



DISCUSSION PAPER NUMBER 3

# **Prospects for the Business Sector in Developing Countries**

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## FOREWORD

This paper was written for the meeting of the International Finance Corporation's Business Advisory Council held in Washington, D.C., on May 7-9, 1989. The Business Advisory Council is a group of 30 leading businessmen, mostly from developing countries, who meet once a year to discuss the business climate and to advise IFC on its operations in developing countries. The paper had two main objectives. The first was to provide the members of the Advisory Council with an overview of current world economic trends and their likely impact on the business climate in the developing countries. The second was to stimulate discussion on the economic factors that are adversely affecting private investment and the response of businessmen to these factors. The paper relies heavily on the narration of examples from different countries in the belief that benefits could result from the sharing of experiences.

The problems discussed in this paper are of broad interest to policy makers and businessmen, particularly in developing countries. It was decided to publish this paper so that a wider audience could have the opportunity to share the experiences described. The paper's perspective is that of private sector business in developing countries, and it is our belief that this perspective deserves broader circulation.

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## SUMMARY

The climate facing private sector businesses in developing countries over the coming year will be conditioned as much by forces in the world economy as by events at home. The strong business connections that have emerged between developing countries and the rest of the world, through trade and financial flows, mean that few businesses can be entirely insulated from developments abroad. So important have these international linkages become that even small businessmen selling on the local market will be affected in some way by the changes in prices, interest rates, and trade flows that are taking place in the outside world. These changes will pose threats or open up opportunities to businesses, depending on the economic environment in which they operate. In many countries, business activity continues to suffer because the environment, in particular the financial environment, is not conducive to growth.

The extent to which developing countries have benefited from recent growth in the world economy has been very uneven. A number of less developed countries (LDCs) have enjoyed rapid growth in production and exports, whereas in others conditions have been very difficult. One extremely important difference between the two groups of countries is the level of investment; where investment is high, growth mostly seems to follow. Business investment allows increased competitiveness and diversification into industries or sectors where market prospects are favorable. In this light, a crucial issue concerns investment in the second group of LDCs, where economic performance has been poor and the business climate difficult. What are some of the factors that inhibit investment, and how do businessmen finance the investments they do make in these countries?

This paper reviews prospects for business conditions in developing countries, focusing on issues and events that have taken place in the recent past and that are likely to be of importance through 1990. The paper is in four parts, each of which concentrates on a different aspect of the business climate.

Part I reviews the broad economic parameters that have a fundamental influence on the business environment. The review focuses on recent trends in world economic performance, looking at growth, trade patterns, commodity prices, interest rates, exchange rates, foreign investment, and protectionism.

Part II examines the problems created for businesses by volatility and uncertainty in exchange rates. The main issues are the difficulties caused by large, sudden devaluations and the implications for foreign currency debts when local currencies depreciate. Since markets do not offer exchange risk cover for developing country currencies, especially for long maturities, the willingness to utilize offshore finance is reduced and firms cut back their investment plans. These difficulties can encourage businessmen to look to their government for assistance in the form of market regulation and the maintenance of overvalued exchange rates. Yet the evidence clearly indicates that long-run benefits accrue to the private sector when these short-term pressures are resisted and markets are allowed to operate properly. Liberalization and realistic exchange rates are, in the long term, good for business.

Part III looks in some detail at trends in corporate finance in developing countries, considering in particular the difficulties faced by businesses in countries with very high real interest rates. The high real rates associated with the scarcity of long-term finance severely restrict investment. A further important effect on companies in this environment is that management becomes absorbed in financial questions to the detriment of the real side of the business.

The implications of restricted availability of loan finance are particularly serious in countries where corporations are forced to rely heavily on bank loans for their financing needs. Other sources of finance are reviewed -- including retained earnings, equity, corporate bonds, and foreign investment -- to assess prospects for their expansion. Also examined is one form of investment finance that has been growing rapidly in the recent past, namely, debt-equity swaps.

Part IV studies two particular economic sectors and examines how businessmen in developing countries in these sectors have faced the challenges and opportunities before them. The two sectors have been chosen for being very different. One, the automotive sector, is among the world's most important industries, which many developing countries are keen to establish. Examining this industry has enabled a number of important issues affecting many businesses to be considered; among these are technological change, new techniques of management organization, and changing strategies of multinational corporations. While the majority of LDCs are too small to support complete automobile production activities, many will find opportunities in production and export of components and subassemblies. Success in the export of automotive components will depend very much on a country's reputation as a reliable supplier. The second sector examined is the horticultural export business, a much smaller but dynamic sector, in which a number of developing countries have attained considerable success. Potential exists for further

development of this industry, but only where a good resource base is coupled with an entrepreneurial private sector and carefully developed marketing arrangements.

The review prompts a number of conclusions. The key economic factors influencing the business climate were very positive for most countries in 1988. Although a slowdown is expected over the next twelve months, it will not be a recession. Prospects are therefore bright for continued rapid growth in the countries that have, over the past decade, invested a large proportion of their GDP, diversified their manufacturing sector, and increased their export shares. These include the newly industrialized countries of East Asia as well as India and China. On the other hand, the debt crisis is stifling investment and private business development in many middle-income countries. Efforts to resolve severe debt problems will be increased, reflecting growing recognition that the social pressures generated by adjustment are now very severe and that the indebted countries cannot make these adjustments without increased external assistance.

Perhaps the most important conclusion concerns interest rates and patterns of corporate finance. Interest rates have been edging higher over the past twelve months, and in the absence of stronger fiscal adjustment in the industrialized countries this upward pressure may well continue. This factor will raise further the cost of financing investment through debt and intensify the search for more balanced corporate financial structures throughout the developing world. There will be more attention given to equity, retained earnings, and foreign direct investment as sources of finance. The development of capital markets in developing countries will become even more urgent as a solution to these financial difficulties.

## PART I: THE INTERNATIONAL CLIMATE AND ITS IMPACT ON BUSINESSES IN DEVELOPING COUNTRIES

### Introduction

This section looks briefly at how world economic trends affect the business climate in developing countries. It then covers recent developments in the world economy and the outlook for the next two years, with particular attention to the business prospects in developing countries.

Global influences are an important consideration in assessing the LDC business outlook. Not only do exports make up around 19% of developing-country GDP on average, but spending by domestic residents is influenced by forces emanating from abroad as well. In recent years, there has been an almost one-for-one relationship between changes in real income growth in the major industrial economies and changes in real income growth in LDCs. This means that in addition to growth in LDCs generated internally, significant changes in local demand and income are transmitted from abroad. Underlying this important aggregate relationship are numerous differences at the individual country level, which vary according to trade dependence, terms of trade movements, level of external debt, etc. At one extreme are the Asian newly industrialized countries (NICs) whose competitiveness is such that their business sector continues to grow even when the rest of the world is experiencing a downturn. At the other extreme are some LDCs, who, for a variety of reasons, experience poor economic growth even when the rest of the world is booming. During the buoyant global conditions of last year, for instance, relatively low growth rates were recorded in the oil exporting countries (for terms of trade reasons) and in the heavily indebted countries.

### Trade and Capital Flow Linkages

The mechanisms through which LDC economies interact with the rest of the world involve both trade and capital flows. Total trade (exports plus imports) averages around 38% of GDP for developing countries as a group, although the range is very wide. India and Brazil, for instance, have total trade amounting to only 14% and 15% of GDP, respectively, while in Korea, the ratio is 76%, and in Malaysia it is 108%. Economies with high trade exposure are typically more sensitive to changes in trade volumes and prices. Of particular importance is the composition of exports. Many LDCs have a high dependence on volatile primary commodity export earnings that flow through to the level of domestic spending and, in turn, affect all local businesses.

Export fluctuations also affect the amount of a country's imports, and these, too, can have a strong multiplier impact on local business opportunities. The majority of LDC imports are not consumer

goods but capital goods, semi-finished items, components, and industrial raw materials. One example has been Indonesia where recent downturns in oil prices forced cuts in imports of capital goods and industrial inputs (which make up more than 80% of Indonesia's imports) and as a result affected investments, production, and employment decisions in a wide range of business sectors.

The second mechanism through which LDC business opportunities are shaped by interaction with the rest of the world is capital flows, which finance the difference between what a country earns and what it spends. Throughout the 1980s, many individual LDCs have found that as the availability or cost of external finance has become more onerous, there has been a forced reduction in domestic expenditure. This, in turn, has meant a harder time for local business. As businessmen in some of the highly indebted countries have found during the 1980s, increases in the cost of external finances are bad enough, but far more serious are the effects on domestic spending when countries have to switch from being net importers to net exporters of financial resources. In a number of countries, this financial drain has been reflected in reduced expenditures by consumers (including governments) and lower investment activity by producers. The consequence has been a depressed business climate.

#### Trade and Growth Outlook

Demand growth in the major industrial economies in 1988 proved to be much better than was expected at this time last year, not only in terms of the level of demand, but in the composition of growth as well. As shown in Table 1, overall growth in the major economies last year was 4.2%, which is remarkably buoyant by the standards of the 1980s and especially so given the pessimism that followed the stock market crash of October 1987. The acceleration in economic activity was led by high levels of investment activity in the industrialized countries and the Asian NICs. The investment growth occurred partly in response to the eased monetary conditions of late 1987 and partly in response to the emergence of capacity bottlenecks as world economic activity entered its sixth successive year of growth.

The year 1988 produced a number of other surprises as well. All of the major currencies showed much more stability than had been anticipated at the beginning of the year, with exchange rate fluctuations occurring within a relatively narrow band. Overall, the U.S. dollar (still the dominant currency of world trade) declined on an SDR basis by only 3.8%.

Given the unexpected growth in demand and stability of currencies, it is not surprising in retrospect that trade growth in 1988 should have been so good. World trade volume grew by 8.5% during 1988, well above the 5.9% growth recorded in 1987 and a good deal higher than was expected by most forecasters only a year ago. 1988 marked the fourth

**Table 1: ECONOMIC INDICATORS UNDERLYING BUSINESS OUTLOOK, 1987-90**

(Percentage change from previous year; except LIBOR)

Indicators	1987	1988 <u>c/</u>	1989 <u>d/</u>	1990 <u>e/</u>
Major-seven output	3.4	4.2	2.9	1.5-2.2
World trade (volume)	5.9	8.5	4.5	4.5
Developing countries' exports (volume)	8.0	9.8	6.0	n.a.
Exporters of manufactures <u>a/</u>	13.7	14.5	7.0	n.a.
Developing countries' GDP:				
Total (90 countries)	4.5	5.1	4.5	3.7-4.1
Newly Industrialized Economies	11.4	8.3	7.2	5.7
India and China	7.2	10.2	8.1	5.5
Highly Indebted Countries	1.7	1.8	1.8	1.8-3.2
Sub-Saharan Africa (ex. Nigeria)	0.8	1.1	2.2	3.4
Major-seven inflation (local currencies)	2.8	2.7	4.2	3.3
Dollar exchange rate (SDR/\$)	-9.3	-3.8	-4.6	n.a.
Export price of manufactures (\$)	9.8	6.4	5.4	n.a.
Commodity prices, except oil (\$)	-0.1	20.1	-1.5	-1.3
Oil price (\$) <u>b/</u>	27.4	-18.6	10.7	7.1
Developing countries' terms of trade:				
Exporters of manufactures	-2.4	1.8	0.1	n.a.
Nonoil primary exporters	-2.2	7.9	-2.7	n.a.
Oil exporters	12.3	-17.4	4.6	n.a.
Interest rates (LIBOR), 6 months (\$, % p.a.)	7.3	8.1	9.9	8.5-10.5

a/ Total export volume from LDCs classified as exporters of manufactures.

b/ OPEC average.

c/ Preliminary estimate.

d/ Preliminary projection.

e/ Where pertinent, a range of outcomes is given to reflect uncertainty regarding policy outcomes in three key areas: U.S. budget and external deficits; protectionism in the industrial countries; and restoration of growth in the debtor countries. Failure to achieve progress in these areas will mean lower growth and higher interest rates.

Sources: IMF, World Bank, IFC.

