BIBLIOGRAPHIC DATA SHEET	1. CONTROL NUMBER PN-AAK-742	2. SUBJECT CLASSIFICATION (695) DE10-0000-0000

3. TITLE AND SUBTITLE (240)
The effect of A.I.D.-supported ICI's on overall development

4. PERSONAL AUTHORS (100)
McClelland, Donald; Blaisdell, William

5. CORPORATE AUTHORS (101)
AID/PPC/EMS

6. DOCUMENT DATE (110)	7. NUMBER OF PAGES (120)	8. ARC NUMBER (170)
1969	40p.	

9. REFERENCE ORGANIZATION (130)
PPC/EMS

10. SUPPLEMENTARY NOTES (500)
(In AID Spring Review of Intermediate Credit Institutions)

11. ABSTRACT (950)

12. DESCRIPTORS (920)
AID
Evaluations
Institution building
Credit
Credit institutions
Industrial credit
Project planning
Loans
Development

13. PROJECT NUMBER (150)

14. CONTRACT NO.(140)	15. CONTRACT TYPE (140)
PPC/EMS	

16. TYPE OF DOCUMENT (160)

AID 590-7 (10-79)

PN-AAK-742

Neoa/PME Record Copy

AGENCY FOR INTERNATIONAL DEVELOPMENT

SPRING REVIEW

INTERMEDIATE CREDIT INSTITUTIONS

JULY 24-25, 1969

THE EFFECT OF A.I.D.-SUPPORTED ICI'S ON OVERALL DEVELOPMENT

PPC/EVALUATION STAFF

JULY 1969

THE EFFECT OF A.I.D.-SUPPORTED ICI's ON OVERALL DEVELOPMENT

By*

Donald McClelland and William Blaisdell

July 1969

I. INTRODUCTION

A.I.D.'s goals in supporting Intermediate Credit Institutions are broadly described in the Manual Order on Development Banks of December 1963. It states:

> "It is A.I.D. policy to foster, promote and encourage the establishment and growth of sound Development Banks . . . to assist in the economic development of less developed countries and areas by financing and promoting private enterprise . . . [through] financing . . . on medium or long-range terms."

The Manual Order also places an emphasis on small and medium-sized enterprises, notes the importance of technical assistance -- especially to sub-borrowers from the ICI, as distinguished from the ICI as borrower -- and discusses the need for selectivity among the various branches of industry in terms of relative contributions to economic development. This evaluation has indicated no need for a major shift in these goals. It does indicate varying degrees of success in their achievement, some needs for further refinement, and need and opportunities for greater achievement.

The treatment of individual topics separately, which is the general approach of this paper, does not highlight some of the broader aspects. Accordingly, some general developments in the field are sketched here at the outset.

Numerous ICI's have been created during the period covered by this evaluation (1958-68), with most of the needs for new general institutions apparently

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*Mr. Blaisdell was primarily responsible for the sections on Loan to Small Industries and TA to sub-borrowers and Mr. McClelland for the other sections.

having by now been met. The emphasis in the future will presumably be less on creating institutions (except perhaps for specialized ones) than on improving or redirecting existing ones. As one Mission has put it, the Mission has moved from "establishing" the ICI to "using" it.

Developments over the years indicate two broad avenues of changing approach First, there appears to be a growing need for a more active role by the ICI's in project promotion and a more refined basis of project selection. As many Missions have noted in one way or another, the "easy" projects have already been financed or the "cream has been skimmed." This is merely a reflection of the experience of LDC economies as a whole as industrialization progresses, and a warning that increased care must be exercised to avoid uneconomic investments. The second main avenue is that suggested by the recent addition of Title IX to our basic legislation. Title IX is referred to in this context only partly as a legislative requirement. More generally, the Title IX philosophy is a reflection of a growing understanding over the years that development is not just economic development and, hopefully, is also an indication of a growing capability for dealing with the harder tasks that this broader concept of development entails.

In reading this paper, a number of classifications of ICI's should be kept in mind. These have already been described in the explanation of the statistical material and include: new and established ICI's, public and private ICI's, and ICI's in countries with some financial sophistication as compared with those that are less developed. Different results are to be expected, and different prescriptions are likely to be appropriate, for each of these classifications. These are specifically noted where they seem most important, but a separate treatment of each under each topic would unduly lengthen the paper. However, these differences are relevant throughout and should be borne in mind even where they are not explicitly discussed.

This paper is based primarily on the evaluation reports from 18 Missions on 27 ICI's with 39 A.I.D. dollar loans totalling $201 million.* The paper will evaluate first achievement of the broad general goals of A.I.D. assistance to ICI's, i.e., (a) mobilizing additional resources for industrial investment and (b) strengthening the private sector. It will then consider several possible refinements or extensions of these broader objectives suggested by past experiences for increasing the impact of this program on development. These are: (a) more refined economic criteria, (b) improving interest rate policy, (c) a broadened range of ICI lending to sub-borrowers and (d) more extensive availability of technical assistance to sub-borrowers. Suggestions from past experience on how some of these changes might best be effected are considered in the final section of the paper.

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*This "sample" differs from the total of 61 ICI's with A.I.D. loans of $354 million in two major respects. The latter includes ICI's in countries where A.I.D. no longer has a Mission (e.g., Israel and Taiwan where A.I.D. has phased out and several Arab countries where aid has been terminated) and Private Investment Funds (primarily in Latin America) administered through Central Banks rather than through separate institutions.

II. THE GENERAL GOALS

A. Mobilizing Investment Funds

One major purpose of loans to ICI's is to create a means of stimulating additional savings and investment; if A.I.D. dollars had no multiplier effect, their total impact would of course be correspondingly limited. In addition, improved quality of investment must be considered along with the quantity.

There are two major ways in which ICI's bring about an additional mobilization of capital. These are, first, through providing the critical margin of resources for starting or expanding industrial enterprises which collect considerable additional resources on their own and, second, through attracting additional resources for the ICI itself. Among important aspects of the first of these is (1) the direct collection of additional capital by the borrowing firm (the "sub-borrower" with respect to A.I.D. loans) from the sub-borrowers' own resources or his family, friends and business associates; (2) the gradual development of a securities market; (3) working out joint ventures with foreign private investors; and (4) reinvesting profits. The direct mobilization of capital by ICI's includes (1) private equity investment in the ICI itself and (2) the attraction of additional capital from abroad. Experience in each of these areas will be examined in the paragraphs immediately following and a more general assessment will be made in Section II-C below.

