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World Affairs Council, Washington, D.C. November 18, 1985

"THE IMPORTANCE OF THE PRIVATE SECTOR
IN THE GROWTH OF DEVELOPING ECONOMIES"

Address

By

A. W. Clausen, President

The World Bank

and

International Finance Corporation

before the

World Affairs Council

Washington, D.C.

November 18, 1985

Thank you, Mr. Callahan,
Good evening, Ladies and Gentlemen:

I am delighted to have this opportunity to meet with the World Affairs Council, and I am grateful to you, Mr. Odeen, for the invitation.

It will come as no surprise to you to hear me say, at the outset, that one of our major preoccupations in The World Bank at this moment is the continuing precarious situation in the highly indebted developing countries, most of which are in Latin America. The difficulties faced by these countries, and the steps that need to be taken by all parties to the problem, were very much to the fore of the discussions in Seoul, Korea, on the occasion of the recent Annual Meetings of the Boards of Governors of The World Bank and the International Monetary Fund.

The Meetings in Seoul yielded some important proposals for an expanded role for The World Bank in its heavily indebted member countries as they adjust their economies to go for growth. One particular proposal, made by Treasury Secretary Jim Baker and echoed by many others, is very much in line with our own strategy. It called for expanded lending by The World Bank and other multilateral development banks to the heavily indebted middle-income countries undertaking medium-term adjustment and reform programs. It also called on the commercial banks to increase their net exposure to these countries in support of adjustment for growth programs which the Bank and the IMF are supporting.

We warmly welcome this initiative. Without additional net flows of external capital the heavily indebted countries are going to find it appallingly difficult to resume growth while at the same time maintaining stable economies and reducing their debt burden. And if they don't get back onto a steady growth path, their medium-term adjustment and reform programs just won't carry the credibility to attract increased commercial bank lending. The participation of the commercial banks is critically important to the implementation of this program. So, whichever way you look at the problem, additional external capital is essential to the solution. The restoration of creditworthiness depends on the resumption of growth, but growth requires capital. Therefore, suppliers of additional capital must see the restoration of creditworthiness as a product of their supply, not as the precondition for it.

Many details remain to be worked out. But, at this stage, we can take great satisfaction from this fact: it is now increasingly recognized that the Bank has an expanded role to play in helping its developing member countries move from an austere and necessary period of stabilization to a dynamic period of investment with adjustment for growth and increased creditworthiness.

This expanded role will be an important feature of the discussions that I shall be holding in early December when I visit three of Latin America's highly indebted countries: Argentina, Ecuador, and Uruguay.

In the meantime I want to seize this opportunity tonight to address an aspect of the problem that has tended to attract far less attention than it merits. And that is the role of the private sector in securing sustained growth in developing countries. For some twenty years, the thrust of the development effort has been directed towards public sector activities. And in international fora where North-South issues have long been debated, discussion of the private sector has tended to carry heavy ideological overtones and to concentrate narrowly on the behavior of multinational corporations and foreign investors.

It has always amazed me that this should be so. I admit to a personal bias. Before coming to The World Bank, I labored in the vineyards of private enterprise for more than three decades and came to some very firm conclusions about the value of motivating people with proper incentives to be creative and productive. I didn't feel at all a fish out of water coming to the Bank with such a private enterprise bias, because the Bank has always understood the key role that private enterprise plays in development.

That makes it all the more interesting -- "mysterious" even -- that the Bank should so often have to defend itself against the charge of neglecting the private sector. Within the international community, we have always been vocal and practical supporters of a healthy private sector, and have consistently urged that the international community as a whole take a more balanced approach than it does. Promotion of the private sector and encouragement of foreign private investment are critically important to the developing countries. That's not an ideological slogan. It is simply a recognition of the little appreciated fact that almost three-quarters of the Gross Domestic Product of the developing countries is generated by the private sector.

It is a recognition too of the fact that the most rapid economic growth in developing countries has been achieved where private initiative has been given scope and encouragement, and where the role of the state has been relatively restrained.

It is also a recognition of the fact that in developing countries plagued by unemployment, strengthening the private sector is the way to create jobs -- jobs, that is, that are truly productive.

