BIBLIOGRAPHIC DATA SHEET

1. CONTROL NUMBER: PN-AAK-745
2. SUBJECT CLASSIFICATION (695): DE10-0000-0000

3. TITLE AND SUBTITLE (240)
Summary ~~[illegible]~~ findings and implications for A.I.D.

4. PERSONAL AUTHORS (100)

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

6. DOCUMENT DATE (110)	7. NUMBER OF PAGES (120)	8. ARC NUMBER (170)
1969	19p.	

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

13. PROJECT NUMBER (150)

14. CONTRACT NO. (140)
PPC/EMS

15. CONTRACT TYPE (140)

16. TYPE OF DOCUMENT (160)

AID 590-7 (10-79)

PN-AAK-745

Reserve PME Record Copy

AGENCY FOR INTERNATIONAL DEVELOPMENT

SPRING REVIEW OF INTERMEDIATE CREDIT INSTITUTIONS

JULY 1969

SUMMARY FINDINGS AND IMPLICATIONS FOR A.I.D.

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CONTENTS

A.I.D./Washington

PPC/Evaluation Staff

September, 1969

NOTE:

This document, which endeavors to summarize the lessons of this evaluation review, is issued for the information and suggestions it contains and the insights which it is hoped it will provide. The document is not to be considered to be instruction or a statement of policy.

SPRING REVIEW OF INTERMEDIATE CREDIT INSTITUTIONS

SUMMARY FINDINGS AND IMPLICATIONS FOR A.I.D.

I INTRODUCTION

This review endeavored to assess the effects of A.I.D. support to ICI's, and their changes over time, with a view toward the shaping of possible changes in A.I.D.'s future activities. The formal documentation was based largely on experience in a fairly narrowly defined sphere; field reports were requested only for A.I.D.-supported intermediate credit institutions in industry that were separable from the regular banking system, and the discussion papers prepared in Washington were based primarily on those field reports. The actual review sessions were somewhat more wide-ranging, particularly with respect to the extensive actions in this field by the World Bank Group and some forms of A.I.D. support through Central Banks or other non-specialized institutions. This wider range in the discussion is reflected in the present document.

The present document is organized like the review itself. Following the Introduction, I, it deals with: II, effects on overall development, III, operational and financial aspects, and IV, an overview of A.I.D.'s prospective future role in this field. Each of the discussion topics is considered in terms of Findings and of Implications for A.I.D. The sections on Findings endeavor to summarize the factual findings and to indicate consensus where there was such; main divergences in views are noted where there was no consensus and where this treatment is practicable. The Implications for A.I.D. sections summarize the most important possibilities, sometimes including alternatives, for future A.I.D. investigation and/or action.

II EFFECT ON OVERALL DEVELOPMENT

A. Summary of Findings

A.I.D.-supported ICI's have been generally successful at stimulating both a greater quantity and an improved quality of industrial investment. Most of the effect has been in the private sector, which has received most of their funds and support. Profitability records of the borrowing ICI's, and repayment records of their sub-borrowers, have to date been generally satisfactory. The effectiveness of ICI's in mobilizing domestic resources has been almost entirely through the stimulation of complementary investment to go along with their loans -- the loans from most ICI's average only a third to two-fifths of the total investment. Amounts of direct accumulation of savings by the ICI's and purchases of equity shares with subsequent resale have been disappointingly low.

One major deficiency of ICI operations arises from frequent distortions in the structure of prices in the markets in which they operate. Since ICI's necessarily depend considerably, in making their individual loan decisions, on expected commercial profitability of the borrower as determined by market prices, distortion of those prices by government policies of excessive protection, overvalued currency, etc. will distort the allocation of ICI resources. There was general agreement that these distortions were often a serious problem and that the preferred way of dealing with them, where practicable, was through correcting the government policies.

Beyond this general agreement, a definite dichotomy emerged.

One view held that ICI's should be guided by market price signals and that

ICI's are not appropriate instruments for setting sector criteria, rationing scarce foreign exchange, etc. This view appeared to be applied particularly to private ICI's, which were established to be profit making institutions.

The other main view was that where changes in government economic policies to eliminate price distortions were not practicable, this situation should not rule out more direct efforts at offsetting policies or practices by the ICI's to correct for excessive protection, overvalued exchange rates, etc. This might be as formal as the general use of shadow prices or might simply provide some kind of priority ranking for certain sub-sectors. Although not discussed as extensively, this view also appeared to encompass the position that even undistorted market forces might not always provide wholly adequate guidance; for example, they might not provide as much impetus as desirable in such areas as export promotion.

