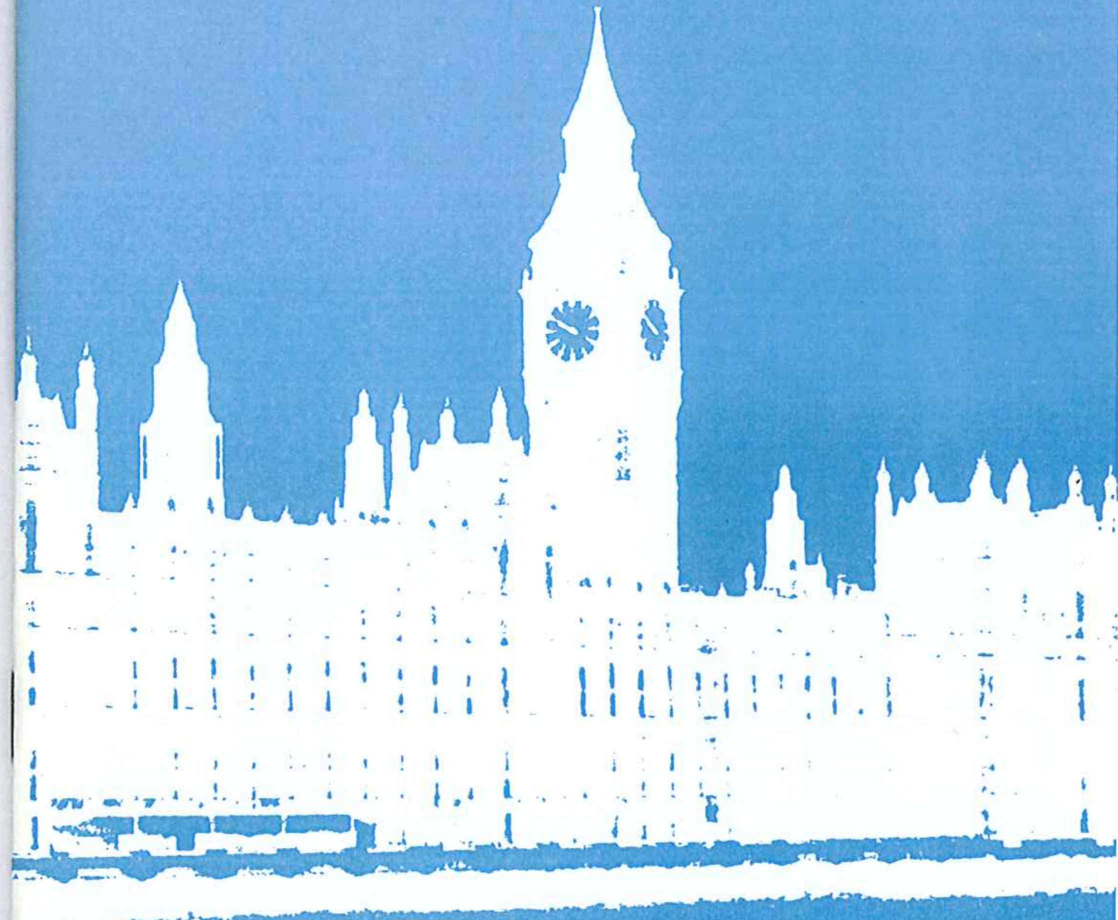
Policy Study No. 99

Home truths for foreign aid

how to encourage enterprise abroad

Frank Vibert



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The author

Frank Vibert won an open scholarship to Exeter College, Oxford, where he obtained a first class honours degree in P.P.E. For 20 years he served as an official of the World Bank, holding a number of senior positions. He is now an independent consultant on international financial matters.

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1
Introduction

THE PRESENT GOVERNMENT HAS EMBARKED ON A PROGRAMME TO reshape Britain – its institutions, the attitudes of its society and the aspirations of its individual citizens. It is a programme which still has far to go. This pamphlet, however, addresses a subject beyond Britain's borders – the problems of developing countries.

With the domestic programme of reform still having so far to go, it may well be asked why should the Government concern itself with the issues of developing countries.