Please don't get me wrong. The role of the public sector is extremely important. Government has a fundamental responsibility to protect its citizens interests, and to a degree this demands direct government involvement in the provision of vital services. The development of both physical infrastructure and human resources are major responsibilities of government, calling for appropriate levels of public expenditure. But when those levels get too high, the private sector can be starved of domestic credit, and there is evidence to suggest that in such situations, average growth rates of per capita GNP tend to be disappointing. Of course, no one is claiming that the role of the private sector is the only factor determining rates of growth. Far from it. But it can be, and in many cases is, a significant factor. You have only to look at countries such as Korea, Thailand, Malaysia and Singapore to realize that. And lower down the economic ladder, the same can be said for countries like the Ivory Coast and Kenya.

Governments should therefore vigorously encourage private enterprise. This essentially involves the establishment of a policy framework which permits markets to function freely, the removal of government interventions which tend to create rather than reduce distortions and the protection of private property rights. In addition, under certain circumstances, countries should consider the advantages of privatization. We have to recognize, however, the Catch-22 element in going such a route. It is not at all easy to find entrepreneurs in the private sector either willing or able to take over bankrupt public enterprises in need of substantial rehabilitation. And often there is no organized equity market to facilitate the establishment of a fair price. On the other hand, governments are understandably reluctant to hand over to private interests public enterprises that by virtue of their revenue-earning record are attractive to both government and the private sector. What we can say, though, is that by strengthening the private sector, we increase the capacity and therefore the willingness of that sector to take over public enterprises with which the state is having little or no success.

While it is not so difficult to measure the contribution of the private sector to the rate of economic growth, demonstrating the impact of foreign investment on growth is much harder. Nonetheless there are good grounds for saying that foreign investment can play an important role in countries where the government is creating and maintaining an environment conducive to strong private sector activity. And by strong private sector activity, I mean strong in the sense of generating high returns to both the country and the investors. Put another way, policies that further productive private sector activity are good for a country's economy. And the encouragement of investment from abroad is an important element of those policies.

Since I began by referring to the heavily indebted countries of Latin America, let me emphasize that a healthy, buoyant private sector is vital to Latin America's future. Many governments in the region have said that they want the private sector to have the freedom it needs to make the maximum contribution to development. But in practice, too many of the old controls and obstacles remain. Their public sectors are too large, too inefficient and too costly a burden on national budgets. In many sectors, private enterprise could do a better job in both economic and social terms.

There are some early signs that the governments of the developing countries and the international community as a whole are moving toward a consensus on the role of the private sector. We should encourage this movement, and help foster a realization of the need to reduce the presence of the public sector in national economies where it is excessive, and the need to shift to a heavier reliance on profitable, competitive private enterprise, regulated by the market place. That, after all, is the most effective road to travel in order to create wealth and to achieve economic growth.

Structural adjustment programs just have to take into account the contributions that the private sector can make. In many countries which have had to carry through painful stabilization and adjustment programs in response to the debt crisis, the private sector has been, at least in the short run, a casualty of the process. Foreign exchange allocations to the private sector have been ruthlessly subordinated to the pressing requirements of the public sector; new raw material costs have risen in response to necessary exchange rate adjustments. This is not to say that the public sector has escaped lightly. Indeed it has not. But the impact of austerity on the public sector can always be reversed by a government decision to deprive the sector no longer. However, in the private sector, when you have been last on line for credit and starved of raw materials, enterprises may simply no longer be around when the government declares that the bad times are over. And a whole lot of investment capital may in the meantime have fled the country for more hospitable climes.

We are very aware of this problem, and in our dialogue with our borrowing member countries working on putting adjustment programs in place, we are emphasizing the need to get a better balance in the central bank allocation of scarce foreign exchange and the availability of domestic credit as between the public and private sectors.

Which brings me to the role that The World Bank family is playing in promoting the vigorous development of the private sector. Let me briefly remind you what our family of institutions consists of.

The World Bank is celebrating its fortieth anniversary this year. The IBRD (or International Bank for Reconstruction and Development, to give it its formal title) is today providing expert, impartial advice, backed with carefully planned and supervised investments, to more than 45 of the more creditworthy developing countries. The Bank's commitments this fiscal year will increase to a range of \$12 to \$13.5 billion. Owned by 149 nations, IBRD has a record of sound financial management that enables it to secure terms second to none in the world's capital markets, from which it draws its funds. The Bank is also a profitable institution. In the last three fiscal years, annual net income has averaged more than \$800 million. In fact, over the forty years of its existence, there has not been a single year in which the Bank has not registered a profit!

The IBRD's loans are typically for a 15-20 year term, and the interest rate is currently 8.82 percent per annum. Our relationships with each borrowing country are based on a desire to help that country put in place economic and social policies that work, so that borrowing from us for productive purposes contributes directly to economic and social progress and to the alleviation of poverty.