The largest source of additional industrial investment stimulated by ICI's is the investment funds provided by the sub-borrowers themselves. Most of the ICI's reportedly lend at most 40 to 60 percent of the fixed investment on projects they are supporting, with the remainder supplied by the borrowing entrepreneur. There are some exceptions such as Ethiopia, which will provide as much as 80 percent, and lending by various ICI's for standard items of equipment where the equivalent of a 20 or 25 percent "down payment" is acceptable. But in general, the borrower from the ICI is expected to provide at least two to three fifths of the fixed capital required. And the average is often very much higher than this minimum requirement. The Indian Industrial Finance Corporation is reported to have loaned 2 billion rupees for new industries for which the total investment was estimated at nearly 8 billion rupees (more than $1 billion). The ICICI in India reports an estimated ratio of 1 to 5 of its loans to total investment in its projects. While these two big banks have a much greater multiplier effect than most, the available information from the field reports suggests that matching investment from the borrowing entrepreneurs probably averages one and a half to two times as much as the ICI loan. Not all of this increased investment was due to the existence of the ICI, but much of it appears to have been, as is discussed below.

Efforts toward developing securities markets have made a very much smaller contribution. Such markets are a major instrument for mobilizing savings in the developed economies, and assistance in their formation in LDC's is accordingly one of the purposes of many of the A.I.D.-supported ICI's. Progress in this area has of course varied tremendously, depending in large part on the degree of financial development and sophistication of the individual economies. In the least industrialized economies such as Nepal, Laos and Somalia, any major efforts in this direction would plainly be premature. At the other end of the spectrum, countries like India and Pakistan already had securities markets. These have certainly been broadened and strengthened by the extensive equity participation and underwriting of a number of the ICI's. The recently established Investment Corporation of Pakistan, which has received A.I.D. technical assistance in its formative period, is designed with this as its primary objective. For the larger number of ICI's in countries between these two extremes, the bulk of them are authorized to buy securities as well as make loans. Most have done this only infrequently, often less frequently than the USAID's consider desirable. Lack of experience, the inherent risks involved, and the unwillingness of many family-held companies to have outsiders hold stock are the most frequently cited reasons. Even so, some of them, e.g. in Ecuador, Ghana and the Philippines, are beginning to provide a nucleus of share-holdings that are, or may be, publicly traded. Such small beginnings are still many years from a full-fledged capital market. But these first short steps must be taken before longer ones will be possible.

Another function of ICI's is to attract foreign private equity investment for the sub-borrowers. A few of the Missions report specific instances of foreign private participation in projects to which they are making loans, and quite a number refer to this ICI activity in general. Thus, although achievements in this area appear to be limited, they are certainly perceptible.

What may well be of greatest importance in the longer run is reinvested profits. (The field Mission reports were not asked to comment on this point, however.) The best source of additional domestic capital is likely to be a rapidly growing economy. Reinvested industrial profits appear to be an important new source of capital in, for example, Korea, West Pakistan and Central America. Although no firm conclusions are possible from the data available for this Review, the indications are that this is a large and growing source of capital for industry, a part of which has its origin in ICI loans.

The other aspect of capital formation is the capital attracted directly by the A.I.D.-supported ICI's themselves. In terms of domestic capital formation, this is much less important than the funds mobilized by the sub-borrowers. But A.I.D.-supported ICI's have had considerable success in obtaining foreign resources from other donor countries and organizations.

Equity investment by private individuals in the ICI's themselves has generally not been a sizeable source of funds. Most of the reports indicated that private, non-institutional holdings of equity were usually small, (sometimes less than one-tenth) compared to the total loans of the ICI, and were frequently increasing less rapidly than the amount of loans. This is not necessarily undesirable financially. Equity holdings by institutions such as insurance companies and commercial banks, often including foreign banks, and equity positions or subordinated loans of the government usually provided the basis for a reasonably sound capital structure. And large loans from PL-480 and counterpart sources have, in a few countries, contributed greatly to the total resources available to the ICI's. But most of these sources presumably did not represent additional mobilization of private savings. Experience to date suggests that private equity in ICI's has not been, and is not likely to be, a major source of capital formation. This is not surprising in view of the need under most circumstances to keep the equity thin and the leverage great if stockholders in ICI's are to receive attractive returns on their investments.

A.I.D.-supported ICI's have had considerable success at attracting loans from other aid agencies. As compared with the $354 million in A.I.D. loans, the ICI's covered by this study have borrowed more than $730 million in hard currencies from other sources, of which the World Bank Group has been the most important single source. In addition, there have been frequent small equity participations by foreign banks. It is probably fruitless to try to determine which aid agency has led which, although it is worth noting that A.I.D. has been in a good position to provide "seed capital" at low interest which has often been helpful to new ICI's in covering their start-up costs. The important point is that A.I.D. and the World Bank Group, working together, have been mutually reinforcing and have also supported and/or stimulated further action by the Germans, the Japanese, the Inter-American Development Bank, etc. On direct borrowing at medium or long-term in the world's money markets, the ICI's have done very little. The basic explanation appears to be that the credit standing of the ICI's or the credit-worthiness of the economies of which they are a part, are still such as to make this kind of borrowing either unobtainable or very expensive. They still find it cheaper to, in effect, have the IBRD or the regional banks borrow in world markets for them and relend to the ICI's. It is instructive, however, to note that a few ICI's in the "more developed LDC's," e.g., Israel and Venezuela, have borrowed directly. This may point the way to future patterns as the ICI's, and the economies of which they are a part, grow stronger.

B. Stimulus to the Private Industrial Sector

A.I.D.-supported ICI's (along with others) have clearly increased the flow of investment resources to private enterprise in the industrial sector. They have also improved what might be called the quality of investment by selectivity in the investments and helping to improve financial and business practices.

A.I.D. dollar loans alone have totalled more than $350 million in the last ten years. PL-480 local currencies and counterpart funds, over which A.I.D. exercises at least some control, have amounted to an even larger figure. *Nearly all of these ICI's, including the public ones, have loaned primarily or exclusively to private enterprises. And, although some of the additional inflow

*These have not been included in most of this study because they are limited to a few countries and their conditions vary too widely for ready generalization.

to private industry has been a reallocation from other uses, there is little evidence to suggest that any significant part has been offset by outflows from private industry to other uses.

A.I.D. loans to ICI's permit us to supply a larger portion of A.I.D. loans for private industrial investment than would otherwise be practicable. The fact that A.I.D. assistance is generally on a government-to-government basis may well introduce some tendency to favor, in our direct loans, infrastructure and other areas normally within the public sector. Probably of even greater practical importance is the fact that loans for roads, power plants and other projects that come in large packages are more readily handled through the A.I.D. loan procedure than are individual loans to all but the largest industrial projects. But the use of ICI's as "retailers" of A.I.D. assistance in this field makes it possible to deal with the hundreds of projects that A.I.D. could not begin to process individually through its own loan mechanisms.

For the countries for which field reports have been received as a part of this review, A.I.D. dollar loans to ICI's over the last ten years have averaged about four percent of total A.I.D. dollar loans. But in India, Pakistan, Turkey and Tunisia taken separately, the ratio was less than two percent. In all four of these cases, the actual support for private industry was much greater than this percent would suggest both because large program loans provided an alternative form of support to the private sector and the ICI's in each of these four countries received large local currency loans from PL-480 proceeds. With these four countries taken out of the sample, the A.I.D. loans to ICI's were 17 percent of total A.I.D. loans.* Clearly this is a large flow of A.I.D. resources to private industrial investment in addition to what would have been possible had our aid to industry been limited to a project-by-project basis.