Four reasons at least may be offered:

(i) Britain has a long standing tradition of concern for the welfare of those living in poverty; a concern backed by historical ties, and manifesting itself in a network of voluntary aid organisations;

(ii) many of the developing countries have become important trading partners, either as markets for British exports, or as sources of British imports;

(iii) as a leading financial centre and proponent of the free flow of capital, Britain must wish to see an end to the instability brought into the international finance system by the debt problems of developing countries;

(iv) Britain's own social structure cannot be insulated from outside problems; for example, pressures for illegal immigration, or traffic in drugs.

The interest of the developed countries in the problems of developing ones was recognised at the Toronto Summit in June 1988. Unusually, issues relating to the latter were prominent on the agenda and in the communique.

Two quite separate issues confront the international community at present. One concerns the over-indebtedness of the so-called middle income developing countries, in particular those which have contracted an excess of commercial debt. The second relates to the failure of the low income developing countries (especially those in Africa) to make progress after two decades or more of development assistance. A third issue, of great importance to both groups, relates to trade and to the need for the industrialised countries to open their markets to the

developing countries despite possible dislocation to some producer groups – including the agricultural sector.

This pamphlet sets out a number of practical steps open to the British authorities in respect of each of these issues.

They share a common theme:

(i) too heavy a reliance has been placed on financing development through capital provided in the form of loans, rather than on finance such as equity which does not create debt;

(ii) too heavy a reliance has been placed by developing countries on the role of the public sector.

In broad terms this paper's recommendation is that the Government should, in its approach to the financing of development, adopt many of the themes familiar from its approach to domestic issues:

(i) encourage the flow of private capital in the form of private direct investment and equity finance;

(ii) encourage market solutions to the problems of over indebtedness;

(iii) counter bias in favour of the public sector and acknowledge the efforts of those developing countries which emphasise the primacy of the private sector;

(iv) enhance the role of voluntary organisations concerned with the poorest developing countries; and,

(v) lay greater stress on trade rather than aid as the way to encourage developing countries to reduce their reliance on capital imports.

A few tentative steps have already been taken by the authorities in these directions. They need to be pursued more vigorously and on a much larger scale. Britain's approach to the financing of development must be redirected.

2
Private capital a market approach to debt reduction

The received wisdom has it that developing countries should grow out of dependence on official external – governmental and other – sources; and stand on their own feet, relying on private sources in global capital markets.

During the 1960s and 1970s many developing countries (the so called middle income developing countries), particularly those in Latin America and East Asia, were indeed able to turn to private sources of capital. However, because of their ingrained suspicion of foreign investors, as well as their policy of favouring the public sector to lead their development, they met their financings through borrowings. It was to the foreign private commercial banks that they turned for loans.

For their part, commercial banks had a ready-made lending instrument – the syndicated loan. It enabled large amounts of lending to be organised in one operation. At the same time the process spread the risk over the large number of banks that participated in a typical syndicate.

Such loans were biased toward public sector recipients. It was the public sector agencies which could absorb large transactions. It was also the public sector borrowers, or the governments themselves, which could provide the guarantees that reassured the lenders.

For every loan that is made, a debt is created. The rapid increase in commercial bank lending that took place in the 1970s led to an unmanageable accumulation of debt by the early 1980s.

The syndicated loan proved to have several important flaws:

(i) guarantees by borrowing governments which did not exert discipline to match their borrowings to their capacity to repay – particularly export earning capacity – proved worthless.

(ii) Many individual banks, participants in the syndicates, felt that the size of their participation scarcely warranted thorough credit analysis and were in any

case ill-equipped to carry out such analysis; and monitoring of collective exposure was inadequate.

(iii) The syndicated loan was an instrument that appealed only to the banking sector, not to other investors; so that the risks were concentrated to excess within the international banking system.

The attempt to finance development through massive reliance on borrowing led to disaster. Mexico, Brazil, Argentina, Chile, the Philippines, Nigeria, and Yugoslavia are among those countries whose development in the 1980s and prospects for the next decade have been blighted by an over-accumulation of debt. Together with a number of other countries relying too heavily on borrowing, they accumulated debt from commercial banks at a rate of over 20% per annum (and sometimes higher during the 1970s). In the same period their output and exports grew at less than 5% per annum. This combination was unsustainable. By the early 1980s their outstanding debt was the equivalent of almost half their GNP and service payment on it was approaching half their export earnings. Over the long term, if not indeed over the medium, the growth of a country's borrowing cannot exceed that of the volume of its exports without a debt crisis.

