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PUBLIC FOREIGN CAPITAL FOR PRIVATE ENTERPRISE IN DEVELOPING COUNTRIES

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Although the private sector employs most of the labor and capital and is responsible for the largest share of the output in developing countries, the vast bulk of foreign economic aid to these countries has gone to the public sector. There are a number of obvious reasons for this, including the fact that most of the economic-overhead facilities—such as power, transportation, and communications, etc.—are owned and controlled by the state in developing countries, and that traditionally most international-loan capital, whether private or public, has financed these activities. Foreign assistance for social-overhead projects—such as health, education, sanitation, rural improvement, low-cost housing, etc.—must by its very nature be extended to governments or quasi-public institutions. In addition, many external loans, however they may be labeled, are for the purpose of supplementing the foreign-exchange resources of the borrowing country, resources which are under the control of governments or central banks.

Foreign financing for industry and resource development, including plantation-type agriculture, has traditionally been provided in the form of direct private foreign investment. While foreign-aid institutions have sought by a variety of means to encourage direct private foreign investment, there remains a vast area of private domestic industry and agriculture in developing countries that has received relatively little financial assistance from foreign sources. This fact has been of growing concern to national and multinational foreign-assistance agencies, and the governments that support them, for two reasons. First, there is a feeling that the present allocation of external assistance may be influencing developing countries in the direction of a greater degree of public ownership and control; in fact, a major critic of foreign aid, Professor Milton Friedman, has argued that external-assistance agencies are driving countries toward socialism. More significant, however, is the fact that the private sectors of many developing economies are lagging or stagnating. Not only are private industry and agriculture the most important sectors in terms of aggregate output, but they constitute the principal engine for growth.

PURPOSES AND TYPES OF DEVELOPMENT ASSISTANCE

Foreign assistance directed specifically to the private sector must be considered in the context of the purposes and types of foreign development aid generally. Current foreign-aid doctrine envisages the functions of assistance to developing countries in terms of relieving or eliminating three types of limitations on economic growth: namely, (1) the skill and management limitation; (2) the savings limitation; and (3) the foreign-exchange limitation.[1] The skill and management limitation covers all of those factors which limit the capacity of a country to employ capital productively, including not only the shortage of skilled workers and experienced managers, but various institutional constraints on the planning and formulation of investment projects and their execution and efficient operation for increasing the social product. This limitation is sometimes referred to as "capital-absorptive capacity," although this term has been defined in several ways.[2] The savings limitation refers to the insufficiency of domestic savings to finance the volume of investment consistent with a given target rate of growth of which the country is capable—that is, allowing for skill, management, or institutional constraints. However, even if there are potential savings to finance the desired volume of investment, a country may lack the foreign exchange needed for the import components of the required volume of investment.

Foreign aid is employed for dealing with all three of these constraints to productive investment, and all three types of limitations apply to both the public and the private sectors of developing economies. Broadly speaking, foreign-development aid takes three basic forms: (1) technical assistance; (2) project loans (or grants); and (3) program loans, which are loans for financing the importation of a broad list of commodities and services without restriction as to the end uses to which these goods and services may be put. Technical assistance tends to deal with the skill and management constraints on productive investment common to both the private and the public sector. However, technical assistance may be employed for encouraging savings—as in the case of assistance for the creation of savings-and-loan institutions and the improvement of capital markets—or it may be directed to expanding the

[1] See Hollis B. Chenery and Allen M. Strout, *Foreign Assistance and Economic Development*, AID Discussion Paper No. 7 (Washington, D.C.: Office of Program Coordination, AID, June 1965). See also Ronald I. McKinnon, "Foreign Exchange Constraints in Economic Development and Efficient Aid Allocation," *Economic Journal*, Vol. LXXIV (June 1964), pp. 388-409; and John C. H. Fei and Douglas S. Paauw, "Foreign Assistance and Self-Help: A Reappraisal of Development Finance," *Review of Economics and Statistics*, Vol. XLVII (August 1965), pp. 251-267.

[2] See John H. Adler, *Absorptive Capacity: The Concept and Its Determinants* (Washington, D.C.: The Brookings Institution, 1965).

production of export goods or to the marketing of exports—as a means of relieving the foreign-exchange constraint. In practice, technical assistance is frequently packaged with financial assistance.