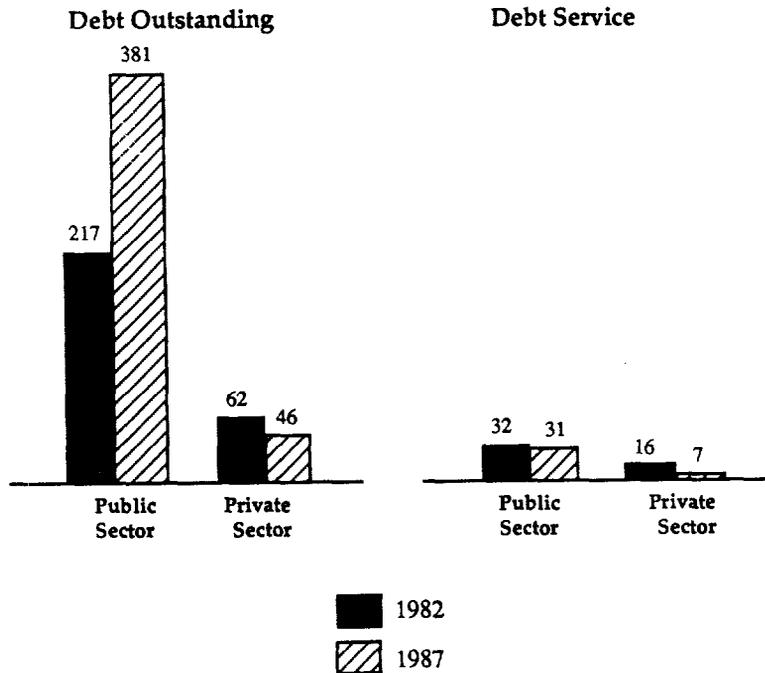
consecutive year of accelerating trade growth, and the sixth consecutive year in which world trade grew more rapidly than world production. For businessmen attuned to opportunities in the world trading system, 1988 represented the best year for growth since the last boom year of 1984.

The strong growth conditions that characterized 1988 are unlikely to be sustained in 1989-90. Already there are signs of a slowdown in the major economies, and it is expected that slower trade and output growth will be more apparent by late 1989 and early 1990. However, as the projections in Table 1 make clear, a slowdown does not mean a recession. Aggregate demand is expected to continue growing in the major economies, albeit at the more modest rates of 2.9% in 1989 and 1.5 to 2.2% in 1990.

According to the International Monetary Fund, one of the main threats to this scenario comes from inflation. If allowed to accelerate, inflation will invite sharper policy clampdowns on demand and result in increased currency instability as well. Inflation in the major economies was expected to be around 4.2% in 1989 (up from 2.7% last year) and 3.3% in 1990. These projections imply that fiscal and monetary policies will remain tight, at least for the remainder of 1989.

Perhaps the most unwelcome by-product of this outlook for LDCs is a seemingly unavoidable rise in interest rates. Even with progress on the policy front, it is unlikely that LIBOR rates will be lower in 1990 than they were in 1988 unless the fiscal performance of the OECD countries improves. Apart from their effect on global demand, continued high interest rates mean a further drain on incomes in indebted LDCs and hence lower prospects for local businesses. With \$400 billion of LDC debt held at variable interest rates, each percentage point fluctuation in LIBOR means a change in interest payments of \$4 billion annually. The bulk of the debt is held by Latin American governments. While their outstanding foreign debt has increased from \$217 billion in 1982 to \$381 billion in 1987, the Latin American private sector has been able to reduce its foreign debt from \$62 to \$46 billion (see Figure 1). The heavy debt burden, combined with increased interest payments, means that investment activity and economic growth will remain depressed in the high-debt countries.

**Figure 1: LATIN AMERICAN FOREIGN DEBT, 1982 and 1987**  
(US\$ Billion)



For world trade, the outlook is for much lower growth in 1989 and 1990 after the boom conditions of last year. One factor that will help to keep trade growing in 1989-90 is the recent strength of business investment in both industrial and selected developing countries (mainly in Asia). The high levels of investment to date mean increased production capacity by 1989-90, and this will help to partially ease pressures of inflationary bottlenecks. An additional positive factor is the extent to which countries are participating in trade. The substantial margin of world trade over world output growth in recent years (8.5% versus 5.5%, respectively, in 1988 alone) is a good indicator that economic linkages between countries are continuing to grow. Whereas trade in the last boom year (1984) was driven largely by growth in imports by just one country -- the United States -- the 1988 boom was led by a range of countries (including Japan at 16.5% import volume growth and the Asian NICs at 14% import volume growth). The growth in the trade base means that the outlook is less sensitive to economic conditions in just one or two countries.

Perhaps the main trade uncertainty in the coming year will be the extent of slowdown in the U.S. economy and the effect this will have on its imports from developing countries. Of all the major industrial economies, the United States faces the most difficult task in controlling both rising inflation and a persistent trade deficit. The United States is also the world's biggest buyer of LDC exports (see Section 5). While policy settings will be tighter in most OECD countries, the effect on demand will be felt most strongly in the U.S. market. Hence, exporters who have a high sales dependence on the U.S. market are likely to find increased buyer resistance and almost certainly a tougher battle to maintain market share across a range of demand-sensitive commodities.

The outlook for economic activity in the developing countries, therefore, is for growth that is slightly slower than last year but which is well above that of the major industrial countries (see Table 1). The main casualties of the emerging trend toward higher interest rates will be the highly indebted countries, for whom the prospect of decent growth has now been postponed yet another year. Encouragingly, though, the growth prospects in Sub-Saharan Africa continue their slow improvement. Strong growth in domestic demand in the year ahead is likely to be confined to the Asian NICs and to the low-income giants, India and China.

#### Commodity Price and Terms of Trade Outlook

After a long period of being at low or depressed levels, dollar prices of nonfuel primary commodities increased by about 20% last year, as compared with a 6.4% increase in the price of exported manufactures (see Table 1). The rise in commodity prices was higher than expected and reflected both climatic conditions (e.g., effects of drought on U.S. crops) and growth in demand associated with the business cycle. Not all products shared in the price improvement, however; last year coffee and cocoa prices were 40% below their 1980 levels in real terms, and oil prices fell to 1986 levels.

The rise in primary commodity prices during 1988 resulted in a 7.9% rise in the terms of trade of nonoil primary exporting LDCs, which was not only high by historical standards, but represented a reversal of the downward trend of the 1980s as well. Other groups of LDCs showed either modest terms of trade gains (e.g., a 1.8% rise for manufacturing exporters) or large falls (17.4% fall for oil exporters).

Only a few primary commodities are expected to show further price increases in 1989-90, and the majority of prices are likely either to be steady or to fall. Nonoil commodity prices are expected to decline, overall, by around 1.5% in nominal terms, with the biggest falls occurring in minerals and metals prices. Prices of manufactures, on the other hand, are projected to increase by around 5.4%, owing to the rise

in raw material costs and the general buildup of inflationary pressures. Oil prices are forecast to increase from their 1988 average by around 10 to 11% in 1989-90.

These price projections indicate the following terms of trade developments, in LDCs, in the year ahead. Nonoil primary exporters are likely to experience a fall in their terms of trade of up to 2.5 to 3%, indicating slower growth in domestic business conditions due to reduction in purchasing power. Exporters of manufactures, on the other hand, are likely to have their terms of trade holding steady over 1988, while oil exporters are expected to see a 4.6% rise in their terms of trade.

#### Trade Performance Prospects for LDC Exporters

With the prospect of less buoyant world trade growth in the next year or so, LDC export growth will depend in part on the ability to hold or expand market share in the major industrial economies. This will be of particular importance in manufactured exports, which often compete directly with domestic suppliers of the importing countries. Not surprisingly, the main category of manufactured exports in which LDCs have done well over the years are the labor-intensive kind: textiles, garments, footwear, leather products, wood products, furniture, metal fabrications, electrical apparatus, etc. Developed-country imports of labor-intensive manufactures increased almost sixteenfold in the twenty years to 1986, considerably higher than the ninefold increase in imports of other nonfuel products. Clothing and textiles are the main individual export earners among these manufactures, although in aggregate, electrical products and components now account for over one-fifth of all labor-intensive exports. However, this growth has been achieved by only a relatively small number of developing countries: around 90% of all labor-intensive exports came from just twenty countries in 1986 (eleven in Asia, four in Latin America, three in Europe-Middle East, and two in Africa).

The demand for LDC exports of labor-intensive products is also narrowly based. The United States is the single largest buyer of these products, taking 55% of total LDC shipments to developed countries in 1986. On a per capita basis, U.S. imports were more than three times those of Europe and three and one-half times those of Japan. Protectionism appears to be a likely cause of these national differences, especially in textiles and clothing, where nontariff barriers discriminate against LDCs. For instance, under the Multi Fiber Arrangement, LDC exports are subject to strict quota limits, while similar goods originating in developed countries are traded more freely. In Europe the EEC-EFTA protocol gives preferences to intra-European suppliers of all products, and European tariffs on many labor-intensive products from LDCs are still very high. In Japan also, the domestic market is less open to competition from abroad than is the U.S. market, resulting in high costs for a wide range of consumer products that could be supplied competitively by LDCs.

The prevalence of protectionism (especially quantitative barriers) means that the strong potential comparative advantage of LDC producers has not been fully realized. Even in the United States, where the market has been more favorably disposed toward LDCs than in other developed countries, some 43% of manufacturing employment is still in labor-intensive products. This means that if LDC exporters are to make bigger inroads into the U.S. market, they must displace either competing suppliers (from industrial countries) or local manufacturers.

With the prospects of lower growth in both economic activity and trade over the next two years, there is the clear risk that LDC exporters will provoke some form of retaliation in the industrialized countries if their exports continue to grow at high rates. The competitive pressure that the developing countries will be able to exert is broadly based; it covers clothing, footwear, textiles, electrical goods and components, wood products, fabricated metals, furniture and fixtures, rubber and plastic products, leather products, etc. However, the broader the competition, the greater will be the pressure within the industrialized countries to maintain or increase protectionist barriers.

#### Outlook for Capital Flows and Foreign Direct Investment

In sharp contrast to the active role that developing countries are playing in world trade, their role in world financial markets and international investment is, for the most part, either static or declining. During the 1980s, developing countries have become, by and large, less sought after places for foreign loans and equity investments than they were in the 1970s. This is despite the spectacular growth that has taken place in global capital flows over this period. The main symptom of the decline has been the net transfer of funds from the highly indebted countries to creditors in the developed countries. Net borrowing from commercial banks by LDCs has been contracting, but lending by official providers of capital has been increasing. In other words, the relative importance of official lenders has become more pronounced as commercial banks take steps to reduce their LDC exposure.

After declining in the early to mid-1980s, private capital flows to LDCs in the form of foreign direct investment (FDI) increased strongly last year, especially in East Asia and those Latin American countries that have operated debt-equity conversion schemes. Net FDI flows to the net debtor countries rose from \$12.7 billion in 1987 to \$17.2 billion in 1988. Not every country participated in this growth. Mexico, after experiencing a surge in FDI in 1987, suffered a 20% fall during 1988 that appears to have been caused in part by the suspension of its debt-equity swap program in November 1987. India, on the other hand, witnessed a doubling of FDI inflow in 1988, due in part to liberalization of some aspects of its foreign investment policy. However, while global levels of FDI have responded to the overall improvement in world economic

activity since the mid-1980s, the share directed toward the developing countries is continuing to fall as firms continue to give preference to investment in the industrial economies. Only in some countries in Asia and in Latin America are FDI inflows showing any signs of growth, and in the case of Latin America, part of this growth has been due to debt-equity swap activity and to retained earnings on existing investments.

Japanese companies appear to be showing increased interest in new manufacturing investments abroad as a means of combating the effect of the high yen. A number of Asian countries including Hong Kong, Singapore, Korea, and Taiwan, China have had increased flows of Japanese FDI during the 1980s, especially in the field of technology-intensive manufacturing. More recently, Thailand, Malaysia, and the People's Republic of China have received increased FDI from Japan. One potentially important shift in strategy is the interest shown by some Japanese companies in exporting directly from LDCs to the rest of the world (including Japan). However, companies will make this shift with caution as reliability of supply from some LDCs remains a problem. One major source of uncertainty in the outlook for FDI into LDCs is Europe 1992 and the perception of it becoming "Fortress Europe" by major U.S. and Japanese corporations. How this perception will affect FDI flows to developing countries over the next couple of years is not yet known, but at the very least, it will make competition for investible funds that much more intense.