When borrowers ceased to service their debt in August 1982 the stability of the international banking system was threatened. This threat has now largely disappeared. The capital bases of many banks have been strengthened and most have put in place substantial provisions against loss. Nevertheless, while the stock of debt remains as high as it is at present, the prospects of developing countries are clouded and voluntary international commercial banking flows cannot be resumed. This in turn impairs international trade and the integration of international markets.

The initial response of the international community to the events of 1982 has been to buy time. Steps have been taken under what is known as the 'Baker Plan' to gain a breathing space[1]. Commercial banking debt has been rescheduled for 15 to 20 years, commercial banks have been forced to continue to lend under involuntary arrangements; and lending from official bilateral and multilateral sources, unrelated to specific investments in the borrowing country, has been increased in order that developing countries should have an incentive to

repay interest and to adjust. This breathing space has enabled the international banking system to overcome the initial threats to its stability.

But the underlying problems remain. These mostly revolve around the fact that the stock of debt generates obligations to repay which remain well beyond the capacity of the countries concerned. As long as this situation persists, lenders will not be able to renew lending on a normal commercial and voluntary basis and borrowers will remain under domestic pressures not to devote income to servicing their external contractual obligations.

Debt rescheduling cannot solve this problem since even with such re-arrangements the underlying obligations remain in place, or even increase if interest or arrears are capitalised. Lenders face the prospect of continued rescheduling of their assets so that, at best, they come to be seen as equivalent to holdings of perpetual debt. And on top of this, lenders still face the risk of non-recovery of principal, and interruption to or non-payment of interest. Inevitably the quality of such assets is suspect. So the banks would scarcely be prudent to resume new lending on a voluntary basis.

Nor can new lending techniques provide the answer. Banks can attempt to secure their assets from the export earnings of the projects they finance, or by requiring borrowers to offer collateral of various sorts, or by defeasance techniques[2]. They can attempt also to spread their risks to other financial intermediaries by 'securitising' the assets. But under present circumstances, whatever the lending technique, the basic problem remains that the reward to lenders cannot justify the risks involved. Normal banking relationships with clients in these highly indebted countries cannot therefore be resumed.

In order to restore a normal working of the market, with both borrowers and lenders interested in sustaining voluntary banking relationships, the stock of existing debt has to be reduced. This erosion can come, and in part will come, simply through the passage of time.

The process, however, needs to be accelerated. Estimates of the desirable extent and speed of any such reduction in the stock of debt is a matter of judgement. In round figures, a reduction in face value of the debt of about $150 billion would

seem necessary. In the market place such assets would be valued at about $50 billion at best. These amounts would of course be spread over a number of borrowers and asset holders. A reduction of this magnitude could therefore be handled in an orderly manner.

Because of its importance as an international finance centre, Britain has an interest in speeding such an operation. Moreover, three out of the four major British banks have had their international standing harmed by the volume of loans which have not been repaid by developing countries.

Calls for governments to take over this debt and to bail out commercial banks from their exposure to developing countries by buying their loans should be resisted. Instead, the Government should encourage market techniques of debt reduction. Market mechanisms, indeed, are emerging to reduce the stock of debt to the underlying capacity of borrowers to repay. There is now a secondary market where the external indebtedness of developing countries can be bought and sold at a steep discount. The borrowing country can in turn capture the benefits of these discounts and repatriate (at a discount) their foreign exchange obligations, transforming them into more manageable domestic obligations.

The repatriation of debt can take a number of different forms. Foreign investors, or residents, of the borrowing country can be encouraged to convert external debt into equity investments; resident corporate or individual investors can be encouraged to use their overseas holdings to invest in domestic debt obligations via the secondary market; other uses for discounted debt can be facilitated, for example, trade financing.

The pool of resident flight capital alone probably well exceeds the discounted value of a debt reduction of the size indicated. With appropriate policies providing domestic investors with adequate returns, debtor governments can attract back part of this flight capital. It should provide the major source of their financing.