Project loans, such as those for the financing of a highway in the public sector or a chemical plant in the private sector, serve both to supplement domestic savings and to provide foreign exchange for the import components of the project. Finally, program loans also may supplement savings, but to a considerable degree this form of aid is made available for relieving the foreign-exchange constraint. In practice, it is frequently difficult to differentiate program loans in support of economic development from balance-of-payments assistance such as that provided by the International Monetary Fund, although officials of the Agency for International Development (AID) insist that there is a difference. An adequate consideration of the rationale for these categories of assistance in relation to the three types of limitations on growth is beyond the scope of this essay. My purpose is to discuss foreign assistance to the private sector in the context of this general approach to foreign aid.

Much of the technical assistance supplied by foreign agencies to developing countries is either concerned with education, health, and other human-resource investments that contribute to productivity and capital-absorptive capacity in both the public and the private sectors, or is of direct benefit to private industry and agriculture. Probably the most important technical assistance is that which accompanies direct private foreign investment, and, while maximum encouragement should be given to such investment, the limitations on its flow are well known. There are also serious limitations on the ability of foreign-aid agencies to stimulate and provide technical advice to private industry and agriculture in developing countries. To be effective, such programs must be formulated in cooperation with local governments. They usually involve assisting governments to develop their own programs in the form of industrial-productivity centers, centers for agricultural research and demonstration, specialized credit institutions for small industries and farms, and so forth. Undoubtedly, more could be accomplished in this field by cooperative efforts of local government and foreign agencies, but there are tolerance limits and an absorptive-capacity limit on foreign technical personnel in developing countries, even if there were no supply constraints on this type of assistance. However, our principal concern in this essay is with the allocation of foreign capital to the private sector of developing economies as a means of dealing with both the savings and the foreign-exchange limitations on growth.

THE CASE FOR CHANNELING PUBLIC FOREIGN CAPITAL TO THE PRIVATE SECTOR

If there exists a proper allocation of capital between the public sector on the one hand, and various branches of industry, agriculture, and distribution in the private sector on the other, as determined or influenced by governmental policies and measures affecting the flow of credit, is there any need for foreign-assistance agencies to adopt special measures for channeling a larger proportion of their largess to the private sector? If foreign-assistance agencies, such as the World Bank, are partial to power and transportation projects usually found in the public sector of developing economies, should not their willingness to lend for these purposes release savings or foreign exchange for use by the private sector of the economy? Likewise, if developing countries receive program loans from foreign-assistance agencies, perhaps mainly as a means of supplementing their import capacity in order to sustain a higher level of investment, will not the foreign-exchange resources be allocated in a rational manner for maximum investment and output in all sectors of the economy, as dictated by the country's development plan?

If the answer to these questions is that developing countries do allocate their domestic and foreign financial resources in an optimal manner, then it makes little difference where and in what form external capital or foreign exchange is injected into the economy. However, developing countries have not employed policy instruments in a way which would achieve a rational allocation of scarce resources—which is one of the reasons why they are underdeveloped—and foreign-assistance agencies operate on the assumption that they have a responsibility for influencing the allocation of resources, both their own and the total investment resources available to the countries they are assisting. If this were not so, foreign-aid agencies could limit their activities to making general budget-support or balance-of-payments loans or grants to developing countries without concern regarding their end use, except possibly for reviewing overall development plans and general monetary and fiscal policies.

Foreign-assistance agencies seek to identify and alleviate specific limitations on growth by distributing their financial assistance among alternative uses, as well as by influencing the overall development policies of the aid recipients. These development-assistance activities, rather than simply the provision of a certain volume of foreign capital, are the most important contributions to growth made by public foreign-lending agencies. Contrary to the assumptions frequently made or implied by development theorists, there is no predictable relationship between the amount of foreign capital a developing country receives and its rate of

growth. Much more important is how wisely the country employs its total resources.

The case for channeling a larger proportion of external public funds into the private sector of developing economies depends in part upon whether the principal limitation on the growth of private industry and agriculture is to be found in a shortage of capital and of borrowing facilities available to the private sector, or whether government policies together with the social and economic structure make for a low level of investment demand. But even admitting the existence of a low level of effective demand, it is possible to devise and support institutions that will increase both the demand for and supply of capital in the private sector, just as foreign-assistance agencies have contrived with considerable success to expand the demand for funds in the public sector by helping governments to plan and to formulate projects suitable for external financing. Nevertheless, it is far easier to supply money and plans and technicians for large projects in the public sector (or simply make balance-of-payments loans) than it is to inject capital for productive uses into the private sector. There is, indeed, a real question as to just how much external agencies can do in this field beyond supplementing the efforts of national governments, since the successful activation of the private sector may depend upon a transformation of the whole social and economic fabric of the country.