The interest rate was widely agreed to be a frequently distorted price. Interest rates held down by laws or regulations were generally thought to be lower than is warranted in many if not most LDC's, and rates charged by ICI's are often at the low end of the scale. A closely related finding is that the availability of funds for medium-and long-term loans is generally of much greater importance to the potential borrower than is the interest rate -- the prospect of obtaining credit on medium-term greatly out-weighs a few percentage points on the interest charged.

The interest rates charged to ICI's by A.I.D., and by the IBRD or others as well, generally include a subsidy -- and sometimes a large one --to the ICI and/or its sub-borrower. It was generally agreed that a "lower-than market" rate to ICI's might be justified to subsidize certain kinds of performance. There was, however, a widely-held view in the review that the amount of the subsidy, its rationale, and who were its beneficiaries all appeared to be less fully understood than they should be and that the providers of such subsidies should know and approve of the purposes served.

Some difference between public and private ICI's was noted both with respect to their performance and with respect to policies in relation to them. The private ICI's appeared to be generally somewhat more efficient, at least in terms of the expeditious handling of loans. The public ICI's on the whole tended to be somewhat more development oriented -- although to a much lesser degree than many had thought. There was considerable sentiment in the review, possibly amounting to a consensus, that sector criteria, special services, etc. were more appropriately expected -- or required -- of public ICI's than of private ones, even when special compensation was provided to cover the special costs.

Medium-and long-term lending to the smaller borrowers was found to be particularly scarce, as is lending to indigenous borrowers in some former colonies. Few regular ICI's make many really small loans, and there are very few specialized small-loan ICI's. There was general agreement that this was unfortunate, but also that it was due to numerous special problems. In general the high costs, small-scale administrative requirements, and needed geographic dispersion make very small-scale lending inappropriate for most existing ICI's, particularly private ones. Higher interest rates are appropriate to cover the higher risks and higher costs, but charging such rates is likely to be politically difficult because it may appear to be discriminating against the small borrowers. Technical assistance to the small borrower is likely to be particularly important, but is also difficult to organize and may have to be unmanageably great if aimed at being more than marginal, i.e., if potential entrepreneurs do not start with a substantial part of the needed skills.

B. Implications for A.I.D.

Agreement on these implications tends to be less than on the findings; in addition to the difference in view of what is appropriate, there must be added the varying views as to what is feasible.

1. Some effort should be made in appropriate circumstances to channel ICI resources into areas of special economic priority and/or away from areas of low priority. There is no consensus as to how frequently and under what circumstances this would be appropriate. The general guidance of resource flows is, where practicable, made better by sound government policy decisions than by ICI decisions. However, this may not always be practicable and more direct action may be appropriate. For example, industries receiving "excessive" protection should not generally be assisted -- if a workable definition of "excessive" can be agreed to. At the other end of the scale, special inducements for export industries may sometimes be in order. Such allocative policies could be effected by any of a number of devices; e.g., establishment of eligible or ineligible fields of activity or purposes for sub-loans, or set-asides of percentages of a loan for certain categories, or setting maximum or minimum percentages that can be used in specified categories. A careful analysis of where industrialization is

going in a particular country will often be appropriate to both the general policy and the ICI allocation questions. When the channeling of ICI lending will be appropriate must be decided on a case-by-case basis but, when done, it should be worked out in advance and included in the loan agreement; the ICI should not be expected to make this kind of decision as a part of its regular operations.

2. A.I.D. should in general encourage, and in some instances press for, interest rates charged by ICI's that give a fairly realistic reflection of the shortage of capital. This is not always the case at present. Negative real interest rates are of course inappropriate in any circumstances. Also, the scarce funds for long-term lending should carry a rate above that for the generally less scarce short-term commercial credit. Rates of 5 and 6 percent, even in real terms, must almost always be too low in capital-short countries, and the same may often be true even of rates of 10 and 12 percent. There is some question, however, as to whether rates of 20 or 30 percent should be attempted by ICI's, even if such levels appear to be the equilibrium rates, unless such rates are part of an overall interest reform.