The British authorities should encourage this market process of debt reduction. In particular:

(i) British banks could be allowed to spread over a number of years the balance sheet impact of selling their developing country assets at a discount.

(ii) Borrowers could be encouraged to take more vigorous steps to enable external debts to be converted into equity investments and domestic uses.

In an early example of a debt conversion, a major U.S. bank acquired an insurance company in Chile through the conversion of part of its holdings of Chile's external debt into Chilean domestic obligations, which in turn financed the acquisition. From the viewpoint of the bank, it had rid itself of a loan asset of doubtful quality which had every prospect of being rescheduled indefinitely. In return, it had an investment which, if managed well, could yield dividends and grow in value. In the long run, the bank could sell its investment, repatriate the proceeds and thus recover its original assets, or remain in Chile if it wished to do so.

British banks have been slow to initiate similar strategies for recovering their assets. Yet the ingredients are there. They have a presence in the debtor countries, and a knowledge of local investors and investment opportunities. They also have a solid base of corporate clients who could benefit from debt swaps. Delays appear to have partly been due to a reluctance to admit the impaired nature of their assets and accept the consequences to their balance sheets. By allowing sales at a discount to be spread out over a number of years any such consequences could be mitigated, and the British authorities could accelerate the necessary market adjustment.

Over the longer term, countries in Latin America and Asia which are in a position to look to markets to meet external financing needs should not rely, as they have done in the past, on debt-creating loan finance. That is the lesson. Private capital in non debt-creating forms must be encouraged. This means above all that developing countries should learn to attract private direct investment and private portfolio investment. A favourable environment must be created, both for the domestic and for the foreign investor.

Fears of loss of sovereignty, or of loss of control, in state interventionist regimes, have led many developing countries to subject foreign investors to discouraging regulations and requirements. Yet from a financial point of view, equity investments have clear advantages compared with debt financing. Once debt is acquired, the service stream is fixed

contractually, whether or not what has been financed yields a return. By contrast, with direct investment the eventual outflow of capital and dividends depends on the success of the investment. Moreover, with equity outlays the investor is directly concerned with the risks of his investment, and likely therefore to proceed only after a thorough appraisal. Lenders, on the other hand, have usually relied for repayment on government guarantees and have shown little regard for the productivity of what has been financed.

The attitude of developing countries towards foreign investment relative to loan capital has to change; but commitment to the private sector can come only from themselves. Nevertheless, the British authorities can fund technical assistance with privatisation, and with developing emergent equity markets and capital market institutions.

Finally, the scale of the risk of granting general purpose loans to governments and public sector agencies in developing countries should be emphasised, so that as countries emerge from their present difficulties the cycle of over borrowing is not repeated. In future the Bank of England should give a higher risk weighting to such assets.

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(1) Named after the US Treasury Secretary James Baker, this plan, announced in September 1985, called for official creditors (bilateral and multilateral) and private creditors (the commercial banks) to provide net new lending to an original list of 15 highly indebted countries in order to encourage them to continue service payment on their debt. Private lenders were intended to share, in roughly equal proportions with official lenders, the increase in new lending.

(2) Under which borrowers set aside certain financial assets which will gain in value sufficiently to cover the eventual repayment obligation of the principal amount borrowed.

3

The British aid programme top priority for the private sector

The last two British administrations have embarked on a commendable effort radically to reform domestic policy. By contrast, they have made few, if any, policy changes in foreign aid. Nor apparently is this Government contemplating any such. During the 1980s, Britain has consistently spent between $1.5bn-$2.0bn a year on foreign assistance. For about two decades this has amounted to the equivalent of 0.3%-0.4% of Britain's GNP. There has been no clear sense of new direction; rather a policy of benign continuity and a timid tinkering at the margins. In theory, assistance is given to foreign countries for two reasons. First, some developing countries are so poor, and have so few human and physical resources, that private capital cannot be attracted or repaid. Official assistance is invoked in the name of both development and humanity. Second, official assistance is intended to supplement the domestic efforts of the poorest countries until they can increase both investments and income to the point where, eventually, they can get private capital markets to tap foreign savings.