*The remaining dollar loan countries, grouped to regions, are the following: El Salvador, Panama, Nicaragua, Costa Rica, Ecuador, Ivory Coast, East Africa Development Bank, Ethiopia, Nepal, Korea, and the Philippines. In addition, reports were received for programs of local currency on technical assistance from Ghana, Vietnam, and Laos.

A second gap that ICI's are designed to help fill is the usual virtual absence of any medium and long-term sources of credit in the financial systems of most less developed countries. Securities markets are rare and adequate securities markets are non-existent. Commercial banks typically lend only on short term. Even though short-term credit is sometimes renewed repeatedly, at least for preferred borrowers, it provides a very inadequate basis for financing fixed industrial investment. And it is often scarce both for working capital and fixed investment, particularly where legal and other limits set interest rates at a low level. But credit for fixed investment is almost totally unavailable. ICI's, which in most of the reporting countries make loans for at least 2 to 10 years, and in some cases 5 to 15 years or more, depending on the nature of the investment, meet a very urgent need in furthering the establishment and expansion of industrial enterprises.

How adequately ICI's fill this medium and long-term credit gap is difficult to assess. In the three big NESA countries, A.I.D. dollar loans alone were a small part of total investment. But, in addition to the other U. S. assistance noted above, ICI's in India, Pakistan and Turkey all received IBRD loans substantially greater than A.I.D. dollar assistance and, as already noted, substantial amounts of PL-480 local currencies. For the other reporting countries, A.I.D. loans to ICI's in recent years have bulked large in the total investment picture. A rough estimate (relating these loans to GNP and estimating that total fixed investment in industry has probably not averaged more than two to three percent of GNP) suggests that A.I.D. loans to ICI's have generally financed some five to fifteen percent of total industrial fixed investment. An alternative estimate for six of the countries, based on Central Bank data, shows A.I.D.-assisted ICI's financing from 4 to 28 percent of total fixed industrial investment.

Also important is the fact that a larger proportion of ICI resources went to new industries than was true of industrial investment as a whole. So, when the multiplier effect of ICI loans is recalled, it is clear that ICI's have provided an important stimulus to growth and modernization of the private industrial sector.

The ICI's have also aided the private sector in ways other than supplying financial assistance. Nearly all field Missions reported that the discipline of preparing an application for a loan generally improved the planning of the applicant. And in many cases the reporting requirements of the ICI improved the accounting and financial practices of the sub-borrower. In some cases, the ICI's provided more direct assistance to the actual or potential sub-borrower in the form of feasibility studies, technical assistance in management, engineering assistance, etc. (This type of assistance was much more limited and, as will be discussed in detail below, several Missions recommended that it be increased). Although even a rough quantification of the importance of this assistance is not possible from the data available, it is obvious that it was at least in the right direction.

C. Evaluation of ICI's Success in Meeting their General Goals

The analysis above suggests that in general A.I.D.-supported ICI's have been quite successful in achieving their broader goals of mobilizing capital for industrial investment and aiding the private sector. They have had a multiplier effect by providing scarce foreign exchange and medium-term credit which has served as a focal point for mobilizing local private investment that has been substantially greater than the amount of the loans by the ICI's. While their efforts at developing securities markets and attracting foreign private investment have not as yet progressed very far, even here some beginnings have been made. Favorable effects on supporting the private sector are plain. In addition to supplying critical needs for foreign exchange and medium-term credit for the private sector, the sheer transfer of resources to private industry was substantial as compared with total industrial investment. Moreover, although difficult to measure, the effects on improved business and financial practices appear to have been important.

This evaluative conclusion of general success is subject, however, to a number of questions, although it seems clear that none of these invalidates it.

There are two possible qualifications about the reliability of the observations. First, it must be recalled that a major part of the information for this evaluation has been supplied by reports from the field Missions who have had the primary responsibility for carrying out the ICI loan projects. This self-evaluation, obviously has some limitations.

There seemed to be internal evidence in a few of the reports that the projects were being viewed through glasses of at least a faintly rosy hue, and there may well be still other cases where this was more real than apparent. Nevertheless, there were enough reports of failures and suggestions for improvements, along with a general consistency between the facts available and the evaluative judgments given, to support the basic premise that evaluation by the individual Missions can be relied upon to give a reasonable basis for broader evaluative findings.

Second, the general success suggested above is based largely on aggregates and averages. It seems clear that some of the projects did not share this general success. The project in Nepal and the first loan to Ethiopia appear to have made relatively little headway. Possible serious financial problems ahead are foreshadowed in a few additional cases. All of these cases are in countries with very underdeveloped financial and industrial structures. Taken together, they suggest the importance of careful study in such cases to determine how ICI's can be best adapted to the special needs of these circumstances. At the same time, these cases do not seriously bring into question the usefulness of ICI's in general.

There are two more fundamental questions about the development benefits.

First, there is some inherent uncertainty about how much of the investment and development that received ICI support would have occurred even without that support and uncertainty about how much was additional savings rather than a reallocation of resources from other uses. Certainly some of the investment would have taken place anyhow, even if on a reduced scale. But the conclusion of most of the field reports that commented is that in many cases, and particularly for new enterprises, the medium or long-term ICI loan provided the necessary stimulus to make the proposed project a reality. How much of the capital resources so mobilized represented additional savings is also unclear. There is no direct evidence available. There is, however, a strong presumption that where there is no well developed securities market as a normal incentive for savings, and where interest rates are low, a promising investment opportunity will be a strong stimulus to additional savings on the part of the entrepreneur, his family and his friends. It may also be a favorable alternative to investment abroad. Even so, a substantial part of this new investment was probably a reallocation from other potential uses. But these, in turn, in the conditions of many LDC's, would often have been low priority uses. Although the field reports were not asked to analyze this question, it seems probable that reducing the obstacles to industrial investment has increased its attractiveness relative to investment in luxury housing, some of the less productive forms of commerce, and even investment abroad. Thus, although we cannot quantify this evaluation, it seems probable that ICI's did induce substantial increases in both savings and industrial investment and that, to the extent that the investment was a diversion from other uses, many of those uses would have been relatively unproductive ones.

The second fundamental question is: How economically productive was the increased industrialization?

Measured by commercial profitability alone, the answer seems fairly clear. With Mission reports noting very few cases of defaults by sub-borrowers, and with all of the ICI's except one that have been in operation for as much as two or three years showing a profit, there is a strong presumption that the increased industrialization was generally profitable. But high financial profits do not provide a complete answer. There may still be low economic productivity if the profits arise from price distortions due to monopoly, excessive tariff protection, etc. There is a growing body of opinion -- not related to this study _per se_ -- that some countries have carried highly protected import substitution to a point where it may not be very productive economically.