These developments should not imply, however, that capital flows are becoming less important as an issue in assessing the LDC business climate. In regions such as Latin America, where net lending by commercial banks was negative in 1988 (and will likely continue to remain low), a major question facing businessmen in the year ahead is the amount of domestic expenditure reduction that will result from further net transfers to commercial banks abroad and what new capital flows (if any) will be coming from other sources. These issues are the subject of ongoing discussions between banks, governments, and multilateral organizations, so it is difficult to forecast accurately their overall effects on capital flows at the individual country level. Compounding this uncertainty is the possibility that if improvements in the debt climate are achieved in the coming year, a change (however small) in sentiment regarding capital flight from LDCs may also occur. It is uncertainty over factors such as these that make it difficult for LDC businesses to forecast demand prospects domestically and to formulate investment plans.

#### Summary of LDC Business Climate Outlook

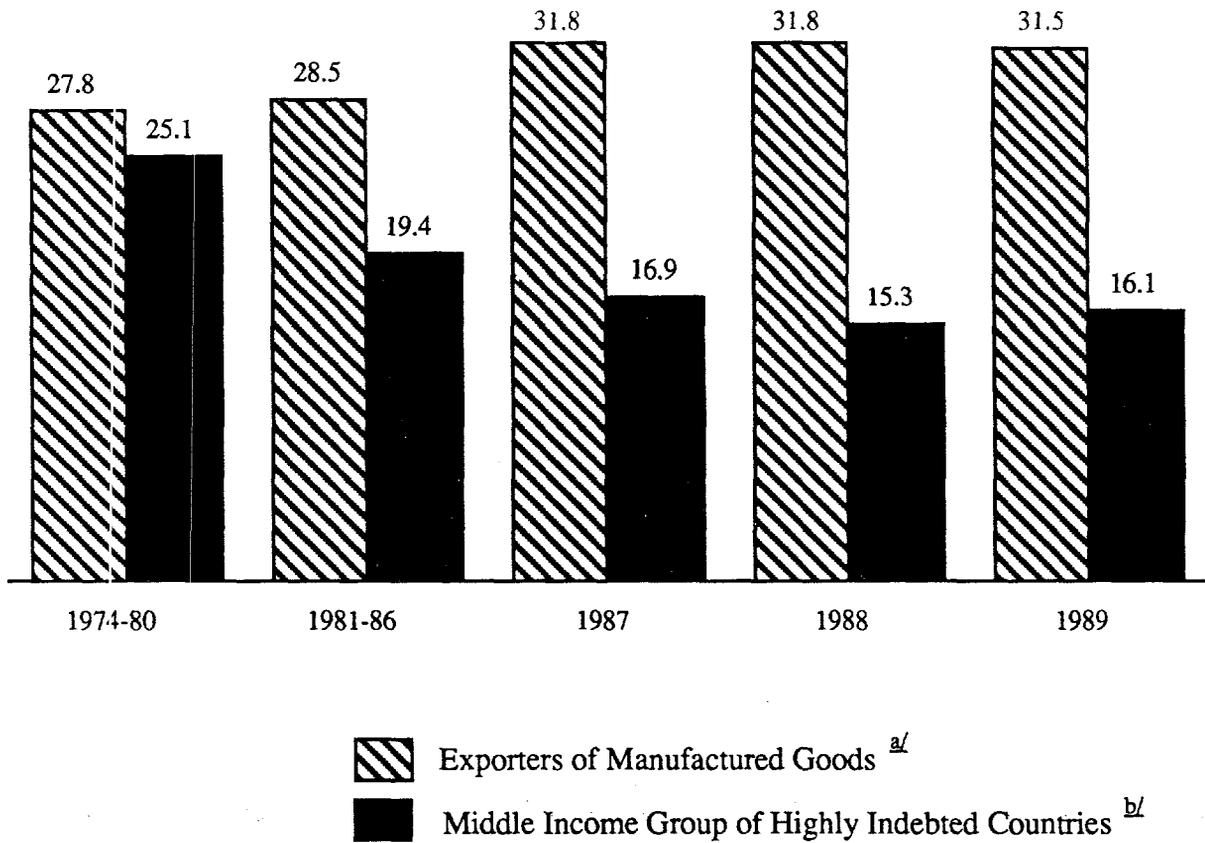
The outlook for the business climate in the developing countries over the next year or so will, on balance, be for continued growth, but at slower rates than in the past twelve months. As growth in the world

economy slows, so, too, will the growth in demand for LDC exports, especially for exporters seeking access to the U.S. market. A number of developing countries will experience slower business growth due to lower terms of trade (mainly the nonoil primary exporters). Policy decisions, in both industrial and developing countries, will have a major bearing on the extent of the slowdown and underlying interest rate pressures. Policy actions will also determine the extent of reduction in the debt burden in a number of LDCs. However, with the prospect of higher interest rates worldwide (unless further fiscal efforts are made in the industrialized countries), the immediate benefits from reductions in debt for the highly indebted countries may be small.

Other issues of concern in this outlook are continuing problems for LDCs in tapping world capital markets and rising protectionist sentiments in the industrialized countries. There is no good reason to expect new foreign direct investment in LDCs to increase beyond current levels in the near future except in East Asia, and if this is correct, it will limit the ability of many developing-country businesses to expand and improve competitiveness. Given this scenario, domestic financing issues will assume greater importance for LDC businessmen in the year ahead. These issues are examined further in Parts II and III of this paper.

It appears that a "two-track" process has emerged in the developing countries, and there is a danger that it will continue. The growth of individual economies and their business sectors is closely associated with high levels of investment, open trading systems, and especially the development of an export manufacturing base. The debt crisis has sharply curtailed investment in Latin America (see Figure 2), and as a result the momentum for future growth has been reduced. In Africa and in some countries in Asia, investment levels (due to government policies and other internal factors) are also low, which limits future growth prospects. In contrast, the high investment countries, which are the most dynamic exporters of manufactured goods, are likely to show continued superior growth. Without restoration of investment activity in the highly indebted, low-growth countries, the gap between the two tracks will widen in the 1990s.

**Figure 2: INVESTMENT, 1974-89**  
(Percentage of GDP)



<sup>a/</sup> Brazil, China, Hong Kong, India, Israel, Korea, Portugal, Singapore, Yugoslavia and Taiwan, China.

<sup>b/</sup> Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

\* Note that Brazil and Yugoslavia are represented in both categories of countries.

PART II: EXCHANGE RATES AND THE BUSINESS SECTOR IN DEVELOPING COUNTRIES

As noted in Part I, relative exchange rate stability among the major currencies was a welcome feature of the global environment last year. In a number of developing countries, however, exchange rates continue to be a major source of problems for businessmen either because of sudden and dramatic changes that result in losses, or persistent overvaluation that distorts all trading and financial transactions. The exchange rate is one of the most important prices in an economy, and it is vitally important to have it properly aligned. Only with a realistic exchange rate can businessmen direct resources into competitive sectors, making it possible for countries to lift themselves into the virtuous cycle in which high investment and high growth go together. The difficulties of adjustment are considerable, of course, which can make many in the business community strong defenders of the status quo. Yet a misaligned exchange rate cannot be sustained indefinitely, and the private sector does benefit from the ending of distortions.

Effects of Sudden Currency Adjustments

Short-term problems arise when a currency moves suddenly and by a large amount. In the past year, many countries have suffered from such adjustments in real exchange rates, and the recent case of Venezuela illustrates the business problems this can cause.

The new Venezuelan Government took office in 1989, determined to reduce the country's dependence on oil exports and restructure the economy. In February, the Government announced the ending of the two-tiered exchange rate system for the bolivar, replacing it with a single floating rate. This was effectively a large devaluation; the official rate, which was used for most transactions, was 14.5 bolivars to the U.S. dollar, whereas the free-market rate stood at 38 to the dollar on the day the official rate was scrapped, and it has continued to fluctuate between 36 and 40.

This large devaluation was intended to shift resources from importers to exporters, but it imposed a massive burden on the import sector. Letters of credit covering imports worth \$6 billion were outstanding at the time of the devaluation, and most of these had been opened with a Government guarantee that foreign exchange would be available at the official rate. (In many countries, the government or central bank operates short-term foreign exchange cover for importers.) Yet the Government did not have the necessary foreign exchange to make good these commitments, and it is likely to meet, on average, only about 40 cents on each dollar owed. This has created massive disruption in the parts of the economy that rely on imports; most car assembly plants, for example, closed down while management attempted to come to terms with the new situation. In an attempt to soften the social impact of this

disruption, the Government prevented companies from laying off workers and is imposing wage increases on private sector employers. These measures are likely to make it more difficult for resources to move into the export sector of the economy.

From the perspective of Venezuelan businessmen, the suddenness and severity of the exchange rate change caused serious problems. They face large losses on their outstanding import bills; they face a large increase in the burden of their foreign debt (private and public debt in Venezuela stands at \$33 billion); and they face Government-imposed obstacles in their efforts to adjust their businesses. Of course, they also have a number of new opportunities in the export sector, but it will be a while before anything positive emerges.

The business sector of Venezuela is not alone in having to cope with problems of this type. In Ecuador, the sucre was valued at 249 to the dollar in July, but moved down to reach 435 by the end of December. In Peru, the inti was devalued in September 1988 from 33 to 250 to the dollar, and again to 500 in November. In Yugoslavia, the exchange rate has moved by a large amount but by steady depreciation rather than sharp steps; the dinar was valued at 1,319 in January 1988 but had eroded to 5,210 by the end of December. The U.S. dollar bought 100 Somali shillings in January 1988 and 270 in December; in Tanzania, the movement has been from 94 to 125 shillings per dollar over 1988. In Asia, on the other hand, currency values have been, for the most part, relatively stable.

#### Currency Management and Long-Term Financing

Sudden drops in currency value are not the only exchange-related problem confronting business in developing countries. Currency overvaluation (especially with inconvertible currencies) and currency risk management are also high on the list of factors inhibiting business growth. When a country's exchange rate is overvalued, foreign investment through joint ventures becomes extremely difficult. For example, in China joint ventures must cope with the valuation of buildings and other civil works at the official exchange rate, which seriously overstates the dollar cost of projects and inhibits investment. The foreign partners are reluctant to put in equity when they know that its value could be reduced suddenly through a large devaluation. In these situations, joint ventures can go ahead only if special arrangements are agreed upon -- for instance, all partners contributing equity in dollars and local contributions being valued at a realistic dollar equivalence. Another common practice is for the local partner to contribute a real asset that can be valued in a way acceptable to all parties; thus, in a Polish joint venture, the local partner contributed a hotel in a prime, central Warsaw location, and the foreign partner brought the money and expertise to refurbish and manage it. In Hungary, joint ventures have gone ahead with land (for prime factory sites) being contributed. Thus, joint ventures

are arranged despite currency overvaluation, but these require special permission from the government and only a few deals a year can be realistically expected in a country.

When exchange rates are out of line, the fear of devaluation discourages investment. Businessmen are reluctant to take foreign loans, even when they are available, for perfectly viable projects because they are uncertain about the size of repayments they will have to make in local currency. The IFC has recent experience with this: for example, in Nigeria some IFC loans have been cancelled because local investors felt the risks involved in taking foreign exchange loans were too great.

Long-term financing problems also arise when an LDC company that needs to purchase equipment abroad has no alternative but to take on a debt in a foreign currency. Devaluation of the local currency adds significantly to the debt burden, and if businesses are reluctant to take on this type of risk, the overall level of investment is reduced. In IFC's portfolio, there are many companies that have borrowed (in dollars, deutsche marks, or yen) amounts that have seemed quite reasonable at first, but that have been vastly inflated by subsequent depreciation of the local currency. Even in the case of a company that is partially hedged by its foreign currency earnings, there can be complications from the mix of currencies it owes and earns: a company that has dollar debts but earns export revenues in the European market will have benefited from the past few years' currency movements, whereas one with yen debts and dollar earnings will be doing very badly indeed. The impact of the increased burden of debt is all the more serious because, in many of the poorer developing countries, the only long-term finance available is foreign currency finance. What can be done to solve this problem?