It was the post-war reconstruction in Europe, financed by official assistance from the United States through the Marshall Plan, that provided the model for this kind of development. But the transposition has not worked. In this case the foreign assistance has not led to increased income; but rather to a stock of debt which cannot be repaid – as demonstrated by the recent initiative of the Ottawa Summit to grant additional debt relief to many of the poorest countries. The initiative should be seen not only as a witness to the insolvency of the recipient countries but also as an admission of the ineffectiveness of aid policies of the donor countries.

There are two reasons why the record of such official assistance is so poor.

(i) Among donor countries development has been only one objective of foreign assistance – and not always the primary objective at that. In some cases the

principal motive has been to obtain contracts for exporters or, more generally, to help retain export markets. In others cases, it has been to do with the aims of bilateral foreign policy. The orientation of U.S. assistance to the Middle East and of France's aid to Francophone Africa are two examples of this latter. Not that such policies are necessarily wrong in themselves – although they may be costly forms of export promotion, and may backfire when intended to secure bilateral political objectives. Rather, the lesson is that one cannot look for development success from foreign assistance when in so many cases development has not been the principal objective.

(ii) Among recipient countries, development policies have often been misguided. A long list of mistakes can be recited – overvalued exchange rates, over-protected industry, neglected agriculture, distorted domestic price regimes – to mention the most glaring. Above all, in almost all developing countries, over reliance on the state rather than on the private sector has been pervasive.

It is against this background that Britain's own aid programme needs to be reshaped. Many demands are made upon it:

(i) a part is intended to support bilateral political objectives;

(ii) a part is reserved to defend British exporters where contracts might be lost because of offers of development aid from other countries;

(iii) a part is needed for humanitarian and emergency relief; and,

(iv) a large part (40%) goes to multilateral organisations including the institutions of the Common Market.

Of these existing components, the one that is most frequently criticised, because it dilutes the impact of the programme, is the element of export promotion. Indeed, the use of foreign assistance on concessionary terms in order to promote exports is a distortion of trade and should be discouraged. It is, however, a reality of international practice which Britain's exporters have to face in the market. Therefore, a component, and if necessary a large component, of the programme must be reserved as a 'war chest' to defend Britain's trading interests and to make it expensive for other countries to distort trade. Moreover, Britain's official aid has rightly focused on the low income countries, and since it has been given in grant form, it has not contributed in recent years to the build-up of debt in those countries. What is more, by taking a lead in the advocacy of debt relief, Britain has allowed for the terms of past aid to be adjusted (including those which relate to substantial loans Britain had itself made available at an earlier date).

Nevertheless, the programme can be channelled more effectively than at present. It could and should serve as a vehicle for some of the main convictions of this Government.

The most important aim should be to ensure that as much aid as possible supports productive investments in the private sectors of recipient countries. This involves having in place an organisation and people with knowledge of local business and ability to appraise capacity on the spot. A remit to make equity investments, portfolio investments and investments in support of local or incoming foreign investment would be desirable.

The Commonwealth Development Corporation has this capacity and could be built up. It has long been in search of a clear focus for its activities. It should be provided with a greatly enlarged capital base and private shareholders. Its capital structure should be such that it can stand on its own feet in the market. In order to ensure that Britain's aid programme is oriented toward the private sector, it should be charged with handling the major part of the programme, and with channelling it into private sector investments. Its charter should be flexible to allow it to provide working capital and to finance imports needed for the maintenance of present capacity in the private sector, as well as to finance new investments. It could play a major part in the rehabilitation of private sector enterprises. It should also take a lead in the privatisation of public sector enterprises. It should be free to operate in all developing countries, and to take advantage of every private sector opportunity available.

A second important objective for the aid programme is to ensure that assistance meant for welfare and relief does indeed reach the poorest in the developing countries and is not siphoned

into the public sector. Aid channelled by government, public sector agencies frequently takes on a government, public sector colour in the recipient country. Britain's voluntary aid organisations may have better grass roots contacts in developing countries and effective means of reaching those most in need. They should be encouraged. That part of the British aid programme primarily directed toward welfare or emergency relief should be channelled through them.

Third, while the needs of welfare and emergency may in some countries be paramount in the allocation of the British aid programme, nevertheless the degree to which the country concerned fosters the private sector and provides an equitable environment for foreign private investors should become a key criterion for allocation of resources.