A general evaluation of the role of protection and industrialization in economic development is clearly beyond the scope of this study. However, two important partial answers of particular relevance to this study are suggested by observations in some of the Mission reports. First, the danger of uneconomic industrialization is often less in the earlier stages but increases over time. Second, at the same time the danger is increasing, the competence of ICI's to deal with it is also growing. A firmly established ICI is in a better position to be selective in its choice of borrowers, and A.I.D. can consequently be more insistent on the application of suitable economic criteria when dealing with an established ICI than when it is trying to help one get started. These points will be applied in subsequent sections.

In conclusion, the various qualifications discussed above serve to put the main findings to date in a broader perspective and to suggest avenues for improvement; they modify the findings but do not appear to invalidate them. In short, A.I.D.-supported ICI's have been generally successful in mobilizing resources for industrial investment thereby stimulating industrial growth and economic development and strengthening the private sector. It appears to follow that experience to date warrants continued A.I.D. loans to ICI's subject, of course, to country-by-country considerations and with due consideration to (1) the changing role of the donors as the emphasis shifts from the creation of new ICI's to the support of existing ICI's and to (2) availabilities from other sources.

III. SUGGESTIONS FROM EXPERIENCE FOR IMPROVING DEVELOPMENT EFFECTIVENESS OF ICI's THROUGH REFINEMENT OF GOALS AND BROADENING OF SCOPE

Despite the apparent general success of A.I.D.-supported ICI's in meeting their most immediate goals, nearly all of the field Mission reports suggested one or more lessons of experience for improving the performance under A.I.D. loans to ICI's. In some cases, these suggestions related to how they might have done it differently if they had it to do over. More often the proposals were of the nature of improving the program by a refinement of objectives, goals and methods as the program evolves. Some of the suggestions were in response to the specific items in the questionnaire sent to the field and others were volunteered in response to the request for the Missions' general evaluation.

The four points selected for consideration here are: (1) the application of more sharply defined economic criteria, (2) improved interest rate structures, (3) a broader range of sub-borrowers served, especially small borrowers, and (4) increased technical assistance to sub-borrowers. (Discussion of these points is preceded by a discussion of our experience with public and private ICI's, not as a separate issue but as a part of the framework for considering some of the others.) Some Mission suggestions for change -- such as improved use of PL-480 local currencies, greater independence from government, an increased emphasis on raising domestic capital -- are not considered here. The basis of selection was to chose possible changes that were both suggested by a number of Missions and appear to have a wide area of potential applicability.

None of the areas considered was suggested by all of the Missions. The usual pattern for each area was a strong proposal from a few Missions and a general indication of desirability by a number of others. Also, in the case of each suggestion, a number of Missions had little to say on it and a few indicated that the change would be unnecessary -- or inappropriate -- under their particular circumstances. None of these suggestions for improvement is new. In fact, all are found to some degree in the Manual Order of 1963. However, achievement of these more refined goals or wider areas of activity has evidently been less general than of the broader goals of mobilizing capital for industry and strengthening the private sector. The remaining sections of this paper are thus less concerned with new directions than with changing emphasis that our experience has shown to hold promise for improving the effectiveness of the total program for assistance to ICI's as it evolves.

A. Public and Private ICI's

This subject is considered at this point not as a case of possible change or refinement of goals, but as constituting part of the framework of experience within which these changes may take place. Changes in emphasis or direction of ICI activities will affect, and be affected by, the choice between public and private institutions.

A.I.D.'s lending to date has been somewhat more heavily weighted toward public ICI's. (This may have been influenced to some degree by the facts that many countries had only public ICI's and that IBRD assistance to ICI's have been concentrated in loans to private ones.) A major conclusion from this review of A.I.D. experience is that the difference between these two types of institutions is less than many had supposed. Reports from most countries having both public and private ICI's indicate that both kinds of ICI's tend to be profit oriented, and consequently tend to be conservative in their financial practices, although to a degree the public ones are less so. Several Missions also reported that private ICI's moved more rapidly and all Missions having both types observed that both serve a useful purpose.

The profit motivation in private ICI's is of course to be expected. A.I.D. has frequently helped to establish private ICI's with one of the major objectives being the direct strengthening of the role of private institutions in the economy, and this objective appears to have been fairly well achieved in most cases. But having established a private sector institution, we should recognize that it will be guided largely by the profit motive, which was a part of the purpose. Many of the field reports indicate disappointment that the private ICI's have tended to follow conservative banking practices and have been reluctant to take sufficient risks in the interest of development objectives.

The above observation is not intended to suggest that development objectives are always in conflict with the profit motive. Appraisal banking, (that is, lending on the prospects of the borrower and the project), if well done, may be as profitable as a heavy reliance on collateral. Nor is it suggested that private ICI's are unconcerned with development objectives. Other things being roughly equal, they would generally chose the loan with the greater development potential. And some have been definitely development oriented in their choice of sub-borrowers. The ICICI in India has concentrated very heavily on fostering new industries. The China Development Corporation has made a major contribution to expanding exports. The same has been true to some degree of numerous other private banks. But in general it must be recognized that there will often be some conflict between development objectives and profit maximization. For example, new industries for export will in many cases involve higher risks than the expansion of traditional industries to meet a growing internal demand. This difference must be directly recognized, and incentives should be provided that make the riskier development-oriented loans also attractive.

In principle one would expect that public ICI's would be much more development-oriented, even at the expense of greater risks. But, as already indicated, our experience has shown that this is true to only a limited extent. Even so, and despite a less favorable record of expeditious action, public ICI's should have advantages where there are higher risks or special costs. This is particularly true where the risks are likely to be large but their magnitude is unknown (as appears likely in a major extension into the small loan field) since some form of subsidy or special support would be needed, but the amount would be uncertain. But experience suggests that even public ICI's cannot be expected automatically to incur the higher costs or greater risks entailed by some developmental activities. A.I.D. might well direct its energies to developing ways of assisting public ICI's in this regard. Expanded use of a low rate of interest to the ICI and grant assistance for technical assistance suggest themselves as possibilities. Where the magnitude of the risks is uncertain, provisions for covering operating deficits -- probably more appropriately by the host government than by A.I.D. in most cases -- should be explored. Whatever the approach, the problem should be squarely faced; our experience shows that it cannot be assumed away.

B. <u>The Application of More Sharply Defined Economic Criteria</u>

As indicated earlier, there appears to be growing danger in some countries that industrialization may be proceeding too rapidly, or with too much protection, in certain branches of industry for the maximum contribution to over-all growth. There is a strong indication that greater concentration in certain subsectors, and avoidance of others, would produce better developmental results.

The nature of the problem is indicated by the following quotations from three of the Mission reports:

<u>El Salvador</u>

> "Experience with this project indicates the need for a much greater degree of specifying goals in the loan document with emphasis on project priorities . . . an attempt to encourage industries that will utilize domestic raw materials and generate exports . . . ."