The financial markets do not offer exchange risk cover for developing-country currencies, especially for long maturities. Some governments are trying to deal with the problem by assuming the exchange risk themselves, sometimes charging a modest premium to the private borrower. Frequently, this foreign exchange cover is not available for all borrowing but is limited to funds on-lent by the local development banks.

In Pakistan, for example, the Government bears the exchange and interest rate risk for all foreign funds that are channeled through financial institutions. Until 1986, the costs of this scheme were covered by a flat fee of 3%, irrespective of the currency of the original credit. Since 1986, the fee for each currency has been linked to the long-term rupee interest rate except for IBRD funds on-lent through local development banks, which still benefit from the 3% flat fee. The Indian authorities are considering a similar scheme, under which subborrowers of the major development finance institutions would receive loans denominated in rupees, with the foreign exchange risk carried by a Foreign Exchange Risk Cover Scheme Fund to be created from a risk premium

charged to the borrower. These schemes have the advantage that an estimate of the cost of foreign exchange risk is directly incorporated into the interest rate paid by the borrower, rather than the borrower facing unexpected changes in the cost of servicing foreign debts. There are two main concerns with schemes of this type. The first is that if the insurance is not priced correctly, the government's foreign exchange liabilities can mount very quickly, giving the government a disincentive to devalue the currency as and when needed. This can prolong distortions in the economy. The second is that the scheme may not be open to all lenders and borrowers; in particular, companies that borrow directly from overseas may not be eligible. This discrimination stifles competition and causes distortions, such as introduction of preference for government-guaranteed debt and underpricing of foreign borrowing.

In some cases, governments allow companies to apply foreign currency earnings to debt repayments and/or to accumulate foreign currency assets and thus control their net foreign currency exposure. Elsewhere, foreign borrowing is allowed only if the companies can generate foreign exchange through exports to service their debts. This forces these companies to export, even when they have no competitive advantage and local markets could absorb the output. In China, Hungary, Poland, Yugoslavia, and other countries, companies have to export, even at a loss, to obtain foreign exchange to pay for raw material imports and debt servicing. This clearly limits the ability of businesses to import equipment to modernize and expand. Thus, capacity utilization suffers because of shortage of imported spare parts and raw materials.

The ideal solution to these difficulties is a system of market-based interest rates with convertible currencies, thereby ensuring that interest rates reflect exchange rate risk. Of course, it is unrealistic to expect such a development to take place quickly in all countries. However, transitional measures can be taken by a local government to mitigate the worst effects of the escalating local currency value of debts. In Kenya, one of the countries where foreign loans are virtually the only source of long-term finance, the Government has recently taken two steps that should benefit the private sector. The first is that foreign exchange loan losses incurred after January 1, 1989, will be recognized as a business cost and therefore will be deductible against a company's tax liability. The second step is the creation of a commission, charged with the establishment of a capital market development authority to develop local sources of long-term finance. There will be no rapid payoff from this, of course, but it is a hopeful sign.

#### Policy Reform and Business Growth

Improving facilities for exchange risk management will bring some benefits to LDC businesses seeking to finance long-term growth. However, the biggest benefits to the business sector will come from reform of the internal distortions that cause currencies to become badly

misaligned in the first place. As noted, the exchange rate is one of the most important prices in the economy, and serious problems emerge when currencies diverge from their appropriate level. Businessmen make their decisions on the basis of relative prices. If one of the most important prices (the exchange rate) changes, some of those decisions will turn out to be uneconomic; clearly, the businessmen who stand to suffer from devaluation will oppose it. The impact on a particular company will depend on how much it imports and exports, and how much it owes in foreign currency. Indeed, in some LDCs the business community appears to support regulations and policies that have not been in their long-term interests. For a number of reasons, they see policy reform as a hindrance rather than a help.

For businesses that have developed behind protective barriers and rely for their profitability on a continuation of protection, the process of policy reform may cause considerable pain and financial distress. Therefore, established businesses generally resist this change. They also may be skeptical about the government's intentions. Political pressures on the government may make radical economic policies difficult to implement, and businessmen can see this as clearly as anyone else. The recent example of Venezuela's policy changes illustrates how hard it is for a government to give up its long-cherished paternalism in economic management. Similar factors can be seen at work in Kenya, where the Government is encouraging export competitiveness through a steady but gentle depreciation of the exchange rate and liberalization of the domestic economy. Price controls on a number of commodities are being lifted. The first company to raise its prices after they were decontrolled, however, was attacked by the Government and by much of the press for its "irresponsibility"; some companies are now reluctant to continue to press for liberalization since they doubt the Government is really prepared to give up its influence over the economy. From their perspective, the advantage of price control is that the Government takes responsibility for higher prices and businessmen can keep a low profile. Others recognize that this is a small advantage compared with its cost.

In the long run, as many business people have realized, protected industries and unrealistic exchange rates lead to poor productivity growth, limited markets, and uncompetitive costs. Nor is protection necessarily a source of profitability. In Mexico, before liberalization, operating returns were uniformly low in seemingly heavily protected sectors such as capital goods, basic iron and steel, consumer durables, and automobiles. This pattern is repeated elsewhere and typically results from the arbitrary way in which price controls, regulations, and protection decisions have been used to favor different groups at different times. It often comes as no surprise to LDC businessmen to find out that instead of receiving positive protection (through, say, a 20% import tariff), they are effectively receiving

negative protection (because of price controls, excessive taxation, or policies that raise the cost of inputs or restrict access to finance at reasonable cost). Similar evidence can be found in a recent analysis of the performance of over 100 IFC investments around the world; financial rates of return were usually lower than economic rates of return. Thus, any benefit to the companies from protectionism was frequently offset by taxes, price controls, or other forms of government intervention.

In most countries where layers of regulations have built up over the years, policies are having unintended consequences in all sectors, and the results show up in poor business growth. It is important, therefore, for business people to see how they can take advantage of the movement toward deregulation, fewer controls, and more realistic exchange rate policies in their countries. This should help move investment toward areas/sectors in which the country has some comparative advantage, enabling businesses to be competitive without government supports and the country to benefit from a more efficient deployment of its resources. The gains to many from such a restructuring would far outweigh the costs to a few. This is seen again and again where trade has been liberalized and government controls on pricing, new investments, etc., have been relaxed.

#### Summary

Doing business is difficult in many developing countries. One common aspect of this difficulty is exchange rate misalignment. Overvalued exchange rates have often been supported by businessmen who rely on imported raw materials, especially if there are also tariffs on manufactured imports, and by those who have contracted debts in foreign exchange. The evidence suggests that the apparent benefits from overvaluation are illusory. What is more, overvalued exchange rates make investors reluctant to commit funds when devaluation can severely reduce their value or increase debt service costs. Misaligned exchange rates cannot be sustained indefinitely, and the correction causes both short- and long-term problems for many businesses. Business leaders have an important role to play, however, in pressing the case for maintaining realistic exchange rates; many are already playing this role. Attempts to secure short-term and even sometimes illusory gains from protectionism and government support are just wasted efforts if they mean the sort of exchange rate problems noted earlier. Businessmen stand to gain from an improved climate and should be in the forefront of persuading the public and their governments of the benefits of economic reforms that result in realistic exchange rates, appropriate interest rates, and open markets.

### PART III: BUSINESS FINANCING IN DEVELOPING COUNTRIES

Improving the financial environment remains as one of the major incomplete agenda items for developing countries in the 1980s. In many countries, there is a serious shortage of long-term finance. Companies respond to this by using short-term funds for long-term projects, and by cutting back on investment. In those countries where finance cannot be obtained at reasonable cost, investment has fallen, economic activity has slowed (in some cases declined), and the business sector has gone backwards. Even businesses that have some internal funds find they cannot escape the market-depressing effects of the low investment-low growth cycle. These problems are exacerbated in countries with high inflation and high real interest rates. Of course, positive real interest rates (i.e., rates that exceed inflation) are needed to ensure mobilization of savings and the efficient utilization of capital. When interest rates are very high, however, there is short-term financial crisis for businesses as well as adverse effects on investment. This part of the paper examines the issue of financing businesses, looking first at the options for financial survival when interest rates are very high, then turning to consider questions of financing longer term business development.

#### Coping with High Interest Rates and High Inflation

A recurring issue in developing countries is businesses' response to high real interest rates. Although there are comparatively few countries where real interest rates approach the 50% per year or higher level seen in Brazil, Argentina, and Turkey, the question of how businessmen respond to the high cost and limited availability of funds is of broader interest.

In countries with high inflation, high interest rates, and high foreign exchange volatility, long-term financing is practically nonexistent. Businesses have responded by cutting back on investment, increasing reliance on internally generated funds and seeking foreign funds, both loans and equity. As noted in Part I, if their response is to cut back on investment in plant and equipment, this has obvious implications for the competitiveness of these private enterprises in the future. This may become an issue in Argentina, where private investment is currently about 50% of what it was in the 1970s. With real interest rates (borrowing) ranging from 4% to 13% per month in Turkey, Brazil, Mexico, and Argentina, capital investments are very hard to justify. However, some companies are still investing for strategic reasons, for supplying to government and other protected-market niches, and as a hedge against further increases in inflation and interest rates that would erode the value of financial assets. Investments in export-based companies are also taking place as these companies can borrow in foreign exchange and repay the debt out of their export earnings.

In high-inflation, high-interest-rate environments, companies have found that the best operating strategy is to minimize debt and, if possible, stay out of it altogether. To achieve this, companies have been concentrating hard on improving their cash management, selling against cash as much as possible, controlling inventories, reducing stocks to bare minimums, and selling off assets. Cash-rich companies have started acting like banks and lending to other companies for periods of up to seven days. As a result, parallel markets have developed, and these have become important sources of short-term funds. In 1988, the extrabursatil (parallel) market in Mexico accounted for approximately 60% of total domestic market funding.

In Turkey (where inflation in 1988 was about 70% and the cost of borrowing as high as 120% p.a.), most of the companies that have done well in the eighties are those that were conservatively capitalized to start with or that managed to increase their equity capital to tilt the balance of funding in favor of internal, as opposed to borrowed, funds. Surprisingly, this was most noticeable in the case of fully owned or majority controlled subsidiaries of foreign companies. They had the option of putting in fresh equity or closing down their operations. Most chose to put in more equity. Purely Turkish companies have found it difficult to raise equity through the domestic stock market because the high real interest rates have depressed the market. These companies have offered equity to their bankers in exchange for their local debt and have also tried to make block sales of shares to foreign partners. Government regulations have made such transactions difficult, but according to the State Planning Organization, efforts by Turkish businessmen have resulted in an increase in inflow of private foreign investment from \$110 million in 1987 to \$351 million in 1988 and an expected inflow of \$600 million in 1989.

Many Turkish companies have reduced their debt servicing by replacing short-term local currency loans with foreign currency loans, even when foreign exchange risk insurance was not available. This has been possible because the depreciation of the Turkish lira, plus interest on foreign loans, has been substantially lower than the effective cost of domestic short-term loans. As a result, the private sector external debt increased from \$2.6 billion in 1984 to \$5.8 billion in 1987. This is happening in other countries where term loans are not locally available. If this investment is not directed into competitive industries because of distortions in the economy (protection, price regulations, etc.), repayment of these loans may be problematic. This leads to the question, Is financing of local currency needs with foreign debt a healthy trend?

#### Management Time

One of the biggest complaints about operating in high inflation countries (e.g., Brazil), both for individuals and companies, is the amount of time it takes to cope with inflation. Huge staffs have to be

hired just to calculate price increases, prove them to the government, and negotiate with suppliers and customers. For retail firms like supermarkets, the situation is a nightmare. People also experience great difficulties with their personal finances, spending an hour a day, or a day a week, managing their funds. One Argentine manufacturing executive said, "In my firm, we meet twice a day to review our investment strategy." Much of this time is devoted not to making money, but to protecting what one has.

Reflecting on the effect on management of high inflation and high interest rates, a management consultant in Turkey said, "Life became extremely difficult for these companies. Some closed down, some went bankrupt, but a good number were able to continue borrowing and functioning while accumulating losses. For their executives, managing the financial crises that came like waves every quarter when interests were due became almost the primary preoccupation, taking away time and effort from other more creative, development-oriented activities [such as concentrating on the operations of their enterprises]."

