

FUTURE FINANCING OF THE CAPITAL NEEDS OF DEVELOPING COUNTRIES

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The decade of the seventies was characterised by an enormous expansion in commercial bank lending and a decline in the relative importance of official capital flows to developing countries. The growth of commercial bank lending reached its peak and spreads over LIBOR became their narrowest in 1979. In 1981, the failure of Poland to make timely payment of interest and principal on its outstanding debt resulted in a nearly complete halt in lending to most Eastern European countries. The Mexican crisis of 1982 and the financial difficulties of Brazil and Argentina led to an end to voluntary new commercial lending to countries in Latin America.

The International Monetary Fund, supported by the US Federal Reserve, the Bank of England, and other Central Banks, helped avert a very serious financial and economic crisis by using IMF influence to ensure that commercial bank creditors would make funds available to some of the most important debtor countries and would reschedule outstanding loans on reasonably favourable terms. The likelihood of a collapse of the international financial system has been reduced for the time being by these actions and modest amounts of new financing have been made available to major debtor countries. Some developing countries in Asia and Western Africa still have access to Eurocurrency loans on a voluntary basis. Nonetheless, there has been a very severe contraction in commercial bank lending to developing countries. It is unlikely that the easy lending of the seventies will return during the eighties. Instead, new forms of lending will emerge but on a more modest scale. The role of governments and official international financial institutions will very likely again grow in relative importance.

The purpose of this paper is to describe some of the likely trends in the external financing of the capital needs of developing countries and to suggest some constructive steps that might be taken by governments and official international financial institutions to facilitate financial flows to the developing world.

Export Finance. Manufacturers of capital goods in the developed countries increasingly recognise that their major markets for the future lie in the developing countries. They also know that their chances of winning sales contracts will depend in many cases on their ability to raise funds for the purchase of their products. Thus, as commercial loans to developing countries become less freely available, new forms of export financing will emerge.

Supplier credits will probably again grow in importance. Suppliers may have to assume some of the lending risks themselves by guaranteeing loans or by accepting delayed payment terms. Official export financing is also likely to increase as capital goods exporters lobby more vigorously for official export credits and guarantees. Countries willing to provide official export credit support will have an increasing advantage in winning export contracts.

Project Finance. A greater proportion of commercial bank loans will finance specific projects rather than provide general balance-of-payments support. Project lending has a number of attractions to lending banks. First, banks often want reassurance that loan proceeds will finance investment in directly productive enterprises rather than consumption.

Second, because typical project loans rely on indirect credit support rather than sovereign government guarantees, the fees and spreads over LIBOR tend to be more generous than for loans made directly to sovereign governments. As provisions for loan loss reserves have reduced bank profitability, they search for more profitable lending opportunities such as those provided by project finance.

Finally, project financing can provide alternative forms of security to sovereign government obligations, enabling a greater diversification of risk. For example, project financing often involves movable assets, such as ships, drilling rigs, or planes, which can be pledged as security for a project loan. Some of the sponsors of a project may be creditworthy foreign private investors whose credit support or equity contributions can add considerable strength to the security package. Projects often generate exports, the proceeds of which can be assigned as security for a project loan.

Political Risk Insurance. The growing caution of commercial bank lenders towards developing countries has encouraged some private insurance companies to develop new political risk insurance programmes to support both loans and equity investments in the Third World. One interesting example is a new programme being developed by the

American International Group (AIG) to finance short-term and medium-term export receivables. A new company, the Trade Financing Company (TRAFICO), has been established to package export receivables from developing countries. The receivables are 90 percent guaranteed by AIG and 10 percent by the developed country exporter. Notes evidencing an undivided interest in the receivables are sold in the US private and public securities markets. The notes generally receive AA or AAA ratings, depending on the note maturity and the quality of the exporter's guarantee.

Official institutions, such as the World Bank and some of the regional development banks, have also been discussing expanded use of guarantee authorities to provide political risk insurance. In the past, these institutions have been reluctant to be very aggressive in the use of guarantees since their existing articles of agreement require that direct lending limits be cut dollar for dollar by the issuance of guarantees. In the future perhaps the use of guarantee authority may have to be expanded to enable total lending to less developed countries to grow at a reasonable pace.

Public and private political risk insurance programmes might be combined. For example, one of the most serious problems with private political risk insurance programmes is their limited maturity. For many countries, the maximum length of policy that most insurance companies will write is two or three years because of the high degree of perceived risk. Maturities are also limited by reinsurance treaties which provide for automatic reinsurance only for policies written with maturities less than a specified maximum.

The World Bank could help extend the effective maturity for privately insured loans by standing ready to take responsibility for political risks beyond the maturities that private insurers are willing to take. For example, a seven-year note could be issued and guaranteed as to political risk by private insurance companies for a three-year period. The World Bank would agree to provide its guarantee, if necessary, for the remaining four years. If the private guarantee is extended each year for four years, then the World Bank's standby guarantee obligation would cease after four years.

Official Guarantee Programmes. The World Bank is now prepared to provide partial guarantees as a way of utilising the World Bank guarantee authority more effectively to generate additional financing for developing countries. Syndicated bank loans can be guaranteed in part with the lending institutions also taking part of the risk. For example, the World Bank is willing to take the credit risk

for late maturities if commercial banks are willing to take the early maturities.

The new World Bank proposals, however, do not provide for separating responsibility for different kinds of risk. For example, many private lenders might be willing to take commercial risks but look for government or official support on political risks. Private lenders for projects may be willing to assume risk after a project is complete, but look for official support regarding completion risk. Private lenders may be able to avoid market price risk through long-term fixed-price contracts, but may seek official support regarding delivery risk. If official guarantee programmes are to be effective, they must more adequately differentiate the kinds of risk that private lenders are willing to bear and should bear from those risks for which official government support is essential.