3. Within the general position suggested in 2. above, A.I.D. may appropriately charge interest rates in special cases that include some subsidy element to the ICI and/or the sub-borrower. Frankly subsidized rates may be appropriate to encourage particular activities. This may even include lending to ICI's at A.I.D.'s minimum interest if this is necessary to make certain kinds of priority activities financially attractive to the ICI.

But, where either the rate of the ICI or the rate to the sub-borrower is below the market rate, the subsidy should be explicity recognized and justified as such, including a justification of the purposes actually furthered by the subsidy.

4. A.I.D. should explore all promising avenues for increasing the availability of medium-term credit and technical assistance to small industrial enterprises, having in mind title IX purposes, but recognizing that there has been only limited success to date. In general, this will probably need to be done outside the structure of existing ICI's, particularly the private ones, and is likely to require outright subsidy. Developing and/or strengthening productivity centers or similar technical service institutions may be one possibility both for providing technical assistance to small firms and for screening out those prospective borrowers who have only enthusiasm and leaving those that have enthusiasm plus a sound idea and some capital. The possibility of developing programs of medium-term credit through existing commercial banks should also be explored, possibly as subsidiaries for this purpose to a larger development financing institution that could provide technical and financial support for its portion of the commercial banks' operations. This might be based on some form of risk sharing. In general, only the local commercial bank is likely to have the knowledge of the character and reliability of the borrower that is generally essential for small-loan decisions. Other combinations of institutions to provide a suitable division of labor in the development/venture finance area should also be explored.

III OPERATIONAL AND FINANCIAL ASPECTS

A. Summary of Findings

There was general agreement on the importance of institution-building. This is a better use for scarce A.I.D. manpower than the detailed review of sub-loans. In this context, it was emphasized that A.I.D. reviews of sub-loans should generally be confined to an assessment of whether the development bank in question is rendering its decisions on the basis of acceptable development lending criteria. A.I.D. should not, except under special circumstances, be reviewing sub-loans in the context of a specific projects' economic, technical and financial feasibility, although it should satisfy itself that the ICI is applying such criteria. In short, although the distinction may not always be easy to make in practice, the purpose of the A.I.D. review should be to determine whether or not the development bank in question is operating in accordance with acceptable development bank standards, policies and procedures rather than trying to substitute its judgments for those of the ICI.

A major finding is that a pipeline of several years is characteristic of loans to ICI's under widely varying circumstances. The discussion indicated that this is true of IBRD loans too. One means of shortening the pipeline would be smaller, more frequent loans. This procedure would also provide a more frequent occasion for exerting leverage on ICI policies. There was some agreement that this course could be useful, but there was little discussion on the issue. It was noted, however, that smaller, more frequent loans would create a heavier administrative burden for the loan processing stage. Two suggestions were that loans to ICI's be treated in terms of a line of credit and that, rather than increasing the number of loans, loans of the present size can be released in tranches with an effect similar to more numerous, smaller loans. This latter approach would largely eliminate the added administrative burden and would meet at least a part of the objective of more frequent opportunities for discussion and persuasion concerning lending policies and practices. On the other hand, the use of tranches would mean that the total loan would have been authorized, and there may be some tendency for A.I.D. to be more lenient in approving tranche releases than in considering new loan proposals. Moreover, this approach would not help reduce the pipeline.

The relation of A.I.D. support to ICI's and promotion of U.S. private investment was generally thought to be a fairly remote one. (One proposition advanced in the discussion papers had been that support for ICI's might go hand-in-hand with private U.S. investment promotion to make the latter politically and idealogically more acceptable.) There was also a general feeling that support of ICI's should be managed by A.I.D. rather than OPIC. Nevertheless, some coordination is necessary particularly to ensure that private U.S. investors have access to local sources of financing as well as the benefit of advice from the local financial community. In these instances, close coordination with A.I.D. at an early stage is important.

On technical assistance, the findings was that more is needed than is presently available, but the feasibility of supplying it is unclear.

For the ICI's the emphasis was on the training of bank personnel. It was suggested that the training could be accomplished in a variety of ways; e.g., in-service training, special courses, swap arrangements with successful ICI's, or with foreign branches of commercial banks, although some felt that, on the senior management level, this latter approach could produce too conservative ICI policies.

For the sub-borrowers there was some argument on whether TA should come through the ICI or from a separate institution. Some felt that banks find a way to provide needed TA whenever the operation appears profitable, either immediately or to improve further loan business. Some thought that the ICI's have badly failed to tap the available technical expertise of their foreign shareholders. Others -- thinking largely of the smaller borrowers -- argued that TA was too costly for the ICI's as such to provide and that separate institutions -- such as productivity centers -- were needed.

