinced that the problems are primarily financial, or that a financial intermediary could make a significant contribution to their solution.

IV. THE TASK OF ESTABLISHING THE BANK

49. A bank capable of responding to the needs identified in the two