Some forty of the poorest nations in the world, nations that are not creditworthy enough to rely on the IBRD, look to our affiliate, IDA (the International Development Association) for much needed concessional finance. They obtain it from IDA in the form of 50-year credits with a zero percent interest rate and only a small servicing fee on drawn amounts. About 90 percent of these funds go to nations where average per capita incomes are less than one dollar per day. IDA, which is funded by 33 donor nations, is currently able to lend about \$3 billion a year. Concessional funds are the hardest funds to raise in the world. And given the scale of poverty and the urgent needs of the poorest nations, what IDA can presently lend is far too little, and risks leaving unexploited much of the vast development potential of these countries. At our Annual Meetings of Seoul, it was agreed that negotiations for the eighth replenishment of IDA's resources should begin in January 1986 and be completed by the time our Board of Governors next meets in September. We are determined to see these negotiations produce a replenishment more commensurate with the needs of our low-income member countries.

The IBRD and IDA lend for similar purposes. Taken together, 25 to 30 percent of their lending is directed every year to the agriculture and rural development sector; 20 to 25 percent is directed to the energy sector. We are also lending for transportation, industry, education, telecommunications, urban development, water supply, population, health and nutrition, and technical assistance. And, very importantly, we also make non-project loans in support of governments' structural and sectoral adjustment programs.

May I, in parenthesis, remind you that the project lending of IBRD and IDA is good business for American business. Under our procurement system based on international competitive bidding, American suppliers have won more than \$12 billion worth of contracts to provide goods and services for Bank- and IDA-financed projects since we went into business. You might want to compare that figure with the \$962 million which the U.S. has actually paid in to the Bank as the paid-in portion of its capital subscription, and the \$7.7 billion it has provided for IDA since its establishment.

The World Bank has always had an important role to play in support of the private sector. The broad range of policy advice it offers to its borrowing member countries and its commitment to the strengthening of institutions in the economic sectors help in the creation of a better environment for private enterprise activity. The Bank's extensive infrastructure financing has historically been and continues to be an important factor in the creation of that environment. And its loans in support of structural adjustment programs and its more focussed sectoral adjustment loans also help promote the conditions in which the private sector can flourish. Further, with certain pre-conditions satisfied, the Bank can make available to the private sector, especially potential investors, its knowledge of the economies of developing countries. Naturally governments have to agree to the release of information; delicate negotiations must not be jeopardized, nor banker/client rules of confidentiality broken. But when the release of information can facilitate better investment decision-making, it is clearly to the general economic good.

That is what The World Bank can do to assist the private sector. But it is our second affiliate, the International Finance Corporation, or IFC, which has the specific responsibility within The World Bank family for the promotion and support of private enterprise in the developing countries. Its activities are therefore crucial to an agenda for action to strengthen indigenous and foreign private investment in the Third World.

IFC does not lend to governments; it invests in companies. It is precluded by its Charter from accepting a government guarantee on any loan or investment it makes. Acting essentially as a catalyst, it is always a minority participant in any venture, usually subscribing not more than 15 to 20 percent in the form of loans and/or equity. Its contribution, therefore, does not dominate in financial terms. Its key role is to bring together foreign or domestic capital, technology and managerial know-how -- in essence, making things happen that would otherwise not happen.

The IFC will not do what the private sector can do for itself. But that means that it is prepared to take on risks that would make others hesitate. The presence of the IFC in a venture can provide reassurance and help reduce political or country risks such as difficulties in securing foreign exchange to finance operating requirements and to service debt.

Risks we will take. But profits we must also make. There's nothing incompatible in a development institution making a profit, as IFC overall does, despite some losses on a few individual investments. It is through profitable investments that IFC contributes to development, because profitable investments enlarge the wealth and resources of the host country.

IFC is an institution very much on the move. In its fiscal year ending June 30, 1985, IFC's net investments of more than \$600 million represented a 55 percent increase over the previous fiscal year, and we expect investments in 1986 to grow a further 15 to 20 percent.

IFC has shown that it has an important role to play in helping the heavily-indebted middle-income countries make the crucial transition from austerity to renewed growth and restored creditworthiness. Increasing export revenues is a key element in the transition strategy, and in Brazil, for example, IFC has helped to finance investment in private sector projects totaling about \$1 billion over the past three years, with special emphasis on exports and efficient, profitable import substitution.