Management time is taken up not only with these financial issues but also with policy changes. When an economy is facing great difficulties, the government may change the policy environment frequently, and adjusting to these changes puts a great burden on management. In Argentina, for example, there have been sixteen major economic policy changes since December 1978 - an average period of only seven months before the environment changes.

The diversion of energy from production to finance leads to greatly increased risks for the firm. Movements in financial markets can generate huge profits and losses for firms in very short time periods, and often these sums are as large, or even larger, than the increase in productivity that could be expected over an entire year.

The importance of management time cannot be underestimated in a discussion of the behavior of businesses. After all, it is managers who make the important decisions about their companies' futures. There may be a silver lining in this cloud of management absorption in questions unrelated to its real operations; however, if a company succeeds in overcoming its financial problems, it can find huge amounts of management energy released for the serious business of improving corporate profitability. IFC's experience in helping to restructure the Mexican brewing conglomerate, Visa, is illustrative of this possibility. Burdened with heavy debts for many years, the company's management had to spend most of its time on financial questions. The company was also so deep in debt that there was little incentive to improve its operations; the benefits would all have gone to its creditors. The restructuring package reduced the debt burden to a manageable level, and management found itself with both the incentive and the time to make productivity and marketing improvements. As a result of this released management energy, the company has been reborn.

A number of corporations, especially in Mexico and Chile, have resolved their financial difficulties sufficiently to benefit from this effect, but in many developing countries, funds are in short supply and investment is difficult. How are corporations financing themselves in this environment?

#### How Corporations Are Using Funds

Businesses need funds for working capital to pay for stocks, for work in progress, for trade debts, for holding cash and other liquid assets, and, more fundamentally, for replacing machinery and plants as they wear out. These expenditures are needed just to operate and maintain the existing capacity. Typically, these capital requirements are higher in developing countries, where businesses need higher inventory levels and receive payment more slowly (and normally do not have access to factoring services.) LDC corporations may also need to make investments in standby generating capacity or in extra storage facilities because of the problems with input supplies; the need for this type of investment has increased in recent years because the squeeze on government finances in much of the developing world is leading to shortfalls in investment in infrastructure.

Since LDC corporations have such large needs for working capital, they have proportionately less capital available for fixed investment in productive assets for their core businesses. In recent years, fixed investment expenditures have accounted for, on average, 52% of total corporate expenditures in India, 58% in Korea, 63% in Japan, and 70% in the United States. On the basis of those countries for which data are available, it appears that fixed investment expenditures have utilized a lower proportion of total corporate resources in developing than in developed countries. As the process of industrialization continues, developing countries will need to direct a greater portion of their corporate resources into fixed investment expenditures, which, in turn, will increase their need for longer term funds.

#### Corporate Sources of Finance

Corporations have three main sources of funds: internal sources (retained earnings and depreciation), loans, and funds raised from the capital markets in the form of bonds or equity. While there is a wide degree of variation across countries, self finance is the principal source of gross corporate funding in the developed countries. Developing countries, however, have relied much less on this source of financing. Self-financing ratios range from a low of around one-third in India and Korea to a high of around two-thirds in Germany, Japan, the United States, and the United Kingdom. In other words, companies in developed countries seem to rely, in aggregate, on internally generated cash about twice as much as in developing countries.

The lower self-financing ratios in developing countries may stem from rapid growth requiring more finance than available internally [as in Korea], poor profitability of companies, or government policies providing incentives for payment of dividends as compared to retentions, as exist in India. So where do corporations in developing countries get their money?

Loan financing is the most important source of external finance in both developed and developing countries, but it is proportionately more important for corporations in developing regions. In most developing countries, commercial and development banks remain the principal source of loan finance. However, in some countries, other classes of institutions have become increasingly important. In Korea, for example, nonbank financial intermediaries have increased their share of credit flows from 21% in 1965-69 to 53% in 1980-86.

Among the developing countries from which data are available, bonds are an important source of corporate funds only in Korea and India, where they account for around 6% and 8%, respectively, of total company financing. Among the developed countries, bond finance is important only in the United States, and the United Kingdom, and, to a lesser extent, Canada. Flow of new equity accounts for an average of 10% and 7% of the total increase in corporate funding in developing and developed countries, respectively. In Korea and India, they have recently become much more important sources of finance; in Mexico, private companies raised over \$3 billion in the securities market in 1987.

The availability of external finance is important for the growth of developing-country corporations, yet in many developing countries, external finance has recently been in short supply. This has been for three reasons. First, there has been crowding out by government and public enterprises. For twenty-two countries for which data are available, the share of the private sector in bank credit declined from 80% in 1979-82 to 69% in 1983-87.

Second, there are institutional deficiencies in the financial sector. Corporations need term finance for investment, but commercial banks are generally reluctant to extend term finance because of problems with matching their deposit structure. While some term transformation by banks is desirable, it becomes risky beyond certain limits. In high-inflation economies, uncertainty increases, compelling financial institutions to move toward shorter maturity loans. In Argentina, for example, maturities of over thirty days currently are considered long term.

Third, even in those cases where term finance is available through development finance institutions, entrepreneurs may be unable to assemble satisfactory financial packages because they cannot raise enough equity.

Finally, the shortage of term finance in many countries in recent years has been greatly exacerbated by the decline in foreign funding. Most of the syndicated bank loans were medium-term credits, often of five to seven years, but these are no longer available, at least for the highly indebted countries. What other sources of finance are available, and how have they been developing?

### Foreign Direct Investment as a Source of Finance

The drying up of external finance from commercial lenders in the 1980s has led to renewed attention being given to FDI as a source of finance for business sector development. Once viewed as a barely tolerable incursion by foreign interests in many developing countries, FDI is now seen as an important source of long-term capital and as a means of achieving employment, skills, technology, and export growth. Unlike loans, which must be financed regardless of circumstances, service on FDI is tied to the financial performance of the business venture, which gives the foreign investor a stronger interest in how funds are used. Joint ventures are also proving to be an effective means of overcoming obstacles to market access, management skills acquisition, new technology, and foreign exchange for many LDC businesses. The experiences in various countries illustrate the potential of these benefits. Partly or wholly foreign-owned corporations were responsible for 85% of the increase in manufactured exports from Mexico during the 1980s. In Zimbabwe, foreign firms produce 70% of the country's industrial output. And in Argentina, a 1983 estimate showed that nearly 30% of the nation's manufacturing output and exports came from multinationals.

Aware of these benefits, many developing countries have opened up their business sectors to foreign investors and have taken other steps to improve their attractiveness as investment locations. The importance of easing regulations on issues such as majority ownership is most evident in electronics and other high-tech industries where proprietary control of technology and production processes is essential.

As places to invest, most LDCs continue to be less attractive than industrial countries. Difficulties with the availability of local inputs, inability to import necessary production goods, restrictions on the mobility of personnel, and exchange regulations are typical of the problems that make foreign investors wary of LDC investments. To these must be added the heightened risk perceptions that foreign investors have of many LDCs. The debt overhang is one form of perceived risk. Others, of continuing importance, are fears of expropriation, corruption, excessive red tape, and the unpredictability of government behavior. When political institutions are weak, even favorable government policies are mistrusted because they can change when key individuals change jobs.

Within the developing countries, a reassessment of competitive strengths and weaknesses in a tougher world environment is already under way. In Latin America, the binding constraint of an unstable macroeconomic environment is now widely recognized, and steps to overcome this are seen as the key to improved attractiveness to foreign investment (as well as return of flight capital). In Asia, the main problems are poorly qualified labor and government-imposed obstacles relating to local employment and foreign equity shares. In Africa and the Middle East, the main constraints to FDI appear to be poor economic performance and perceived political risk, compounded in some countries by inadequate infrastructure, restrictions on imports and dividend remittances, and limited availability of skilled labor. Steps to overcome these domestic problems will take time to yield benefits.

### Debt-Equity Swaps

Given the scarcity of term finance in developing countries, debt-equity swaps have emerged as an important means whereby companies can obtain foreign investment in the form of equity finance. Debt-equity swaps are dual-function instruments. Because they permit a company to pay less than the full cost of an investment, they are an investment incentive. Because they permit a debtor government to retire its foreign debt at a discount, they are a debt management tool. From the viewpoint of heavily indebted countries whose net inflows of foreign investment fell precipitously in the 1980s, both functions may be important. From the viewpoint of companies in those countries, swaps have become an important means of financial restructuring and/or paying for new capacity, in situations where few alternatives are available.

Companies in many countries have used debt-equity swaps. Recently, an agriculture project in Zambia based on sprinkler irrigation went ahead because the foreign partner could make a part of his equity investment in local currency by swapping debt purchased at a discount. Currently, countries such as Yugoslavia, Hungary, and Poland are looking at the possibility of using debt-equity swaps to attract foreign investment. However, debt-equity swaps have been of most significance in Latin America. In Brazil, nearly \$4 billion of debt have been converted into equity since 1977. In recent years, over 40% of foreign investment has been financed through debt conversions. In 1988, there was a spectacular growth in debt-equity conversions, with the face value of debt converted reaching \$1.9 billion. However, the Government of Brazil suspended the program December 1988 as one of the measures to control inflation. Recently, it restarted the program at a more modest level, with auctions of \$100 million a month.

During 1988, the financial community manifested a growing interest in investing through debt conversion funds. Most completed debt-equity swaps have involved one or two investors, who expect to take an active management role, and a single investment. Debt conversion funds, on the other hand, allow many firms to pool their funds, diversify their investments, and not undertake any management responsibility.

Several funds have already been sponsored in Brazil, ranging from \$50 to \$200 million in size and approaching forty in number. They have not been very successful so far, having made only a nominal amount of investments (a total of about \$10 to \$20 million) in stock market securities. The only fund to make direct investments (in the amount of \$85 million) has been the one sponsored by Banque Paribas with the advisory assistance of the IFC. Conversion funds have not taken off in Brazil, because the funds must remain in the country for at least twelve years and because of a ban on transfers of ownership for five years.

In Chile, about \$3.5 billion of debt have been converted into equity since 1985, the largest, as a proportion of debt, in any country. Another \$2.5 billion are expected to be converted in 1989. In Mexico, \$1.3 billion of debt were converted into equity during 1986 and 1987. After that the debt conversion program was suspended by the Government. More than a third of the debt conversions were for investment in the automotive industry and about \$500 million for investment in tourism.

Argentina's debt-equity swap program has been operative since 1987, and conversions have been about \$1 billion of debt. In 1988, the face value of debt converted was over \$600 million. The main objective of the Argentine debt-equity swap program has been to encourage private investment and new development, rather than to simply lower the country's overall debt burden.

While debt-equity swaps have been used by many countries to reduce debt and facilitate the flow of foreign investment, there has been considerable doubt about their costs and benefits. The arguments against are that debt-equity swaps do not result in additional foreign investment but just exchange one type of liability for another, that debt-equity swaps are inflationary, and that they enable foreigners to buy local assets at bargain-basement prices, thereby increasing their presence and influence to unacceptable levels. All these apprehensions are true to some extent. But companies who are being ground into bankruptcy by the burden of debt at high interest rates, as in Turkey, Argentina, and some other countries, would much rather swap their high-interest debt for foreign equity than go bankrupt. Even an exchange of liabilities without any fresh investment is beneficial for these businesses and the economies in which they are located.

The additionality of most equity-for-debt swaps is ensured by the injection of fresh cash for rehabilitating the recipient companies. This infusion may not take place at the time of the swap, but once a foreign partner comes in or increases his stake in a company, he is interested in improving operations and prospects since his return depends on the profitability of the company. A study done by IFC (IFC Discussion Paper No. 2) reported that in 61% of the ninety-nine transactions studied, swaps made a difference in the sense that the particular investor would not have made the investment if a swap program had not been available.

Other objections center on the way in which the local costs of paying for the swap are met. The fear is of inflation, if local currency is provided by the Central Bank, or of crowding out, if it is met by borrowing on the local market. Doubt has also been expressed about the wisdom of replacing foreign debt with even higher cost domestic debt. Certainly, many debt-equity swaps require the issuance of local currency or local debt. Therefore, an additional burden is put on government's fiscal or monetary budget. However, if debt-equity swaps are used for privatizing public enterprises, there is essentially no local currency involved, the foreign debt being directly swapped for equity in the company. Again, if the swap is executed by a private company directly with a foreign investor, there should be no first-round effect on the government's budget; in the long run, the government's budget should benefit from higher tax revenues as the company's efficiency and profitability improve.