MEANS OF CHANNELING FOREIGN CAPITAL TO THE PRIVATE SECTOR

The major sources of public foreign capital for economic development are the Agency for International Development (AID); the Export-Import Bank of Washington (Eximbank); the World Bank (IBRD) and its affiliates, the International Finance Corporation (IFC) and the International Development Association (IDA); and the Inter-American Development Bank (IDB). (In addition to these public foreign-lending institutions, there are two development-assistance agencies of the European Economic Community—the European Development Fund and the European Investment Bank; several European national foreign-assistance agencies; one Canadian and two Japanese foreign-lending agencies. All of these public foreign-assistance agencies provide some loans to the private sector of developing countries.)

Most of the capital made available by these institutions takes the form of loans, although the loan terms vary from those that reflect the cost of borrowing in the private international markets—as in the case of loans made by IBRD—to no interest (other than a three-quarter of one per cent service charge) and 50-year maturities—as in the case of loans made by IDA. Most of the loans made by AID are relatively low-inter-

est loans (currently 2½ per cent) with a maturity of 40 years. The Eximbank makes only so-called hard loans, with terms similar to those of the World Bank, while the IDB makes both hard loans and loans at relatively low interest rates repayable in the currency of the borrower. The IFC, which makes both loans and equity investments solely in private enterprises in developing countries, employs loan terms that reflect rates of interest in the domestic markets of the countries where the loans are made.

Excluding investment guaranties and other efforts to promote U.S. private direct investment in developing areas, the following types of arrangements are employed by public foreign-lending agencies for channeling funds into the domestic private sectors of developing economies:

(1) Direct loans to domestic private enterprise or mixed domestic-foreign-ownership entities;

(2) Equity investments and the underwriting of securities of private firms;

(3) Program loans to governments or government agencies, the foreign-exchange proceeds of which are earmarked for the financing of imports by the private sector of the borrowing country;

(4) Loans to intermediate credit institutions for relending to the private sector, including industry, agriculture, and housing.

Although sizable amounts of loans are made by public foreign-development agencies directly to domestic private firms in developing countries, this channel for financing the private sector is rather limited except for loans by the Export-Import Bank of Washington and by other national export-credit institutions—such as those found in Western Europe, Japan, and Canada, the principal function of which is to promote exports rather than economic and social progress. The World Bank has not made any direct loans to private firms over the last couple of years, while the Agency for International Development and the Inter-American Development Bank have provided only a handful of such credits.

The International Finance Corporation, which is the only multinational agency empowered to make equity investments in private firms in developing countries, made loans and equity investments averaging about $20 million a year over the period July 1963-June 1965. The work of the IFC is quite important as a catalytic agent in mobilizing private domestic and foreign capital for investment in private enterprise and in contributing to the improvement of private-capital markets in developing countries. However, as a medium for channeling large amounts of foreign capital to the private sector of developing

countries, the IFC is subject to the same general handicap of all foreign-financing agencies: it does not have the staff and knowledge of local conditions nor the opportunity for continuous contact with the borrowers necessary to the role of retailer of loans on a world-wide basis. By and large, foreign-development agencies must serve as wholesalers of capital funds.

Program loans have become increasingly important as a method of foreign assistance by AID to developing countries in recent years. Program loans, which currently constitute about half of AID's development-loan assistance, are not tied to specific projects, but provide financing for broad shopping lists of imports—including industrial raw materials, spare parts, and replacement equipment—an estimated 75 per cent of which goes into the private sector of the recipient countries. A principal argument advanced by AID officials for the program-loan technique is that it assures a larger allocation of the total foreign-exchange resources available to the country for use by the private sector, both agriculture and industry. For example, in the case of the $150 million program loan to Brazil authorized by AID in December 1964, a substantial portion was specifically earmarked for the purchase of a broad list of essential imports made available through special letters of credit issued to private importers. A similar arrangement was established under the $80 million AID program loan to Chile in December 1964. A substantial proportion of AID assistance to India and Pakistan also has taken the form of program loans, with the bulk of the imports financed going to the private sector. In June 1964, the International Development Association made a $90 million program loan to India to finance imports required mainly by the private sector in India's industrial-machinery, commercial-vehicle, and construction industries. The credit constituted a new departure for the World Bank and IDA, which previously had made virtually all their loans to developing countries on a project basis.