Sale of Bank Loan Assets. Commercial banks are severely constrained in their future lending by country limits, imposed either internally by management or boards of directors or externally by regulatory authorities. If commercial bank lending to developing countries is to expand, it may be necessary to enable banks to sell off part of their loans in order to bring or keep asset levels below country limits.

World Bank or governmental guarantees, partial guarantees or standby guarantee obligations could be combined with private insurance to create marketable securities out of syndicated loans on the books of commercial banks. For example, medium-term to long-term existing loans on the books of banks or new loans originated by them could be pooled so that the sovereign risk is diversified by country and by geographical region. Private insurance companies would be more willing to insure a diversified package than an individual loan. Private insurance would be complemented by partial guarantees or standby guarantee obligations of official institutions and the securities might be rated by Moody's Investors Service or Standard & Poor's. The rated securities could be sold to institutional investors such as insurance companies or pension funds or to regional banks. In this manner the large banks which are more active internationally could continue to originate new loans, sell them into the pool at a price which covers the cost of the various guarantees, and still keep under their country limits.

Commodity Price Supports. One of the reasons why many countries find it difficult to obtain financing is that they are dependent for exports on one product or a few products whose prices are highly unstable. Similarly, a new resource project, regardless of location, may be very difficult to

finance on a project basis, i.e., on the expected cash flow, because of commodity price instability. The risks of lending can be substantially mitigated if the price risk can be removed by a medium-term or long-term fixed-price sales contract. Such a contract can provide security for the loan in that the borrower can amortise the loan and pay a fixed amount of interest with the sale of a specified amount of commodity, regardless of what happens to market price. Such a contract protects not only the lender, but also the borrower, from adverse commodity price movements. The market-price risk is borne by the purchaser of the commodity. The purchaser's credit, not the credit of the borrower, can be used to support all or a part of the loan.

Another variation is one in which the contract specifies a minimum guaranteed price rather than a fixed price for future delivery. A contract of this sort provides even more security to the lenders since the borrower is protected against downside price movements but benefits fully from any increases in price.

The growing volume and liquidity in commodity futures markets and the recent introduction of exchange-traded options on futures is opening up a wide range of new possibilities to provide price supports or guarantees which can be used as security for lending to resource-oriented projects, companies or countries. Although liquidity in commodity futures markets rarely extends much beyond six months, techniques are being developed which enable a commodity trading firm to offer a medium-term fixed-price contract for which the trading firm can hedge itself by selling forward the full amount short term and rolling over the short-term sales, much in the same way medium-term Eurocurrency loans are funded by rolling over short-term Eurocurrency deposits.

One of the problems with medium-term fixed-price contracts is the production and delivery risk. If delivery does not occur, either because a project is not completed, because a strike, civil disturbance or natural disaster stops production, or because the producer chooses not to deliver, the purchaser can sustain very substantial losses, especially if the purchaser has hedged his position by selling forward at a fixed price and prices have increased. Guarantees or insurance against failure to deliver may be essential in order to enable price support contracts to be used to secure loans to resource-oriented projects or countries.

Counter-Trade and Barter. As developing countries find it increasingly difficult to export into a depressed world economy, they will be turning more frequently to counter-trade and barter as means of financing their imports of capital goods. Counter-trade involves an agreement to

make cash sales and purchases between two trading parties in such a manner that a balance is achieved over an agreed period of time. Barter involves a direct swap of goods without cash settlement by either party. While barter and counter-trade may lead to inefficient pricing and hidden trade subsidies, these techniques may be the only feasible alternative means of stimulating trade in a severely depressed economic environment.

Perhaps more importantly for developing countries, counter-trade and barter often contain an implicit or explicit financing element. If there is a time lag between the receipt of imported capital goods and the export of items to pay for the imports, then the counter-trade or barter provides a financing vehicle for the importing country. In some instances, this financing burden is borne by the supplier who keeps a receivable on his books. In other instances, commercial bank financing is sought to cover the gap.

Commercial bank financing of a counter-trade or barter transaction may be far preferable to the lending bank than a straight, unsecured, sovereign-risk loan. A counter-trade transaction produces an identifiable and contractually agreed stream of foreign exchange earnings. The counter-trade contract rights of the parties and the foreign exchange earnings under the contract can be assigned as security to the lenders. Security of this sort may provide the only basis on which some developing countries may be able to obtain commercial credit.

Cofinancing. Another likely trend in financing the capital needs of developing countries will be the growth of cofinancing of various types. Cofinancing can refer to the financing of a project by several different official sources, including official export finance agencies, international development lending institutions, and bilateral aid agencies. The funding of these official institutions has not kept pace with the loan demands that have been placed on them. These demands will grow in the coming years and the only manner in which many projects will be financed in developing countries will often be through the cooperative efforts of a number of official financing institutions.

Achieving cooperation among a variety of official agencies to finance a capital project is a formidable task. Each institution has its own objectives, each requires different security and commitments from the host country, and each usually has an entrenched bureaucracy that is resistant to providing the kind of flexibility and imaginative financial engineering required to arrange a multi-source project financing. An awareness by political leaders of the need for official institutions to be flexible can help in this process.

Another form of cofinancing is that between official lenders and commercial lenders. This is likely to grow in importance as commercial lenders seek the comfort of official participation in their lending efforts. Since cofinancing is usually tied to specific projects, this form of financing could have added attractiveness for commercial banks. A major problem in the past has been the unwillingness of official institutions to provide the kinds of comfort sought by commercial lenders, especially in respect to cross-default clauses.