<u>Ghana</u>

> "Until recently, the National Investment Bank was probably relatively little concerned [with relative developmental importance] so long as the project appeared viable in Ghana. More recently, however, partly as a consequence . . . of A.I.D. financed economists who assisted in surveying valid investment opportunities, more attention may now be given to whether a proposed project is really a desirable undertaking for the national economy."

Panama

> "The ICI has not employed criteria of national economic profitability . . . to a desirable extent. Panama's industrial base is largely import substitution oriented, sheltered from external competition by a system of import quota restriction . . .
>
> GOP development policy . . . stipulates considerations of national economic profitability. In administrative practice, this largely has been ignored in the past . . . [There should be greater] concentration on developing projects that contribute to the growth of commercial agriculture, forestry, fisheries, and foreign exchange earnings."

Some may raise the basic question of whether trying to influence the investment decisions of entrepreneurs is desirable in any case. It is often argued that the profit motive and market forces will make the best decisions. But where government policies have markedly distorted price relationships, market forces may be expected to produce the wrong decisions. For example, if the currency of a country is over-valued, profit incentives for export production will be much less than free market forces would provide, even though increased exports may be of obvious importance for economic growth.

The best solution to this problem is to use our influence to encourage improved economic policies rather than trying to adjust ICI practices to offset them. But in an imperfect world other considerations both practical and political -- and often beyond the reach of A.I.D. influence -- may rule out adequate solution through general policy changes. Situations similar to an overvalued currency may also exist with respect to low legal interest rates, high tariffs on some items, etc. While the best approach will vary widely from one situation to another, special priorities by ICI's for certain industries -- and possibly prohibition of loans to others -- will clearly be economically desirable in many circumstances.

The detailed application of economic criteria is probably of least importance in the least developed countries. In countries such as Niger, Laos, Nepal, and possibly a few others, the difficulties of starting any industrialization in the private sector are so enormous that, if one is to undertake it at all, in the early stages, commercial viability is probably the only reasonable criterion. The idea should be to limit protection to levels that are "reasonable" and more-or-less consistent among projects but to look mainly at profitability prospects.

In another group of countries, the basic criteria for different types of industrial investment are set -- in fact as well as in principle -- by the governments through their planning organizations. The Mission reports indicate that this is the case in India and Pakistan and, perhaps to a lesser degree, in Turkey, Korea and elsewhere. Under these circumstances it is probably inappropriate -- and doubtless futile -- to try to circumvent these decisions through different criteria for the ICI's. Where there are problems, direct work with the planning organization or other government entity would appear to be much more useful. And, if the governments investment criteria and policies appear to be wholly inappropriate, discontinuance of support to the ICI might be the indicated alternative.

For the larger number of cases, including the three from which the quotations above are drawn, some stronger use of economic criteria appears often to merit consideration. This is not to say that economic criteria have been generally ignored. A dozen of the ICI's considered are reported to give special weight to import substitution and 14 report criteria for exports and a significant use of domestic raw materials. But the tenor of the reports in many cases is that these criteria are more a statement of general intent than a basis for careful project analysis or promotion. With the development of

ICI's, more carefully defined and tightly applied criteria may well be in order. Second loans, and, where appropriate, third and subsequent loans may often be a practicable point at which to strengthen these procedures.

What the most appropriate economic criteria are will vary widely from country to country. Export promotion and import substitution using domestic raw materials are among the most frequently mentioned. But no attempt is made in this study to pinpoint them because of the widely varying country circumstances. Other kinds of economic considerations, in addition to priority sectors, may also be important.

C. Interest Rates Charged by ICI's

At least three aspects of interest rates are important for ICI activities. The general interest rate structure in the economy is of obvious importance for the development process; the very important illustration of Korea will be noted below, but the ICI is not likely to be the device for restructuring the whole rate pattern. A second aspect is the use of differential interest rates for different kinds of investment. There was little support in the Mission experience for this device. The most important operational question is the relation of the ICI lending rate relative to other rates in the economy.

The suggestion that higher interest rates be charged by ICI's is proposed explicitly by the Missions in India and Panama and has been made in practice by the Korean ICI's. The general argument in favor of low rates has been that they provide an important stimulus to investment. But experience does not appear to support this view. Several Missions report that the return on well-conceived, well-managed investments in the capital-short LDC's is generally expected to be 20-30 percent or more. So, the difference between, say, seven percent and as much as 14 or 15 percent would not be likely to be a major determinant in making an investment decision. The point is summarized in one of the reports from Equador which notes: "Interest rates are not as important as the long-term availability of credit."

It seems likely that, in many cases, interest rates that are low for the particular economy involved create more problems than they solve. In some cases, the rate of inflation is greater than the interest charged; thus, the effective rate of interest is less than zero, which is clearly unwarranted. In other cases, the ICI rate for medium and long-term credit is below the commercial bank rate for short-term credit. (This is specifically reported in the cases of Panama and El Salvador.) This has obvious disadvantages. It provides an additional incentive for the ICI to depart from its basic purpose and make short-term loans. It also provides a strong incentive for the whole business community to try to borrow from the ICI, whether the need is of the sort the ICI was created to meet or not. This situation is almost certain to divert some funds from their intended use and may even introduce an element of corruption. Even where the ICI rate is the same as that for short-term commercial loans, it distorts incentives. Medium and long-term loans normally have a greater risk, and the structure of interest rates should reflect this.

If ICI's are to have the proper incentives to perform their developmental functions, they should be encouraged -- perhaps even required -- to charge high enough rates to enable them to provide additional services or to undertake the riskier investments implied by more selective economic criteria. (This point is made strongly by the Ghana Mission with respect to small loans, and is developed further in this connection later in this paper.) In such cases, it will also be appropriate, of course, for A.I.D. to draw the loan contract with the ICI to assure that the additional spread will be used for these purposes.

In any case, it seems desirable to charge a rate for medium and long-term loans above the prevailing short-term rate.

The possibilities of setting the "appropriate" interest rate will depend upon circumstances. If the basic problem is one of a low legal maximum, a loan to an ICI will generally not be an adequate basis for getting a revision of the legal limits. In such cases, the inappropriateness of the interest rate should be a major consideration in whether or not to make the loan at all. But in the more general case, it should be possible to include an appropriate interest spread, and appropriate use of the increased potential profitability, in the loan agreement.

A very interesting example of adjusting interest rates in the direction of the economic realities is found in Korea. One example is the third loan to the Korean Reconstruction Bank (KRB). The first and second loans to the KRB had specified relending rates of 8 percent with maintenance of value (MOV). The third loan calls for a minimum rate of 10 percent and a continuance of the maintenance of value provision. Consideration was given to requiring even higher interest rates but, given the availability at rates of less than 10 percent from other external sources, this was considered undersirable at the time. However, it was agreed that this minimum interest rate could be adjusted upward if changes in other interest rates made that appropriate.