In its developing member countries, the IFC is also enlarging its activities in the development of local financial and capital markets. It is also playing an important role in restructuring companies which have run into difficulties, as many did in the wake of the global recession and the austerity that that imposed. And in a growing number of countries, IFC is being asked to assist in the process of restructuring enterprises which are publicly owned and which governments wish to privatize.

A growing role for IFC calls for more capital, so IFC's Board has recommended a doubling of its capital from \$650 million to \$1.3 billion. We're close to getting the required number of shareholders' votes to make this possible, and that should allow a doubling of IFC's investments over the coming years.

Within this expanded program, IFC will be giving very special attention to Sub-Saharan Africa. Over the next five years, IFC expects to undertake about 100 projects costing perhaps some \$2.8 billion in total with an IFC contribution in excess of \$600 million. IFC is also in the process of establishing a project development facility on the ground in Africa, which will provide technical help and advice to African companies and entrepreneurs in designing projects and arranging finance. It is to be sponsored by the UNDP, the African Development Bank and IFC, and managed by IFC.

IFC has set itself an ambitious target, but certainly not too large in relation to the needs and the huge potential of the developing countries' private sectors. The doubling of IFC's capital is crucial to this effort. The United States Administration has strongly supported the capital increase proposal. What we need now is the legislation in Congress which would put us over the top in the number of votes required to make the increase effective. We hope you will encourage this legislation.

We are very determined to strengthen IFC's business promotion efforts, recognizing that this will, in turn, have a substantial impact on the promotion of the private sector in developing economies. But there is more we can do to strengthen our efforts to promote international investment. We have to do more. Direct foreign investment cannot, and should not, seek to provide more than a partial offset to the gap left by the dramatic decline and projected slow recovery of commercial bank exposure in the developing countries. But an increase in direct foreign investment from current depressed levels is extremely important, and mechanisms to promote that increase are clearly needed.

That is why we have been working so hard over a great many months to establish a Multilateral Investment Guarantee Agency (or MIGA), an agency designed to improve investment conditions worldwide by providing more comprehensive coverage of non-commercial risks to foreign investors in developing countries, and by heightening awareness of investment opportunities, and increasing the flow of information, knowledge and expertise related to the investment process.

Last month, in Seoul, Korea, the Board of Governors adopted a resolution opening for signature the Convention establishing MIGA. That the resolution was adopted without any objections and with less than ten percent of the member countries abstaining is another welcome sign of the growing recognition of the importance of the private sector and of direct foreign investment in the development process. Much of MIGA's business will be coverage against the risk of currency situations that would keep foreign investors from repatriating profits. But it will also provide guarantees against the risks of political violence and expropriation. These are all vital considerations for foreign investors.

MIGA will operate very much as a member of The World Bank family in promoting investment for development. In addition to its research and information dissemination activities, it will be able, at the request of a member government, to supplement the work of the Bank and IFC in providing technical advice and assistance to improve investment conditions in that member country. Such advice and assistance could be aimed at removing impediments, in both the investor's and the host's country, to the flow of investment to the latter. MIGA will also encourage the amicable settlement of disputes between investors and host countries, and promote and facilitate the conclusion of agreements, among its members, on the promotion and protection of investments.

In the months ahead we will spare no effort to secure firm governmental and business support for MIGA to ensure, as rapidly as possible, the establishment of this valuable agency, and its widespread use. It is something of a triumph that nearly a quarter of a century after the first of several efforts were made to bring such an instrument into being, we have, on this try, achieved such a consensus. To bring the Convention establishing MIGA into force, we need the signatures of five industrialized countries and fifteen developing countries, provided that these countries subscribe to at least one-third of MIGA's capital. Three developing countries signed it in Seoul, and another has signed it here in Washington. We now look to the United States to lead the way in securing the industrialized countries' signatures.

To sum up, Mr. Chairman, The World Bank's family of institutions, old and new, are actively engaged in helping to mobilize more fully the entrepreneurial spirit of the developing nations on their long, difficult road to prosperity. That means promoting a truly active partnership between business, governments, and institutions such as The World Bank, in supporting the development of the private sector in the developing countries.

It is a crucial part of the total development effort of which all of us are the essential beneficiaries. Our efforts are being strongly supported today by our shareholders. We are very appreciative of this, for this gives us a strong mandate to make a still larger contribution to economic progress and poverty alleviation.

So we hope you will join us in these efforts.

Thank you.