Britain has made a start in this direction. For example, about $20 million a year is provided to the voluntary agencies, and a small build up of the Commonwealth Development Corporation is taking place. However, a much larger change is required. The aim should be to increase the scale of the voluntary agencies' activities from their current level of $100-200 million a year to say $500 million a year. Similarly the Commonwealth Development Corporation's activities should be expanded; in particular its capacity to make equity investments should be increased to say $500-700 million a year.

Such expansion will not be easy. It is important to preserve the non-official identity of the voluntary agencies. Equally, it is important to retain the market orientation of the Commonwealth Development Corporation, even though its expanded role will make it subject to political pressures. But techniques exist to overcome these problems.

This sharpening of the focus of Britain's aid effort would help to concentrate Whitehall's mind. In particular, the Commonwealth Development Corporation would become the principal official vehicle for a private-sector oriented programme – administering funds in trust for those parts of the programme which derive from commercial or foreign policy considerations, on behalf of the DTI and the Foreign Office respectively. With a reconstituted Commonwealth Development Corporation and an enhanced place for the voluntary agencies, the Overseas Development Administration could be phased out.

No particular target for the volume of aid should be set for Britain's foreign assistance programme. How the volume of aid might be increased should depend upon the capacity of the Commonwealth Development Corporation to increase its investments and the effectiveness of voluntary agencies in reaching those most in need. The long term aim must be to help developing countries to rely on their own resources and to phase out official assistance. Reference is sometimes made to countries such as Britain accepting as a goal an aid level equivalent to 0.7% of their GNP; but there is no merit in such a target. It has no empirical foundation. It assumes, quite incorrectly, that official assistance has an importance greater than that of private capital flows. The Government's commitment to it should be abandoned. Reference is also made to a target of 1% GNP for total flows, both private and official. Private flows, however, are not amenable to targeting; so this target, too, should receive no endorsement.

4

The multilateral finance institutions privatising development finance

Developing countries meet a part of their financing needs from the multilateral development institutions – notably the World Bank and the Regional Development Banks. Britain is a leading shareholder in the World Bank and a member of the Regional Development Banks. Its support for them should continue.

But the multilateral institutions are subject to the same dangers as public sector agencies in a domestic context. They can ossify. They can lose their relevance. They can have a public sector bias. In certain respects they are more conservative than a bureaucracy in a national context because no single shareholder can institute change without the support of others. Their capacity for internal regeneration is poor.

Change is needed. The focus of the World Bank and the Regional Development Banks has been on the provision of loan finance. They have used their government provided capital to borrow to the maximum and to lend to the maximum. This was a valuable function when international markets did not provide loan capital to developing countries. However, the volume of commercial bank debt of developing countries is witness to the fact that too much loan capital has become available.

The purpose of public sector institutions should be to make up for imperfections in the market place. The major imperfection in the pattern of global finance since the 1960s has been an insufficiency of non-debt-creating finance – and in particular insufficient flows of private direct and of portfolio investment.

The World Bank has a specialised affiliate to encourage private direct and portfolio investment – the International Finance Corporation. This should become the centrepiece of World Bank activities. Its main handicap is a fragile balance sheet and a lean profit record. It needs to be strengthened. This can be achieved by a transfer of capital resources from within the World Bank group. For example, the IFC's balance sheet could be strengthened by a number of steps, including a transfer of the World Bank's portfolio of loans in areas of relevance to the private sector – energy, industry and agriculture. Project staff in these areas could also be transferred to the IFC.

Other institutions for multilateral development should be encouraged to set up affiliates to foster private direct investment. For example, the Common Market has no such institutional capacity. One should be established; or the European Investment Bank might be adapted for the purpose.

Over the longer term, the issue of management of finance institutions for international development has to be addressed. While originally established to use their capital base flexibly in association with the private market (as with domestic public sector bodies) they become self perpetuating, lose touch with the market and indeed inaugurate policies to insulate themselves from the market. To counteract such tendencies private sector shareholders should be sought for the international finance institutions, which could thus, in the long term, conduct their operations so as to meet future capital increases from the private sector rather than from governments. A start in the direction of privatisation can be made forthwith, beginning with the IBRD and the IFC.