Although the capacity of swaps to lower the overall debt burden is clearly limited (since equity markets are small in relation to the debt overhang), swaps can have an extremely important role in stimulating much needed private investment. The swap incentive is, in essence, an upfront discount on the cost of an investment. If this incentive is not offset by government restrictions, it can be a potent instrument for reactivating both foreign and domestic investment. Swaps are also an important source of term financing for domestic companies in countries where long-term financing from local sources is virtually nonexistent. New instruments, such as country debt-equity conversion funds, are being developed to give private companies easier access to this source of equity. In Brazil, for example, rapid expansion in debt-equity conversions has been occurring through the informal sector and the "parallel" exchange markets. The participants on the demand side are also increasing. Participation by Japanese corporations is expected to grow now that the Ministry of Finance has allowed Japanese banks to participate in debt-for-equity swaps tied to Japanese foreign direct investment. In short, in the next few years much will be heard about financing investments through debt-equity swaps!

#### Development of Capital Markets

In many developing countries, long-term growth prospects are being retarded by the lack of investment. Ironically, in many countries where there are investment opportunities, there is inadequate access to finance, particularly risk capital. This underlines the urgent need to accelerate the development of local capital markets in developing countries. This need is likely to intensify over the coming year, as world economic growth slows somewhat and as term finance remains hard to obtain.

A number of countries have made great strides in recent years in establishing and invigorating equity markets and these now exist in more than forty countries. Indeed, the market capitalization of exchanges in Malaysia and Jordan represent a higher share of GNP than in France and Germany, while India's stock exchanges list more companies than the stock markets of all other countries (except the United States). The stock market has played a large role in the recent expansion of India's corporate sector. Capital markets accounted for 8% of corporate finance in the early 1980s, but this had risen to 17% by 1986-1987 (the latest year for which data are available). In 1987, corporations in India raised sixteen times as much money from markets, in the form of equity and debentures, as they had in 1978. Similarly, in Kenya, the Government has established a Capital Markets Development Authority to encourage the availability of long-term local finance. Kenya also boasts a small but growing venture capital sector; it is proving a slow process to educate Kenyan entrepreneurs about the special features of venture capital, but progress is being made.

Despite these achievements, capital market development is taking place far too slowly. In Argentina, Egypt, Indonesia, and Tunisia, stock markets remain small, involve few shareholders, and have limited activity. Corporate bond markets have been even slower to develop. The greatly needed development of capital markets is being held back in many countries by government controls on the cost of money, government ownership of banking institutions, and these institutions' resistance to the introduction of competition. Other important factors are the absence of an appropriate legal, regulatory, and tax framework and the reluctance of family owners to dilute their ownership, to comply with information disclosure requirements, and to risk having to pay taxes, hitherto evaded. Corporations have also grown up in an environment in which debt finance has been cheaper. Increasingly, however, as we have seen, long-term local currency debt finance is simply not available in many developing countries.

While local capital markets are expanding, corporations whose needs cannot be met locally are reaching out to the international capital market. Governments that prevent such international links are retarding development. Market-based financing (whether domestic or international) is a discipline that can improve the efficiency of private companies.

### Summary

All in all, the current investment climate in developing countries is variable. Some countries are enjoying what can only be described as an investment boom, with ready access to international finance, both for loans and direct investment. In this category are countries such as Korea, Malaysia, Thailand, and Taiwan, China. In other countries, particularly those with heavy debt burdens, the availability of term financing is severely restricted, and this is seriously affecting the private corporate sector. A small number of blue chip corporations

may enjoy access to international finance, but for most companies the only long-term debt finance available is credit from the World Bank, bilateral donors, or regional development banks which is lent through local development banks. Businessmen have had to look hard for alternative forms of finance such as foreign investment, debt-equity swaps, retained earnings, and local equity. But in many countries the volume of investment that can be financed by these techniques is far short of what is needed. This lack of investment financing bodes ill for these countries' long-term development prospects, since investment is the generator of growth and of diversification into manufactured exports. The problem is that those countries most in need of investment are those without access to finance. This scarcity of financing resources points to the urgent need for accelerating the development of capital markets in developing countries.

#### PART IV: TWO SECTORAL CASE STUDIES OF BUSINESS DEVELOPMENT

The first three parts of this paper have concentrated on the global economic environment and various financial issues that affect investment patterns in developing countries. This final part changes the focus somewhat and examines recent developments in two industrial sectors from the perspective of the developing countries. These sector studies illustrate earlier themes, but they also bring out other aspects of the changing business climate in developing countries. Different though the two sectors are, they share two features that are increasingly important in the world economy. First, there is the acceleration of business processes; the ability to respond rapidly to changing conditions of supply and demand is becoming a key aspect of business success. Developing this ability requires both new business practices (especially in inventory control) and enhanced management skills (especially in rapid assimilation of information and effective decision making). Second, there is the growing globalization of the world economy. Part I of this paper noted how world trade has been growing much more quickly than has world GDP, as countries are drawn more and more into international trade. Both of these sectors illustrate this trend.

#### EXPORT HORTICULTURE

##### Recent Trends in the Sector

The horticultural export business in developing countries has grown dramatically over the past ten years, driven by both supply and demand pressures. On the supply side, there has been a pressing need in many countries to diversify away from their traditional agricultural export commodities, the prices for many of which have been low throughout the 1980s. The export of horticultural produce represents a way in which good export earnings can be generated; returns per acre are typically many times higher in horticulture than in the cultivation of other commodities such as sugar, coffee, or grains. Both governments and farmers, therefore, have been keen to expand. They have been joined by a third interest, at least in many poorer countries; the nature of this export business is such that it lends itself to financial transfers, and there has been no shortage of companies wishing to get involved in exports in order to transfer money overseas.

On the demand side, the rapid growth in the market has been driven by consumer tastes and the changes in market structures that have taken place in order to meet these tastes. In the OECD nations, and especially in North America, there has been a pronounced shift in consumer diets in favor of fresh fruits and vegetables at the expense of

frozen and processed. Retailers have responded to this by increasing their allocation of space to fresh produce and by insisting on improved availability of fresh items. Traditionally, the bulk of fresh fruit and vegetable demand has been met by local production, but the growth in consumer demand has necessitated the growth of imports for two reasons. First, the inherent seasonality of production means that local producers cannot meet demand throughout the year. Second, there are other products that, for climatic or other reasons, cannot be grown in the consuming country. Recent years, therefore, have witnessed the growth of trade in both off-season and tropical fruits and vegetables. In Western Europe, the import market for horticultural produce is worth about \$3 billion and is growing at about 10% per year. In the United States, it is twice as large and growing as quickly. There is widespread agreement that the market will continue to grow overall, though the prospects for each individual product vary considerably.

One consequence of this trade pattern is that direct competition between local producers and overseas suppliers is rare; with very few exceptions, it is not economic for overseas suppliers to compete with local production during the local season since their production costs are not low enough to absorb the large transport costs disadvantage they face and still make a profit. One important exception is the flower industry. Rising costs (especially for land and labor) in the importing countries, substantial cost advantages (especially in labor) in developing countries, and rapidly growing demand have enabled direct competition to emerge. Indeed, U.S. flower growers have felt the keen edge of competition sharply enough to petition the U.S. International Trade Commission for import relief on antidumping grounds.

The horticultural industry has a number of other interesting features that differentiate it from many others. The highest value is obtained from the export of fresh items; processing does not add value, although a processing industry can be useful to absorb low-quality output. Thus, developing countries are quite happily exporting unprocessed products. Also, the import market in rich countries is a market for high-quality produce for two reasons. In the first place, standards of quality control in food retailing in North America, Europe, and Japan are high and improving. As supermarkets increase their dominance over retailing, uniform quality, appearance, and packaging become more and more important. Second, the price gradient between low-quality and high-quality products is normally very large; a difference of 100% is not at all unusual (illustrating the large and growing importance of quality). Since developing-country exporters' transport costs are substantial (sometimes as much as two-thirds of the cif price), they have a powerful incentive to supply only the top end of the market.

The preceding observations apply to all horticultural exports. In the case of off-season products, however, there is a further complication. The time window available to any particular exporting

country may be very short. In the case of the European market, where the growing season is long thanks to climatic variability and research into early maturing varieties of many products, and where certain Mediterranean basin countries (notably Israel) have a strong market presence, the window of opportunity for other developing-country suppliers can be very short.

Taken together, these factors have created an industry that is rather different from those in which developing countries have traditionally excelled. It is a fast-moving, entrepreneurial industry where quality and flexibility are of the utmost importance in determining success. The need to supply high-quality fresh produce imposes a need for certain infrastructure (transportation, cold storage, and packaging facilities in particular) and for efficient coordination of the various steps in the marketing chain to ensure that the goods reach the market as quickly as possible. Consider the steps that are taken by a Kenyan exporter of french beans. The beans are harvested as late as the early afternoon under a preexisting contract between exporter and grower. They are transported to the exporter's packing house, where they are sorted, graded, and packed. (Some exporters pack them into supermarket-ready plastic trays.) They are then taken to the airport, where they may be loaded into a cold store. They are liable to be inspected by the Horticultural Crops Development Authority and by customs. (Both bodies have some of their employees employed as porters at the airport, where they monitor the trade.) Then pallets are assembled, cleared by customs, and loaded onto the planes to Europe. The flights are mostly overnight, so the produce arrives in time to be cleared through customs and moved into the retail market the same day. Thus, the time between picking and final consumption can be measured in hours. Clearly, there is scope for delay at each step in this long chain, and many developing countries have failed to build a horticultural export industry because these steps are difficult to coordinate. One typical problem is ensuring customs clearance; often officials delay shipments for no good reason.

Effective coordination of the information flow about products in demand and their prices also is needed. Because the time between harvest and retail sale is small, exporters are in a position to adjust their shipments in response to changes in market conditions. But in order to do this, they must have good relationships with the importers handling their produce so they have the confidence to act quickly on the importers' market assessments. Good relationships with growers are also needed to ensure the necessary production response. Again, many developing-country suppliers have failed because of their inability to supply the desired quantities of the desired products on schedule. In such a fast-moving market, these factors can make a large difference to the returns realized from export shipments.

### The Sector in Chile and Kenya

Because of the need for flexibility, quality, and efficient coordination of many different steps, one would expect developing countries to experience difficulties in this industry. Yet it is an industry where some developing countries have done extremely well. Chile, for example, has become the major supplier of off-season fruits to the United States, exploiting its climatic advantages and its Southern Hemisphere location. Fruit is now Chile's second most important foreign exchange earner, accounting for 12% of the country's \$7 billion export earnings. It has attained this position rapidly; fifteen years ago fruit exports were negligible. Major export items are grapes and apples, which together account for almost three-quarter of exports, nectarines, plums, pears, and kiwifruit. Roughly half of exports go to the United States, with Europe accounting for a further 40%.

Kenya is another example. Horticultural exports are the country's fourth largest foreign exchange earner, behind coffee, tea, and tourism, and they have been steadily growing. The great bulk of exports go to Europe during the October-May period; the United Kingdom alone takes almost half, but there is a growing export to Mid-Eastern countries. Major export items include cut flowers, avocados, pineapples, mangoes, french beans, and chillies.

The industry in both Chile and Kenya has a surprisingly similar structure. The largest operations tend to be foreign owned, giving them the strong links into the importing channels in the United States and Europe that are so important. Del Monte runs a huge pineapple farm in Kenya; most of the output is canned, but export of fresh fruit is growing. Sulmac, owned by the U.K. multinational Brooke Bond, accounts for roughly half of Kenya's cut flower exports. Standard Fruit, the U.S. Corporation, is one of Chile's largest fruit growers and exporters. These corporations typically own land and both grow and export their produce. In Chile, some of them were financed by debt swaps, but they all have involved the injection of some foreign capital.