B. Implications for A.I.D.

1. In order to provide maximum availability of scarce manpower for institution building, the project-by-project review of sub-loans should be held to a minimum and should focus on the meeting of generally accepted criteria and practices rather than project particulars. Exceptions will sometimes be necessary where it will take some time to strengthen the institutions. The scope of sub-loan review responsibilities should already be defined in loan agreements, and should be within the anticipated management capabilities of the A.I.D. Mission. A.I.D. should in general limit

its area of formal responsibility by setting the cut-off level -- below which A.I.D. review is not required -- at the highest possible level consistent with the capabilities of the ICI.

2. On specialization of staff in AID/W, what changes, if any, are appropriate will depend on the magnitude and direction of future A.I.D. support to ICI's. The probable substantial reduction in the creation of new institutions and a possible shift toward industrial sector loans or other alternatives to ICI's are relevant. The possibility was proposed of developing a source of expertise to assist the regional bureaus. It appears that some step in this direction would be appropriate to follow up on some of the unanswered questions of this Review.

3. A.I.D. should endeavor to reduce the length of the ICI pipeline somewhat, bring principle and practice closer together in this regard, and use successive loan agreements to gain some greater degree of influence over ICI policies. Experience to date has been that nearly half the loans to ICI's are not substantially committed by the ICI's for four years or more, with a sixth of them requiring more than five years. (These time periods are estimated from disbursement data on the assumption of a years' time lag between the ICI commitment and A.I.D. disbursement.) A preferable target might be a maximum of meeting three year commitment requirements, realistically estimated, which should be a practicable possibility for reducing the pipeline and increasing the frequency of negotiations to influence ICI policy. An alternative would be meeting four years requirements but with funds released through annual or biannual tranches.

4. Possible means of providing additional technical assistance for industry, not necessarily through ICI's, should be explored -- despite recognition that the prospects may be difficult -- by the new office of private enterprise and/or by any central staff that may be created to deal with ICI's. New avenues should be actively sought. In addition, and in the context of possible increased A.I.D. involvement in the utilization of ICI's to influence developments in specific economic sectors, it is believed that some form of technical assistance to government ICI's and other government planning agencies will be necessary in order to encourage efficient sector and sub-sector planning.

IV. AN OVERVIEW AND INDICATIONS FOR THE POSSIBLE FUTURE ROLE FOR A.I.D.

A. Summary of Findings

The total role o. ICI's in economic development has been a rapidly expanding one over the past decade or so. A.I.D. dollar loans have been relatively constant, averaging $30-40 million per year, with A.I.D. local currency financing (primarily from PL-480) constituting a larger, and more variable, resource availability. Other donors have played an even greater role. The World Bank Group has made available capital of nearly $1 billion to ICI's over the past 15 years, with a greater degree of concentration by country than A.I.D.'s and at a rapidly increasing rate. Of the fifteen-year total, more than two-thirds has been provided in the past five years, and a fifth in the last year alone. Moreover, it appears that the planned rapid expansion in IBRD lending in general will be more than proportionately reflected in lending to ICI's. Other donors are also playing an increasing role. Of particular importance to A.I.D. planning, the Export-Import Bank has entered this field and indicated an interest in doing more. It is estimated that to date total resources of ICI's are approximately $2½ billion and investments with which they are associated are of the order of $7½ billion. In many countries this has, in recent years, constituted some 10 to 20 percent of total industrial investment, and a substantially higher proportion of the total in new fields of industrial activity.

Within these overall totals, A.I.D. appears to have played a more than proportionate role as an innovator. The proportion of funds going into new institutions, and the proportion going to countries with less developed financial structures, has been distinctly higher for A.I.D. than for other donors. Even so, the World Bank Group has reportedly assisted in the establishment of 18 of the 28 institutions it is supporting, with A.I.D. and the IBRD playing a joint promotional role in some of these cases. The need for the specialized role played by A.I.D. continues and appears to be beyond the likely scope of alternative sources of external financing for ICI's.

The role of ICI's has been changing, and the nature of support for them has been changing with it, as industrial development in the LDC's advances and the ICI's become more firmly established. There is considerable indication that in many countries the "easy" industrial investments have already largely been made and the questions of project development and selectivity are in many cases becoming more important. The increasing experience and maturity of the ICI's puts them in a better position to adapt to this changing role.