5

Surveillance and supervision promoting portfolio investment

The drawing together of national capital markets and the creation of a global market for finance has been one of the striking developments of recent years. It is of benefit to all countries, both developed and developing. It helps ensure the efficient channelling of savings, a competitive market place and continuing financial innovation. It is a necessary accompaniment to a dynamic trading environment. Britain has rightly been at the forefront of this movement.

Because of the size of international capital flows and the speed with which capital can be transferred, multilateral surveillance, centred on the International Monetary Fund, has become more important over the years. So also have the efforts of national banking supervisors to co-ordinate their approach to the banking systems under their authority.

An important gap remains in the system of international co-operation – that dealing with the flow of international equity capital. Over 35 developing countries have equity markets. But many national markets are thin, easily destabilised, with a great variety of rules governing financial intermediaries outside the commercial banking sector. For equity markets to work properly and to attract foreign investors, rules of trading, intermediation and disclosure of information need to be clear. Requirements of capital adequacy of intermediaries must be rigorous and accounting standards must meet international levels of acceptability. It is important that equity markets grow. It is particularly important that this growth also takes place within developing countries so that they can attract their share of international portfolio investment and rely less on loan capital. In order to provide an international environment that will promote a flow of private equity capital, efforts must be made to strengthen supervision of equity markets and to co-ordinate supervisory standards.

Through the Bank of England, Britain has played a leading part in increasing international co-operation among supervisors

of national banking systems, and in generating agreement on common financial standards for commercial banks. This effort now needs to be extended to financial institutions outside the commercial banking sector, and to embrace equity markets. The Bank of England could again play a principal role in organising this effort.

6

A supportive trading environment more trade, less aid

It is the aim of all developing countries to cease being permanent importers of capital. To this end they need the fullest possible access for their exports to the markets of developed countries, including those of Britain.

One of the great achievements of the post-War world has been the dismantling of international trade barriers. In recent years, however, progress in this direction has been under threat from protectionist sentiment. Non-tariff obstructions have increased. Trade in agricultural commodities remains grossly distorted by patterns of price support, subsidies and restrictions to market access. Yet this is a trade of particular importance to developing countries.

Britain supports their aim to reduce reliance on foreign capital. Accordingly, it must support a continued dismantling of barriers to their exports.

As a result of successive rounds of trade negotiations under the auspices of GATT, negotiated levels of tariffs on manufactures are now quite low (about 6% in the case of the Common Market). However, non-tariff barriers (NTBs) under the guise of Voluntary Export Restraints and Orderly Marketing Arrangements have increased. They have become the main instrument of protection. Trade in textiles, footwear, leather goods, steel, shipbuilding, car and consumer electronics are among those sectors where non-tariff restrictions to trade apply. According to World Bank estimates NTBs apply to at least 17% of industrial countries' imports and bear more heavily on developing than on industrial countries' exports.

GATT negotiations so far have failed to liberalise trade in agriculture. This is a failure of particular importance to developing countries. The current round of multilateral trade negotiations – the Uruguay round – is paying particular attention to this problem (as well as to that of non tariff barriers).

In order to defuse criticism by developing countries of the Common Market trading arrangements, the Common Market provides a group of 66 African, Caribbean and Pacific (ACP) countries with preferential access. But these arrangements have not stopped the share of ACP countries in Common Market imports from declining. Moreover, in certain areas, the arrangements have had very adverse effects on developing countries *not* included in them. Even beneficiaries have had their export prospects damaged by the effect of Common Market agricultural policies on other markets in which they both compete.

The costs to developing countries of protectionism in the industrialised countries in manufacture and agriculture are extremely difficult to quantify. One such estimate is that in the case of temperate zone crops, developing countries would gain about $20 billion from global liberalisation; but the study on which this is based excludes tropical agriculture – of particular importance to them. Moreover, since developing countries still rely mainly on agriculture and raw materials to generate exports, the secondary effect on their economies of liberalising agricultural trade would be still greater.