Although large, these corporations do not dominate the industry either in terms of production or export marketing. The number of growers involved in production for export is very large; in Kenya, up to 250,000 farmers produce something for export, and at least 100,000 of these are fairly seriously involved. In Chile, the numbers are smaller; there are approximately 2,000 large-scale growers. This is principally the result of differences in the types of crop exported from the two countries; most Kenyan exports are of annual crops, for which investment requirements for production are small. In Chile, on the other hand, some of the largest exports are tree crops with larger investment requirements.

The export sector is similarly competitive, with about twenty large exporters in Chile. In Kenya, five companies account for about half of the export volume, with the remaining half split among an extremely large number of small firms. Although the largest exporters are those companies that grow their own produce, the others typically buy from independent growers and export for their own account.

Overall, then, the industry is highly competitive. In both Kenya and Chile, availability of capital, land, and technology have been adequate to allow the industry to grow. Indeed, this is an industry where capital requirements are low and where the limited availability of varieties adapted to local conditions has not been a serious constraint. Both countries have also solved a problem that has severely hampered the industry in other countries: the need to coordinate efficiently the various steps in the marketing chain to ensure that the best quality produce is delivered as quickly as possible. It is difficult to generalize about the conditions necessary to achieve this; as most businessmen are aware, things simply work better in some countries than in others. Often this is a question of the attitude taken by government officials; customs officers have the power to make life difficult for exporters, and the burden of paperwork in some countries is enough to deter all but the most determined entrepreneurs. There are, however, two features of the Chilean and Kenyan industries that are suggestive of the conditions for success.

The first is that the industry has been predominantly a private sector preserve. Even in Kenya, where the government regulates large sections of the economy, its role in horticulture has been limited and supportive. It has recognized that the industry moves too fast for a bureaucracy to be able to play an effective role, apart from providing a supportive infrastructure. Hence, Kenyan customs officials adopt the attitude that they are there to help exporters, not a common attitude among customs officials in developing countries. Similarly, the parastatal that monitors the industry and ensures that export and farm gate prices are reasonable does not delay the speedy flow of produce through the airport facilities. Overall, the willingness of the government to stand aside is probably more important in this industry than in many others.

A second important factor has been close links between importers in developed countries and the exporters. In some instances, the two companies are divisions of the same corporation; there are examples of exporters setting up their own import companies as well as integration in the opposite direction. Some of these are large corporations, such as Standard Fruit in Chile, whereas others are small; most of the Asian-owned Kenyan exporters, for example, have family links to importers in the United Kingdom. Even those with no formal family or corporate links have developed close business relationships, allowing information about market trends in importing countries to be rapidly transmitted back

and, which is perhaps more important, giving the exporter the confidence to act upon the intelligence received.

### Problems and Constraints for Exporters

Whatever problems the Chilean industry may have faced in sustaining its rapid growth were thrown into the background on March 12th when two cyanide-laced grapes were discovered in a Chilean shipment to the United States following threats of poisoning made to the U.S. embassy in Santiago. The U.S. Food and Drug Administration (FDA) promptly imposed a ban on all imports of Chilean fruit. The comprehensive ban lasted only a few days before some products were exempted and a hastily arranged inspection program put in place. This episode raises short-term problems for the Chilean industry and long-term problems for all exporters.

The short-term problems for the Chileans are essentially financial: the trade bans came in the middle of the exporting season, and exporters needed their export earnings to service their bank debt, estimated at about \$400 million. The Chilean Government has announced a \$28 million assistance plan, and commercial banks have granted reprieves on loan payments until June 30. Clearly, there is a danger that a number of exporters will not be able to survive. In the longer term, however, Chile enjoys a genuine comparative advantage in fruit production, and renewed growth can be expected once publicity about the episode has quieted.

A longer term issue concerns health standards in the importing countries. The severity of the FDA's action in banning all Chilean imports owes much to the climate of public opinion in the United States. There has been longstanding public concern about pesticide use in the Mexican tomato industry, and early in 1989 there was a public outcry over the use of alar in U.S.-produced apples. A study was also released in March 1989 claiming that existing standards for pesticide residues in crops were giving inadequate protection to children. The result has been massive press coverage of food safety issues, and the poisoning of the Chilean fruit was uniquely badly timed in the light of this public mood. Public interest in such episodes inevitably wanes, but the result could well be tighter regulations on health-related issues. This will have implications for all developing-country exporters of fresh produce; their incentive to maintain quality by their own inspection programs will increase, perhaps eventually leading to brand names that will be recognized by consumers.

Kenya's problems, rather different in nature, revolve around transportation difficulties. Virtually all of Kenya's horticultural exports are shipped by air. Although the Government regulates the price of air freight (and has regulated the growth of the tourist industry to

ensure there is air cargo capacity on tourist planes), air freight is inevitably expensive. Yet sea freight has proved difficult to develop - in part because a sea voyage takes much longer and so not all crops can be preserved and in part because the volumes of produce needed for sea freight, and hence its capital cost, are beyond the capacity of the country. Research is under way, however, and 1988 saw the first sea freight of avocados from Kenya to Europe. (Chile provides an interesting contrast. The products exported from Chile have a longer postharvest life, and the greater volume of trade has allowed sea freight to be economical.) The fundamental constraint on the Kenyan industry at the moment is the availability of air cargo space. Dedicated air freight is too expensive for all exporters except those shipping the highest value produce (i.e., cut flowers) and is restricted by the limited demand for air cargo from Europe to Africa. (If an aircraft has to fly empty one way, then the costs inevitably rise.) The amount of cargo space available on passenger aircraft is also limited by the number of passengers going to Kenya (and by the type of aircraft used and its onward journey pattern). Kenyan exporters feel that their markets could absorb substantially greater quantities of their produce, but they have, at present, no economic way of meeting this demand.

### Conclusions

The horticultural export business has enjoyed vigorous growth in recent years in a number of developing countries, despite the constraints on investment that were identified in earlier sections of this paper. Of course, this is not a capital-intensive sector; rather it is one where the most important factor in production is entrepreneurship. Entrepreneurs in Chile, Kenya, and numerous other countries have shown that the problems of doing business in developing countries can be overcome. The benefit to the development process of their success goes beyond the employment generated and the foreign exchange earned; their countries benefit from the encouragement of their entrepreneurial skills and the vigor their activities bring to the private sector.

At the same time, it is not clear how replicable the success of Kenya and Chile is. Although the overall market for horticultural products is growing, it cannot absorb the huge quantities that would come from unrestrained expansion. This is particularly true at the upper end of the market on which exporters depend. Certain product markets (for example, tomatoes and cucumbers in Europe) are already oversupplied, and others are about to face supply surpluses; the rapid expansion in kiwifruit plantings in Italy, for example, will soon lead to serious oversupply in Europe. The countries and companies that will continue to do well will be those who tailor their production and shipment to the changing pattern of demand. In other words, rapid response to market trends and efficient management of the marketing chain will remain vitally important.

**AUTOMOTIVE INDUSTRY TRENDS AND INVESTMENT OPPORTUNITIES IN  
DEVELOPING COUNTRIES**

**Introduction**

The automotive industry represents a significant portion of global economic activity with extensive upstream and downstream linkages to many diverse industries and sectors. In 1988, world production of all vehicles totaled about 48 million, a 4.5% increase over 1987 and a 20% increase over 1983. The bulk of the production is concentrated in the OECD countries, although many LDCs produce cars and others are considering entry into the industry. This section deals with the business opportunities in developing countries and with the conditions under which the production of particular automotive products makes economic and financial sense in LDCs.

Not all aspects of the automotive sector are covered in this review. The automotive industry is extremely diversified; major product categories include passenger cars, buses, trucks, utility vehicles, and two-wheeler and three-wheeler vehicles. The characteristics of each of these products varies with respect to demand, production processes and organization, technological requirements, marketing, and distribution. This paper focuses on passenger and small utility car production and related components, although there are investment opportunities in LDCs for other automotive products as well. Many of the issues raised here are also relevant to the other automotive products.

The automotive industry in the developing world offers a number of important contrasts to its counterpart in the industrialized world. LDC automotive production is typically small volume and key operations such as research and design are virtually nonexistent. In almost all cases the LDC manufacturer is linked with a foreign automotive interest in either a subsidiary, joint venture, or licensing arrangement. Over the past few decades, LDC automotive sector growth has been driven mainly by government policies that feature high levels of protection and high local content requirements. In many instances these policies have stimulated local manufacture of cars and components, but they have often resulted in local industries that are, by and large, inefficient. In a few LDCs, however, automotive manufacturing has reached a level of efficiency that allows LDC products to compete successfully in local or international markets.

In assessing the prospects for the automotive sector in LDCs, a distinction needs to be drawn between the integrated production and assembly of automobiles, and the production of specific parts and components. Not only do these two types of activity differ technologically and economically, but they are likely to be affected

differently by emerging trends in trade and industry policy. Future prospects are strongest in the production of parts and components.

### The Structure of the LDC Automotive Market

The automobile market in LDCs, while small compared with that of the rest of the world, is growing at a faster rate. The total LDC vehicle fleet, estimated at 78 million in 1985 (16% of the world total), is projected to increase to about 140 million (21% of the total) by the year 2000. LDC automobile production is also comparatively small. Of the 38 million passenger cars produced worldwide in 1988, only about 10% were produced in LDCs. LDC car production is dominated by a small number of countries; five (Korea, Brazil, Poland, Mexico, and India) account for 70% of the total. In sum, about thirty LDCs produce cars, and at least sixty produce parts and components. In most LDCs car manufacturing is characterized by high cost, low throughput assembly plants operating in a protected environment.

All LDC car assembly operations utilize a combination of imported and local components, the proportion of each usually determined more by government policy than by market forces. Almost all LDCs have local content requirements, usually exceeding 60% of the value of the car. In reality, the local content is often much less, in many cases 20 to 30%, since many imported inputs for component assembly or manufacturing are ignored when local content is calculated. In a few countries, however, a competitive components industry has emerged that supplies both the local and export markets. Although the bulk of international trade in car components takes place among developed countries, the share of imports from LDCs has grown from 0.6% of the total in 1965 to 6% in 1985. Countries that have been particularly successful in increasing component exports recently include Taiwan, China (US\$618 million in 1987, a 600% increase since 1980), Korea (US\$181 million, 800% increase), Portugal (US\$130 million, 2000% increase), Singapore (US\$98 million, 20% increase), Turkey (US\$72 million, 68% increase), Thailand (US\$22 million, 135% increase), and Morocco (US\$16 million, 128% increase).

The demand prospects for the industry are encouraging. Demand for cars to the year 2000 has been forecast by industry analysts to increase by an average of 2.3% per year in the OECD countries and by 8.0% per year in LDCs. Although a global overcapacity is projected for the next two to three years, the growth in demand, together with significant ongoing developments in the industry, present a variety of opportunities for profitable investments in LDCs.

### Car Manufacturing

Car manufacturing is a highly complex undertaking. It requires significant financial, technical, managerial, and organizational resources and expertise. It also needs large production and sales volume

if payback is to be achieved within the technological life of a particular design. Only a relatively small number of LDCs have the necessary conditions to support an economically viable car manufacturing industry.

The initial investment required for setting up a car manufacturing facility is substantial. It can range from US\$1.5 billion for development, engineering, and tooling for a new passenger car in Europe, to US\$150 million for a 35,000 car/year assembly plant (ckd) in China. The high initial investment cost and the need for frequent additional re-investments to remain competitive, make large-scale production essential. A volume of 250,000 cars/year is often cited as the minimum economic size of a car manufacturing plant. However, the major automobile manufacturers are trying to develop management and production processes that will be profitable at lower volumes. Developments in product design and organization of production allow a variety of technically competitive products to be manufactured with minimum retooling. Already there are a few examples of highly efficient Japanese plants operating profitably at volumes of about 150,000 cars/year. This development may increase opportunities for investments in some LDCs that are now constrained by the small market size. However, because of the inescapable need for access to research and development, any such investment must be linked to a major manufacturer.

The minimum economic size for car assembly operations is not as well defined. It is indicative, however, that an assembler with a 25,000 car/year production in southeast Asia and another with a 16,000 car/year production in Southern Europe both believe that they cannot remain competitive in the long run unless they can increase their production volumes to at least 40,000 cars/year to achieve lower unit costs.