And as more of the institutional gaps have been filled, as more ICI's have been established, the relationship of the donor becomes less one of creating new institutions than of using and improving the operations of existing ones. This introduces opportunities to carry on more specialized or sharply defined kinds of activities and introduces the question of whether different kinds of institutions, or alternatives to ICI's, should be more actively explored to complement the role played by ICI's: i.e., should A.I.D. also encourage and support more differentiation of functions and specialization of institutions than was originally envisaged in setting up the typical all-purpose ICI?

It has also become apparent with experience that one of the usual features of A.I.D.'s assistance to ICI's, i.e., loans in dollars, is often not fully adapted to the role the ICI needs to fill. (In those few cases where large quantities of PL-480 local currencies were available, these problems are mitigated.) The central need for additional medium-and long-term finance is not limited to foreign exchange; there is generally a similar scarcity in local currency. Special availabilities of dollars places the ICI in a position of being a rationer of scarce foreign exchange -- a role for which it was usually not created and may not be well suited -- as well as a rationer of scarce long-term credit. It also means, in the case of A.I.D. loans, that ICI's and the sub-borrowers must deal with the problems of tied procurement item-by-item, not just in general terms as with a more general import program. Also, although low rates of interest charged by A.I.D. to the ICI's may sometimes be warranted to cover special services such as technical assistance to sub-borrowers, the ICI may not always be the best institution to provide such services and their costs will not necessarily be dollar costs.

Sector loans for industry -- or for special branches of industry -- with the dollars used for commodity financing and the local currency being loaned to industry are an alternative to loans directly to ICI's. Such sector loans might be administered through the Central Bank and the regular banking system. These possibilities were not included in the detailed evaluation, as they did not involve ICI's in the usual sense, and experience is still very limited. But the limited experience to date and some discussion in the review sessions suggest that this approach may well be a preferable means of achieving certain goals, such as concentrating on certain industrial sectors or sub-sectors.

B. Implications for A.I.D.

1. The overall experience with ICI's suggests that they should continue to receive A.I.D. encouragement and support. Indications are that there is a rapidly increasing capability of ICI's to use external assistance effectively, but there is also a rapid increase in the sources of such assistance. There is no indication in our experience of a need for a policy of increasing or decreasing the total level of activity. Rather, A.I.D. should apply its general policy of support on a selective basis, with the mere need for additional capital not in itself constituting a case for a loan and with assessment on a case-by-case basis of important needs that might otherwise go unmet.

2. A.I.D. should continue to use the flexibility and special influence inherent in low-interest loans, and the advantages of having field Missions, to be an innovator in the ICI field. This may well include working further with new institutions and in the financially less developed countries. Consideration may also be appropriate for new possibilities such as small loan institutions and other kinds of specialized intermediate lending activities and expanded training and technical assistance.

3. Sector loans for industry -- or sub-sectors of industry -- should be actively explored as an alternative or additional means of achieving A.I.D. objectives in promoting private industrial development. This might take a number of different forms; for example:

(a) a portion of local currency generated by program loans for industrial credit.

(b) a sector loan can be negotiated on the basis of policy change desired in industry, or an industrial sub-sector, with the foreign exchange fully or partially reserved for capital imports, and the local currency used for industrial credit or other related activities. Technical assistance can be financed through the loan, or a related grant.

Under such a sector loan the foreign exchange can be handled either by the Central Bank working through the commercial banks, or by an ICI, depending on the specific uses involved, and the requirements of the situation.
The local currency credit, which presumably could be used to purchase foreign exchange, can also be allocated to the most efficient institutional manager.

One or another of these variants might have important policy or administrative advantages as compared with dollar loans to ICI's. It could avoid some of the more complicating specifics of tied procurement. (To the extent that financing specific U.S. exports was important, the Export-Import Bank can be encouraged to lend to ICI's.) It might provide a better balance between medium-term credit in local currency and medium-term credit in foreign exchange. It might avoid a dual system of foreign exchange rationing by both the Central Bank and the ICI. And it should assure the benefit of A.I.D.'s concessional terms to the economy without the necessity of using the two-step procedure or incurring the danger of unintended subsidies to private individuals.

Although the sector approach was not covered in any detail in the Review, it appears to merit further investigation, including the experiences already accumulating in the Latin American program, by the Regional Bureaus and/or such new central staff as may be created.