An even more striking case is that of the Korean Medium Industry Bank (MIB). This bank has reportedly made loans of ₩25 billion ($90 million dollar equivalent) financed primarily by Korean deposits of ₩23 billion (about $86 million). Interest paid on deposits are as high as 25 percent on long-term deposits and interest rates to sub-borrowers range up to 18 percent (with government subsidies to cover the differential). Most of this experience is probably not readily transferable to other ICI's, since it is just one part of a very bold and extensive rationalization of the whole interest rate system. But it does illustrate some important general possibilities and suggests the practicability of setting minimum interest rates in appropriate cases.

D. Broadening the Range of Sub-Borrowers Served - Loans to Small Industries

The ICI's have understandably concentrated their activities to date in the easiest areas. This is true not only with respect to the particular industries supported. In addition, most of the sub-borrowers are large (in terms of the size of the economy), in the modern sector of the "dual" or "enclave" economies that characterize most LDC's, members of the financial (and often the social) elite, and generally concentrated in the vicinity of the one or two main urban areas.

All of the ICI's have, for practical purposes, a minimum size of sub-loan. In most cases this is formally prescribed and for some of the larger ICI's is as much as $50,000. There is also some tendency to raise this minimum; COFIEC in Ecuador is proposing an increase from $5,000 to $10,000 and Ghana reports that although the formal minimum for the National Investment Bank is $10,000, the <u>de facto</u> minimum is $25,000. This ruling out of loans that are small (relative to the operations of the bank or the size of the economy) is to be expected. From the point of view of administration alone, loan processing costs will be a larger percentage relative to the loan as the size of the loan decreases -- there are certain required costs for all loans. In addition, and probably more important, small borrowers will often be more difficult to appraise and follow up on, so the risks of default will, on the average, be greater.

There has also been a concentration, and for similar reasons, by type and location of borrower. Although the evidence is not as clear-cut, it is plain that most of those in a position to borrow from ICI's belong to that small group of better educated, more sophisticated persons and are generally located in the "westernized" part of the economy in the political or commercial capital of the nation. But the entrepreneural talent of the country is not necessarily similarly limited. The concept of a more wide-spread, more decentralized form of development is receiving greater consideration as exemplified, for example, by Title IX of the A.I.D. legislation.

By their nature the ICI's are not likely to become mass organizations. But the stage may well have been reached where a broadening of their geographic range and a reaching farther down into the group of potential sub-borrowers may be a real possibility.

One limitation on present activities of ICI's is the special requirements it implicitly demands of its sub-borrowers. The establishment of an ICI brings not only a new idea, but also an expanded need for specialized kinds of expertise: bankers, accountants, engineers, economists, and, in government-owned ICI's, development agents. But the most striking need is for a new kind of borrower, one who has the sophistication and knowledge to put together a modern, western-style, long-term loan application. Such individuals are rare in an LDC. The Philippine Mission, in discussing the inability of the Industrial Guarantee Loan Fund (an ICI) to make full utilization of its availabilities, reports: ". . . the original rules of the IGLF were based on the classic method of doing business in the U.S. Lending and financing practices here are distinctly different and it may become necessary to revise some of these rules to accommodate current business practices."

Another limit is geographical. This raises a point of conflict between development and the profit motive in the privately-owned ICI's. The privately-owned Turkish ICI, one of the oldest and most prestigious, has maintained for a number of years that it can get all the acceptable loans it can handle in the Istanbul-Ismir centers, and that geographical scattering would be an unbearable expense burden; these contentions are doubtless accurate. A wider geographical clientele would require the acceptance of smaller loans and much more work in processing and administering them.

Africa seems to have a special problem of loan eligibility. Although not mentioned by the Missions, some officers in A.I.D. are very convinced of its validity: "The trouble with African development banks is that they won't lend to Africans." This contention is of significance only because a believable case can be made for it. Where there is a limited group of indigenous educated elite, and where the LDC's social and cultural priorities push these elite into government service and the professions, the only eligible borrowers from an ICI may well be nationals of another country who have immigrated to the LDC in order to profit from the commercial opportunities there, or who are expatriates remaining from an earlier colonial era. Considering the strong and sophisticated Western orientation of most of the ICI's, the foreign-owned firms could well be accepted as much better credit risks than the indigenously-dominated or owned firms. In some cases, the foreign-dominated firms may well comprise the only private industrial sector in the country, and efforts to create an indigenous private industrial sector through the use of ICI sub-loans could be expected only from a state-owned ICI, where profits could be subordinated to other motives if the management of the ICI were to make that determination.

These varying situations -- the Philippine, the Turkish, and the African -- present an apparent conflict of evidence. The Philippine IGLF, a government-owned ICI administered by the Central Bank, cannot utilize its funds fully, pleading the indigenous Philippine lending environment as at least a partial explanation; the Turkish IDB, a privately-owned ICI, is constantly seeking additional funds for lending, and has found acceptable borrowers in a limited geographical area. The African case, where on an average funds have been disbursed slowly, presents still another kind of evidence. But all serve to limit the scope of ICI activity.

Against this kind of background, a number of Missions have noted the desirability of, and in some cases efforts toward, making loans to smaller businesses. Panama, Nicaragua and El Salvador all report efforts, but not very extensive or successful ones, to make loans available to small firms.

The Ghana report provides the most extensive treatment of this problem. It states that the National Investment Bank (NIB) "considerably circumscribes its potential of being a generalized catalyst for the growth of business and commerce by restricting its assistance to only larger projects . . . . The smaller businessman has the greatest need and represents the greatest potential for the NIB to really contribute to basic development." In the Ghana case, the small business issue is related to the interest rate issue, discussed above, in the Mission's suggestion that "higher interest rates be permitted for smaller and/or more risky firms which would be almost entirely small Ghanaian businessmen . . . (who now have) no place to turn for credit except to the private unofficial moneylenders, where usurious rates are demanded . . . . Unfortunately, contrary to what would appear to be good sense, the idea of raising interest rates on loans to small borrowers is considered to be anathema from a political point of view."

The largest and most ambitious effort to reach small businesses through an ICI, as reported by the Missions, is the National Small Industries Corporation (NSIC) in India. This institution is owned by the Central Indian Government; it is funded by Government equity purchases and loans and by foreign borrowing, including a $8.765 million A.I.D. loan extended in 1961, and a $4 million equivalent loan from the German Kreditanstalt fur Weideraufbau (KFW). In the strictest sense, NSIC is not an ICI, but a financial installment sales ("hire-purchase") house with additional functions. It deals only with "small-scale industries," defined as those having an original capital investment of not more than $100,000 equivalent, excluding investment in land and buildings. It finances installment sales of machinery and equipment; assists small producers' marketing, including the organization of sales to the Central and State Indian Governments; and operates three training centers for artisans, workers, and technicians in small industries.