In order to assist developing countries reduce their dependence on external capital and to be able to move away from official assistance, Britain must play an active part in the current round of international trade negotiations. It must be willing to shoulder its part of the costs of reducing NTBs. In addition, within the Common Market it should press its partners to take a more forthcoming position on the need to eliminate distortions in trade in agricultural produce.

Finally, Britain should re-examine with its Common Market partners the aid and trade relationship with all developing countries. The extent of trade distortions in the Common Market arising from the Common Agricultural Policy and the application of NTBs appears likely to outweigh official flows of development assistance from the Common Market. The Common Market bloc should emphasise trade rather than aid. It should aim to reduce the adverse impact of Common Market trade practices on all developing countries and not merely ACP countries. Britain should withhold agreement to further replenishment of Common Market aid until substantial improvements in access to the Common Market for all developing countries have been negotiated, including access for agricultural produce.

7

Conclusions and recommendations

The 1960s were a decade of optimism about prospects for developing countries. Post-War reconstruction in the developed world had taken place much faster and more successfully than had been imagined in the aftermath of the war. It was believed that this success could be duplicated in developing countries. Independence for many of them was also believed likely to accelerate their progress. Official aid programmes were actively established in almost all capital exporting countries. The World Bank embarked on a major expansion programme. Regional Development Banks were established.

By the early 1980s the optimism had collapsed. Problems of servicing loan capital had engulfed many of the developing countries. Independence in some cases went hand in hand with regression. Successes were few.

It has become commonplace to blame policies in the developing countries themselves for many of the shortcomings. This is surely correct. In particular, too little reliance has been placed on the private sector. External financing was obtained, in the main, by public sector borrowing. Inflows in the form of private direct investment were generally discouraged. This public sector bias has been reinforced by the way in which capital has been channelled by both official and private lenders in the developed world. A move away from loan capital as a means to finance development, and measures to counter public sector bias, are essential.

Measures to encourage private sector direct and equity investment

The main elements in a programme to encourage a greater flow of private direct and equity investment are as follows:

(i) British banks should be encouraged to reduce their loan exposure to developing countries by selling such loans at a discount for conversion into equity investments. This could be done by allowing banks to spread the balance sheet impact over the remaining lives of the loans.

(ii) The Commonwealth Development Corporation should be reconstituted to become the leading instrument for official assistance to the private sector.

(iii) A technical assistance programme should be funded by the Government to enable the expertise of the City of London to be tapped by emerging equity markets and capital market institutions in developing countries.

(iv) The Bank of England should be asked to initiate international efforts to provide a regulatory framework for international flows of portfolio investment.

(v) Britain should work with other leading shareholders to make the International Finance Corporation the centrepiece of the World Bank group, so as to shift emphasis in the international finance institutions away from the provision of loan finance, and toward the encouragement of equity flows.

(vi) The Regional Development banks and the European Investment Bank should be encouraged to set up affiliates for the purpose of fostering private direct investment and portfolio flows.

Measures to counter public sector bias

Measures to counter public sector bias in the channelling of finance should include the following:

(i) The allocation of the official British aid programme should give pride of place to whether recipient countries are taking steps to foster their private sectors, and to provide a favourable environment for foreign private investment.

(ii) British voluntary agencies should be encouraged in their activities and be asked to administer a part of the British aid programme aimed at the poorest in the developing countries.

(iii) Attitudes towards risks of private lenders contemplating loans to governments or government agencies should be sharpened by the authorities applying a higher risk weighting to such assets.

(iv) A start should be made in privatising the international development finance institutions.

A supportive trading environment

To help developing countries reduce their reliance on external capital, Britain should press for an early and successful conclusion to the Uruguay round of trade negotiations. In particular, Britain should urge its Common Market partners to negotiate reductions in non-tariff barriers, and to reduce distortions in agricultural trade arising from the Common Agricultural Policy. Within the Common Market, Britain should urge a review of the LOME arrangements; a thorough reassessment of Common Market aid and trade arrangements with all developing countries is essential.

* * *

By encouraging trade rather than aid, by urging policies orientated toward the private sector in developing countries, by enhancing the role of Britain's voluntary agencies and by working for a greater reliance on private direct investment, the Government could and should reshape Britain's approach to the financing of development, in a way that conforms to the principles which guide it in domestic issues.

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