Program loans, as contrasted with project loans (which go mainly to large economic and social-overhead projects in the public sector), may serve as a means of channeling a larger proportion of external assistance to the private sector in those cases where the availability of *foreign exchange*, rather than *savings* as such, constitutes the major constraint on private-sector investment and output. Where imports for investment and current production are not restricted, program loans to finance private-sector imports would not be of direct benefit to the private sector, although there might be an indirect benefit through an increase in the availability of credit from the banking system or from special government-credit programs. Under program loans for the purpose discussed here, the additional capital resources go to the government, which sells

the foreign-exchange proceeds through the central bank to private importers for local currency. Conceivably the government might reduce its allocation of foreign exchange to the private sector below that which would have been made in the absence of the program loan earmarked for private imports. To this extent, the purpose of a program loan designed to alleviate the foreign-exchange constraint on private investment would be defeated. However, since, according to AID officials, program loans are made on the basis of a continuous review and evaluation by the external-assistance authorities of the overall development program of the recipient, such devious action on the part of the recipient government would soon be discovered. The major objection to program loans, even where their use is limited to a selected list of raw materials and intermediate goods of various kinds imported by the private sector, is that they provide no control by the lending authority over the end use of the imports. The same imports may be used to produce luxury apartments and automobiles, or low-cost housing and farm machinery.

Of growing importance in the financial and technical-assistance activities of nearly all external-development agencies are loans to intermediate credit institutions, which in turn relend the proceeds to private industrial firms, farms, cooperatives, and private-housing ventures of various kinds. Loans and investments by the World Bank Group, AID, IDB, and the Export-Import Bank to intermediate credit institutions or other financial institutions in developing countries for relending to the private sector totaled nearly $300 million in 1964, and they will run as high or higher during 1965. This assistance has made possible thousands of sub-loans to private firms and farms in developing countries. Aside from program loans, loans to intermediate credit institutions constitute the most important channel, in terms of value and number of firms assisted, for directing public external assistance to the domestic private sector of developing economies.

Each type of intermediate credit institution—for example, industrial-development banks, agricultural-credit institutions, and home-loan institutions—involves special problems both from the standpoint of the operations of the institution itself and from that of the foreign-lending agency. In order to limit the scope of this essay, I shall deal mainly with public foreign financing of intermediate credit institutions concerned with financing private industry, which I shall refer to as industrial-development banks. This type of institution has received most of the public foreign financial assistance that has been extended to intermediate credit agencies in developing countries.

There are several types of intermediate credit institutions through which external funds have been channeled to private industry, and the terminology relating to such institutions has not been standardized.[3] First, there are the privately owned and operated industrial-development banks or private *financieras*, which make loans to, and equity investments in, private enterprises. In some cases these institutions specialize in venture-type capital and promotional activities, concentrating their operations on a few firms in which they take a special interest. In other cases they may make medium- and long-term loans to, or equity investments in, a large number of private firms, standing ready to consider applications for financial assistance from a number of sources. The Industrial Credit and Investment Corporation of India is an example of this latter type of institution. Second, there are the publicly owned and operated institutions in which there may or may not be a minority private-equity interest. The Nacional Financiera of Mexico, the Corporacion de Fomento de la Produccion de Chile (CORFO), and the Banco Nacional de Desenvolvimiento Econômico (BNDE) of Brazil are representative of these institutions. These public development agencies usually provide financing for both private and public enterprises. Most developing economies have organized public development agencies which operate as a branch of the government in promoting investment in various sectors of the economy. In some countries the central bank, or possibly a large commercial bank in which there is a substantial public interest, may make development loans to private enterprises. In a number of cases these institutions, whose principal functions are other than those of a development bank, have been employed by public external-lending agencies as media through which to channel loans to private enterprises. In some cases external loans destined for specific projects in the private sector have been merely "passed through," and perhaps guaranteed by, the central bank, while in other cases external loans have been made to such institutions for relending on their own initiative to a number of private firms, subject to review by the foreign-

[3] For a discussion of industrial-development banks, see William Diamond, *Development Banks* [The Economic Development Institute, International Bank for Reconstruction and Development] (Baltimore: The Johns Hopkins Press, 1957); Shirley Boskey, *Problems and Practices of Development Banks* [International Bank for Reconstruction and Development] (Baltimore: The Johns Hopkins Press, 1959); J. D. Nyhart, *Toward Professionalism in Development Banking*, Working Paper (mimeo), (Cambridge, Mass.: MIT, 1964); *Private Development Finance Companies* (Washington, D.C.: International Finance Corporation, June 1964); and Robert W. Adler and Raymond F. Mikesell, *Public External Financing of Development Banks in Developing Countries* (Eugene, Oregon: Bureau of Business and Economic Research, University of Oregon, 1966).