In its installment sales, NSIC has furnished equipment to some 8,000 small entrepreneurs at a cost of Rs. 350 million (nearly $50 million), an average transaction of about $6,000 equivalent. The NSIC field staff visits all purchasers periodically to determine the condition and maintenance of the machines, for the only collateral held by the NSIC is title to the machine. This service is offered to small-scale business at a uniform interest rate of 7% per annum.

In addition, NSIC offers low cost training for operatives and technicians for small enterprises, even though the latter may not be purchasers of equipment from NSIC. For this training, NSIC runs three training centers, in the establishment of which it had the assistance of the German, Japanese, and U. S. Governments. In the training shop they also produce certain prototype machines for small-scale enterprises on a job basis. The training function is subsidized by the government.

The Indian Mission points out that, by using the installment device, the NSIC has established a financing service that cannot be had elsewhere by the small Indian industrial enterpriser. It considers the rate of default on installment contracts to have the appearance of reasonable proportions, and comments that the NSIC is now considering expanding its services to medium-scale enterprisers. The Mission believes that, in addition to its financing services, which are unique for the clientele served, NSIC has given good help in marketing and in technical training, although the latter has been too limited to be called a success. All of these functions are judged to be inadequate relative to the vast need. The great weakness, according to the Mission, is that NSIC has made no effort to include financial and management expertise among its training areas: a contribution to development could be made there. It also believes that the accounting practices in connection with defaults could be tightened up.

The Mission report does raise doubt about the adequacy of the pre-lending investigations, particularly since the NSIC requires continuing title to the purchased machinery as its only collateral; recommendation from an area Director of Industries is all that is required in addition, and this could be a weak link. The lending operations are reported to have shown a loss of about $540,000 in FY 1968, but this was due to a loss of $680,000 arising from Indian devaluation, since the maintenance of value was borne by the NSIC rather than its borrowers. So, aside from this special non-operating loss, the NSIC showed a small profit.

As to the A.I.D. loan, agreed in 1961, an original $10 million face amount was reduced to $8,765,000 after further utilization of the loan was tied to U. S. procurement in 1963. Much of the fund had been already spent on procurement in England and Germany, and the "tie" to U. S.-sources sharply curtailed the possibility of further utilization; deobligation of $1,235,00 followed.

From the viewpoint of this review, the NSIC offers an example of how one country has attempted to develop an ICI for small industry financing. It is an imaginative effort at adaptation of a western device to an LDC, and may well be adaptable elsewhere. The installment rate aspect appears to have been particularly advantageous in simplifying the financial arrangements in dealing with small borrowers. The banking weaknesses of the operation (management, credit investigation, and provision for losses) are not unusual in an LDC, and appropriate application of technical help could strengthen them. Training weaknesses, in which the greatest developmental gain could be made, would probably require continuing additional financial support, but are not beyond correction.

In addition to the NSIC, there have been other cases of small loan programs which were not covered in the field submissions because A.I.D.'s rate was small. These include the East Pakistan and West Pakistan Small Industries Corporations and the Industrial Development Institute of Colombia. In addition the Medium Industry Bank in Korea has some relevance, although, as noted above, most of its lending was from Korean resources. Limited information on these efforts supports the conclusions from the discussion above that programs for small loans will often require separate institutions, that the operations need to be decentralized, that some element of subsidy -- generally implying a government institution -- will normally be required, and that extensive technical assistance to the small borrower is of great importance.

E. Broadening the Technical Assistance Component - TA to Sub-Borrowers

Technical assistance to the borrower, i.e., to the ICI, has been used extensively. (Some observations on this aspect are included in another paper.) But this technical assistance is of only limited value to the ICI's customers, the sub-borrowers. And technical assistance directly for the latter is much less generally available.

The evaluation of experience to date suggests a major need for expanded TA to sub-borrowers, particularly the smaller ones. The important requirement, of course, is that the TA be available; its availability need not necessarily be through the ICI. Much of A.I.D.'s experience in providing TA to industry has been through productivity centers. A brief review of A.I.D.'s experience in technical assistance to industry suggests that there have been many problems, but a detailed evaluation of these activities has been beyond the scope of this ICI Review. Consequently, the observations here are more heavily weighed toward the need for such TA than toward the practicability of providing it, and the general conclusions must be qualified accordingly. But with the present Agency rethinking of, and reorganizing for, its total technical assistance function, further explorations, to the extent a need is indicated, should fit readily into current Agency activities.

The reporting Missions indicate that only five or six ICI's seem to be furnishing technical assistance to sub-borrowers on a substantial scale. On the other hand, several Missions report varying degrees of disappointment at the lack of TA for sub-borrowers. The Turkish Mission approaches the problem gingerly: "In the area of balancing the requirements of security loans with appraisal of the entrepreneurship and worthiness (emphasis supplied) of a particular project much is still to be accomplished." The Mission in India comments: "At the time the A.I.D. loans were made, the need for money was obvious, and there was little awareness of the need for improving the operations of the ICI's in the areas of lending procedures and general assistance to sub-borrowers. The ICI's, the sub-borrowers and the Mission now recognize the need for more emphasis on general assistance," i.e., technical and managerial help for sub-borrowers in contrast to financial aid. The Nicaraguan Mission states, "We would insist on more technical assistance to the institution on project development and analysis and on giving management guidance to sub-borrowers if we were starting over . . . INFONAC (the government-owned ICI) has not insisted on adequate financial planning by sub-borrowers . . . the scarcest resource [is] management talent." These quotations give an indication of the concern for increasing the level of financial and managerial sophistication of the sub-borrower group over and above the special needs of small borrowers noted above.

TA to Sub-Borrowers: the Barriers. There appears to be little difference in principle on the desirability of extending TA to the sub-borrowers of an ICI. But there are three important difficulties: high costs, administrative control of the TA, and scarcity of appropriate personnel. Title IX gives a new impetus to face them.

The Cost Factor. In order to get started on the extension of TA to potential ICI sub-borrowers, A.I.D. should be prepared to carry the cost burden, using such host country local currency availabilities as it may own together with the necessary dollars along with low interest loans. If development of the human resource is to receive greater emphasis, the increased costs inhering in that shift should be accepted, even though such expenditures do not create a lasting physical edifice such as a steel mill or a school building. And reductions in other kinds of assistance may be required by the limitation of funds; in other cases, the addition of TA to an activity may in itself dictate a reduction in the amount of other assistance funds which can be properly allocated.

Financing of the activity from other sources should be pursued as rapidly as possible. In some countries, in view of the real lack of long-term capital resources except from the ICI, it might be possible without great difficulty to widen the margin between the interest rate paid by the ICI for its funds and the interest rate received by the ICI from its sub-borrowers, thus creating a pool of funds to finance TA for sub-borrowers. Government-owned ICI's might be willing to include funds for such a pool in the body of the A.I.D. loan; privately-owned ICI's would be less likely to do so. From the beginning, the possibility of some direct contribution from the sub-borrowers (partial payment for services) should be actively explored. Contributions from the host-country budget might be difficult to arrange, at least at the beginning, but the possibility should be actively pursued. Each LDC-ICI situation would have to work out its own methods of gradually replacing the initial A.I.D. funding.