The industry is undergoing major changes with respect to process and product technology, and these changes have important implications for the competitiveness of LDC manufacturing and assembly operations. One of the most significant areas of technological development is in the field of new materials. There is an increasing shift from iron and steel to aluminum, and from special steel and die-cast zinc to plastics and composites. Iron and steel content in an average car is expected to decrease from 72% in 1980 to 60% in 2000, while aluminum and plastics are expected to increase from 3% to 8% and from 7% to 17%, respectively, over the same period. The second main product technology area is electronics. General Motors is anticipating that the average value of electronics in a passenger car will rise from US\$500 in 1988 to US\$1,200 in 1995, with significant applications in the majority of an automobile's functions, ranging from door locks to engine management.

Robotization and computer-aided design and production are now widely adopted by manufacturers of automobiles and components in the industrialized and the more advanced developing countries. These technologies enable manufacturers to improve quality and respond to consumer preferences by producing different models on the same assembly line and, through less retooling, rapidly shifting to new models with shorter production cycles. Design is particularly important because about 70% of the cost of an automobile is determined during this stage. Design engineering has become highly sophisticated as the flexibility and adaptability required, in both design engineering and production, can be achieved only through extensive application of integrated computerized systems.

The implication of these technological developments for LDCs is that the labor content in the cost of production has decreased and that the production process requires experience and expertise not easily available in an LDC. As the gap between modern automotive technology and LDC technological capabilities widens, some LDC vehicle producers will find themselves at an increasing disadvantage. This may be offset in some cases through collaboration between domestic and international manufacturers, but in countries with a poor manufacturing and engineering base, the scope for efficiency gains will be limited. Collaboration has been very common to date, mostly in the form of joint ventures and licensing agreements, and these arrangements will become even more important during the next several years.

Some experts in the automobile industry suggest that modern technology is not required for companies that manufacture and market cars in LDCs. There exist several examples of old-product and old-production technology transfer projects. European-designed or U.S.-designed models are still being produced in protected markets in Eastern Europe, China, India, and Latin America, although long out of production in the OECD countries. The main advantage of the old technology approach is the reduced size of the investment. A disadvantage is that such vehicles are inefficient, particularly with respect to fuel consumption, serviceability, and functional efficiency, and their exportability is limited. Furthermore, old design vehicles are less preferred by consumers and require high levels of protection to preserve market share.

In addition to technology, organization of the production process is changing rapidly, particularly in the area of component procurement characterized by the Just-In-Time (JIT) inventory concept. JIT aims to improve the efficiency in the flow of materials, reduce storage costs, and increase production flexibility. Optimally, it requires suppliers to deliver components to the assembly line when needed, several times a day, with no inspection, no storage area, and minimal in-plant movement of stock. JIT entails reliable and timely delivery, dependable quality, a manageable supplier network, manufacturing flexibility (the supplier must be able to react quickly

to deliver whatever part the assembler needs), and elimination of formal receiving operations. A related trend is the decrease in in-house manufacturing. At present, in the United States and Europe, only about 40% of an average car is produced in-house. This gives the car manufacturer increased flexibility, reduces his costs, shifts a part of the research and design responsibility to suppliers, and spreads the related risks. The growing application of JIT and the increase in out-sourcing make the existence of an adequate supplier network of paramount importance for car production. Since most LDCs would not be able to adopt JIT except to a very limited extent, their automotive industries would not benefit from the related cost reductions. However, the few LDCs (e.g., Korea or Taiwan, China) with the necessary level of technical and organizational capability and a developed infrastructure (transport and communications) to adopt JIT would be able to achieve lower production costs and attract foreign investment.

Although plants of a somewhat smaller economic size may become more common in the future, car manufacturing will remain a high-volume operation during the next decade. Accordingly, car manufacturing will continue to require a large market, of which the home market will need to be a major portion, as has been demonstrated by the experience of all major manufacturers. LDC production primarily for export is not a viable proposition since labor costs, about 15% of the total car manufacturing cost, are not by themselves a sufficient reason to locate in an LDC. Accordingly, profitable car manufacturing in LDCs is much more likely in countries with a large home or regional market. Establishment of production facilities to serve nearby markets, first started by U.S. companies in Europe and Latin America in the 1950s, is expected to become again an important feature of the industry in the 1990s. More recently, this strategy has been adopted by Japanese companies that replaced exports from Japan with production in the United States, Europe, and in some LDCs with growing economies to supply the local markets. Nissan, for example, recently announced that at least 25% of its total production will be outside Japan by the beginning of the 1990s.

Local production is encouraged by LDC government import substitution policies restricting automotive imports. Although such policies result in greater opportunities for local manufacturing, they stunt the industry's growth in the long run. In most cases, local markets are too small to support large volume production needed to attain economies of scale, and the higher cost, compared to imports, is borne by taxpayers or consumers. In a few countries (e.g., the Philippines), strong public reaction to these higher costs may force the governments to reduce the protection afforded the industry. An important adverse effect of protection is that companies in protected and high local content environments become less and less competitive by international standards. They have higher costs not only because of low volumes but

because many locally made components are more expensive than imports and their incentive to modernize and remain competitive is moderated.

In summary, economically viable investments in car manufacturing may materialize only in LDCs with a large domestic or nearby market, although this will also depend on developments in trade policies. The producing country must have a sufficiently developed industrial base to produce high-quality raw materials and components at low cost and to ensure their timely delivery. The need to have access to technological innovations, both technical and managerial, and to marketing and distribution networks, particularly if part of the production is to be exported, will necessitate associating with a major car manufacturer. Associations in the form of joint ventures could also be a source of long-term foreign exchange finance, often in short supply in LDCs. Assessing individual country prospects based on analysis of competitiveness is obviously difficult but Brazil, India, Korea, Mexico, Yugoslavia, and Taiwan, China, appear to have some of the preceding characteristics. In the longer term, there might be scope for development of viable car manufacturing in other countries including Argentina, China, Pakistan, Portugal,<sup>1/</sup> Thailand, and Turkey.

#### Component Manufacturing

In developing countries, there appear to be more opportunities in component than car manufacturing. The types of components that could be produced in an LDC would depend on industry requirements, and on the technical capabilities and export opportunities in the country concerned. Growth of the components industry depends primarily on opportunities for subcontracting or out-sourcing, both in the LDC itself and internationally.

With the introduction of the JIT system, car manufacturers in developed countries have moved toward single-sourcing by dramatically decreasing the number of their primary suppliers. This is coupled with, as noted earlier, an increase in out-sourcing. The main advantages of single-sourcing are logistic efficiency, easier quality assurance and control, and economies of scale at the supplier level. For example, Ford is implementing a plan to reduce its primary suppliers in North America from 22,000 in 1984 to only 1,700 by 1992. While the number of primary suppliers has been decreasing, they, in turn, still deal with a large number of subcontractors. For example, one Japanese manufacturer has only twenty-five primary engine parts suppliers, but these suppliers deal with 912 subcontractors, who in turn procure from 4,960 third-level suppliers.

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<sup>1/</sup> Portugal has access to the EEC market. Its supplier network, which has grown substantially, can be easily supplemented by Spanish component manufacturers.

Out-sourcing has increased substantially because of the need for greater flexibility and the emphasis on lowering costs. In the United States and Europe, an estimated 40 to 45% of a car is produced in-house and 55 to 60% is sourced outside. (The ratio is about 30/70 in Japan.) While out-sourcing has significantly increased business opportunities for suppliers, they have had to assume greater responsibilities in research and design, quality control, and cost reduction. For example, Ford's suspension systems are designed by its supplier company through a fully computerized process in collaboration with Ford. The same is true for many other components and, increasingly, component systems. All Ford suppliers are rated on quality, and underperformers are eliminated. With respect to costs, Chrysler has requested a 1% price reduction from its suppliers across the board, and Ford has a standing request of its long-term suppliers for a 2% price reduction every year. This means that the need to reduce costs, often exacerbated by appreciating currencies and wage increases, will greatly contribute to increased opportunities for component manufacturing in LDCs, provided that strict quality and delivery standards can be met.

Different types of LDCs will attract different types of component production. JIT and greater involvement by the supplier in design engineering means that sophisticated, capital-intensive components (such as engine parts, gear boxes, or special metal parts) are likely to be produced for the local or export market only in technologically advanced LDCs with a developed automotive industry (e.g., Brazil, India, Korea) and/or are near major manufacturing countries (e.g., Mexico, Portugal, Singapore,<sup>2/</sup> Turkey, Taiwan, China). Production of labor-intensive, simple technology components such as wire harnesses, upholstery, interior trim, batteries, exhaust systems, and odometers will be feasible in less technologically advanced LDCs (e.g., Algeria, Malaysia, Morocco, Philippines) primarily for export to car manufacturers in North America, Europe, and Japan. In almost all cases, association with a major company to provide R&D support will be necessary. With the JIT system, the supply to original equipment manufacturers will have to be extremely reliable, which will rule out politically unstable developing countries.

The importance of real exchange rate movements in the location of component manufacturing facilities is illustrated by the influx of Japanese investment in Southeast Asia since the rise in the yen. This movement is expected to continue at least during the next two or three years with Philippines, Indonesia, China, Malaysia, and Taiwan, China, high on the list of candidates for Japanese investment. Thailand will continue to attract investment, but rising labor costs and infrastructure bottlenecks are causing a more cautious approach among potential investors.

In addition to components installed as original equipment, opportunities will develop in LDCs in the area of replacement (spare) parts. This market is characterized by numerous marketing outlets and

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<sup>2/</sup> Primarily car electronics.

higher profit margins than for components supplied to manufacturers. As car manufacturers tend to provide broader and lengthier warranties, the market for parts not authorized by car manufacturers may grow less rapidly than in the past.

In all cases, with possible exceptions in spare part manufacturing, local investors would need to associate with established component manufacturers to ensure availability of technology and access to the market. It would be extremely difficult for a newcomer to penetrate the market, especially with the very stringent quality standards required and the traditionally close ties between car manufacturers and their suppliers.

Policy developments are likely to be of importance to the future growth of the components industry in LDCs. One possibility is that traditional import substitution policies may give way, in part, to regional trade agreements among LDCs. Progress to date on this front has been limited. The ASEAN complementarity program, which was specifically established to facilitate trade of automotive components among member countries, essentially fell victim to the protectionist barriers that each country maintained. Some private companies, however, are playing a role in promoting trade. Mitsubishi, for example, within the limitations of regional trade policies, has been particularly active in Southeast Asia in producing auto components in different countries and supplying its assembly or servicing operations in the region from these sources. More successful examples are the Auto-Latina project jointly undertaken by Ford and Volkswagen, under which automotive products are exchanged between the two companies from facilities located in Argentina, Brazil, and Venezuela; and the Scania facilities in Brazil and Argentina that also exchange portions of their respective outputs.

### Conclusions

During the 1990s, three basic trends affecting LDCs are likely to characterize the industry. First, the demand for cars will rise at a faster rate in the NICs and possibly in the larger LDCs than in the industrialized countries. Second, production facilities will be located closer to the markets. Finally, there will be increased out-sourcing of parts and components. Although the increasing adoption of JIT and the emphasis on quality argue against investments in some LDCs, the search for low-cost production and the rising demand for spare parts will present LDCs with opportunities for viable projects.

Automobile manufacturing will be economically viable only for those LDCs that have a large domestic market, an adequate supply of components at competitive prices, developed infrastructure, and a marketing and after-sales service network. Joint ventures or licensing arrangements with established manufacturers will be necessary.

Most opportunities for LDCs will be in the production of components, spare parts and related raw materials. The high yen will continue to exert pressure on Japanese manufacturers to seek lower cost locations. This will work to the advantage of countries in Southeast Asia. Similar opportunities will exist for LDCs in a position to market their output in Western Europe, particularly in some of the EEC associate members (e.g., Turkey), or in the United States (e.g., Mexico). Of course, LDCs which are developing their own car manufacturing capacity also present opportunities for suppliers of components. However, growth in the trade of components will depend largely upon the willingness of governments to lower their trade barriers. Foreign investment will be attracted mostly to countries with easy access to a nearby market, an advanced technological base, a stable political and social environment, policy continuity, administrative efficiency, good infrastructure, and easy cross-border movement.