Administrative Control Factor. One of A.I.D.'s functions from the beginning would be to develop local personnel for the activity, and eventually release the total TA function to local control. Whether an existing organization or a new one should be used for this purpose would depend on the individual country situation

The TA activity is not a banking function, but it could be argued that it is a development banking function. In more developed countries, bankers assume that their clients are sophisticated businessmen; in an LDC, development bankers cannot accurately make this assumption except perhaps for the limited elite group already mentioned. If the thrust of Title IX is accepted, then at least government-owned ICI's might count TA for sub-borrowers among their functional activities. However, this aspect would have to be worked out also in each individual LDC situation. In principle, close contact would have to be maintained between the TA activity and the ICI.

The Personnel Factor. Finding and recruiting the right people to carry out this kind of undertaking plainly poses some difficult problems. A more focused effort within the Agency might help and the new emphasis on private enterprise make it easier. The new Office of Private Resources may be in a good position to provide the needed focus and capitalize on the new emphasis. Extensive use of nationals in the country assisted should eventually ease the personnel problem, but this is not likely to help greatly at the outset.

It is also possible that the difficulties of finding TA personnel for this kind of assignment have diverted recruiters' attention from some of the simpler facts of the LDC situations. Specifically, a high level of technical expertise is not required to assist unsophisticated LDC businessmen in their efforts to finance, organize, manage, operate, and maintain a small business. In fact, efforts to impose a high level of expert assistance on the small businessmen in an LDC is likely to be disastrous; a computer is not of much use without knowledge of a number of subsidiary and ancilary disciplines. However, in addition to adequate technical knowledge, the technical advisor much have the qualifications which make him an acceptable and effective personality. A number of returning Peace Corps Volunteers should make excellent prospects for foreign TA industrial extension agents, particularly if they were given short training courses in specific areas of expertise.

IV. SOME MEANS FOR OBTAINING CHANGED DIRECTIONS IN ICI ACTIVITIES

(Note: This section really applies to the entire review subject. It is presented as a part of this paper, however, as having greater applicability to overall changes in scope or direction of ICI's than to their operating and financial aspects. The points explored here, however, should be borne in mind in the consideration of the latter as well.)

All of the suggestions for changed and improved ICI performance -- taken separately from unilateral improvements in A.I.D. performance -- have meaning only if there is some means of bringing them about. Some observations have been made on individual points both in this and in other papers. More generally, there is need for a variety of approaches. As indicated in the evaluation of the Use of Program Loans to Influence Policy -- and as would appear to be true of A.I.D. activities in general -- there should be a combination of persuasion, inducements, and formal agreements to exercise influence. A continuing dialogue and specific conditions both play a role. Some general area of agreement at the outset is essential to success. But formal agreements can also be important. A.I.D. experience in dealing with ICI's suggests some principles and approaches in this regard.

The first principle is that no single loan can accomplish all of the desirable objectives. No one loan can be expected to provide sufficient incentive to achieve, say, (1) the acceptance of non-traditional means of project appraisal with an emphasis on cash flows rather than collateral, (2) the extensive and effective application of refined sector criteria, (3) emphasis on small loans and geographic dispersion, (4) effective technical assistance to the sub-borrower, and (5) sufficient profitability to attract additional capital. It is necessary to set priorities at any given point in time and at different points through time. Probably the most clear-cut distinction is that between the goal of establishing a viable institution and subsequent goals of using that institution to serve a somewhat more specifically defined range of purposes. If an institution were required in its initial stages to perform all of the functions that are hoped for eventually, it would very likely be stillborn. Fortunately, many ICI's are now well established, so there are new opportunities.

A second premise is that definable aspects of the expected performance should be stated in clear, enforceable terms in the loan agreement. Once the loan has been made, much of the means of influence has been used. This is particularly true of loan agreements with private ICI's, but seems generally to be applicable to public institutions as well. This observation simply means that the relationship is a contractual one; A.I.D. agrees to lend funds on terms more favorable than are available elsewhere and the ICI undertakes to perform in certain ways -- some of which may be at the expense of maximizing profits -- in return. The suggestion of a contractual relationship does not imply bad faith on the part of anyone, nor does it mean that performance can be assured by a formal contract in the absence of reasonably general agreement as to what is to be done. But experience does suggest that carefully spelled out agreements will accomplish more than vague ones and that reducing the agreement to writing adds to both its clarity and its enforceability.

A third principle is that some objectives are more readily included in a formal agreement than others. For example, it should be possible to have a workable agreement that loan funds are to be limited to certain specified categories of industries, or that certain minimum staffing requirements will be met, or that a specified percentage of loans will be for some given time period. On the other hand, it is probably not practicable to have a workable formal agreement on the emphasis to be given to collateral requirements. Persuasion may be enough in such cases. But the persuasion should be largely in terms that it is not contrary to the interests of the ICI's, rather than that they should do it.

The application of these principles will vary widely. The degree of financial and industrial development of the host country will greatly influence the most appropriate approach, and the degree of development of the institution itself will make a difference in what tactics are likely to be most effective. As noted earlier, the prospects for improved performance in achieving economic goals are limited in the least developed countries. At the other end of the scale, for the most fully developed ICI's, which are likely to have access to funds from a variety of sources, the possibilities for influencing their policies are likely to be less necessary and to be more sharply limited.

But for a large number of ICI's, the principles just discussed probably have considerable applicability. The most generally applicable technique appears to be a carefully drawn and effectively negotiated loan agreement for second, or subsequent, loans to already established institutions.

The second loan of $5 million to COFISA in Costa Rica provides an instructive case study for the use of this technique. Experience under the first loan was generally satisfactory, but there were too many loans for the minimum term of two years and too few equity participations. More important, developments in both the ICI and the economy set the stage for a greater concentration on priority areas. The highest priority, which was not covered in the first loan agreement, was judged to be diversification of agriculture (overproduction of coffee) into new export products. A continuing priority area was efficient import substitution industries using predominantly Central American raw materials. The inducement for COFISA to undertake this riskier business was an interest rate to the ICI of only 3 percent for funds loaned in these priority areas. It was judged, however, that this business alone would not permit COFISA to cover its overhead and operate at a profit. Consequently, it was agreed that up to half of the loan, on which the interest charged by A.I.D. was to be 5 percent, could be used for regular loans. (Also, certain specifically defined low priority areas were excluded completely.) As a further safeguard, the loan agreement specified that a comprehensive review of lending activities would be required before sub-loans totalling more than $1.75 million were permitted.

The negotiation of the second COFISA loan was a long and arduous task. It has only recently been completed (signed May 8, 1969), so there is as yet no operating experience. Moreover, it cannot provide detailed guidance for other loans, since no two country situations are the same. Even so, it does provide an example that, with appropriate modifications, may have a wide applicability in sharpening the focus of A.I.D.-supported ICI activities.