INTERNATIONAL BANK FOR
RECONSTRUCTION AND DEVELOPMENT

December 29, 1949

TO: Messrs. Black, Garner, Iliff, Rist, Crena de Iongh, Sommers, Parker and Wheeler.

FROM: Richard H. Demuth

Attached is a paper on the proposed International Development Corporation for consideration at the weekend meeting - Jan. 6 - 8, 1950.

R. H. D.

Attachment.

CONFIDENTIAL

Staff Office
December 29, 1949

superseded by paper 3/16/50 in Gen File

Proposal for an International Development Corporation; a suggested application of the Point IV policy

1. Introduction

It is generally recognized that the pace of economic development can be much accelerated by foreign private investment. Considerable thought has therefore been given to possible methods of overcoming the unsatisfactory "climate" inhibiting this investment in countries where it could be usefully applied. The United States Government, in particular, has taken certain steps to this end as a part of the Point IV policy enunciated by President Truman. Examples are the recent treaty with Uruguay and the bills put before Congress that would empower the Export-Import Bank to extend to private investors guarantees against certain risks peculiar to overseas investment.

The Bank has often encountered the need for private investment in underdeveloped countries and has felt that its contribution to the development of such countries would be greatly magnified if the need could be satisfied. The Bank has accordingly considered ways in which it could, in greater measure than at present, fulfil one of its principal purposes, as defined in Article I (ii) of its Articles of Agreement:

> "To promote private foreign investment by means of guarantees or participations in loans and other investments made by private investors:"

While this article specifically refers to guarantees of and participation in "loans and other investments" and does not in any way limit the role of the Bank to lending transactions, the specific provisions of the Articles dealing with the Bank's operations do not expressly authorize or envisage types of financing other than loans. And in fact the Bank has to date participated only in creditor-debtor transactions. Moreover, since all the Bank's financing has been on a loan basis, it has all come within the express provisions of Section 4 of Article III of the Articles of Agreement requiring, when the borrower is not a member, a guarantee by the member or its central bank or comparable agency. This condition, too, tends to limit the Bank's freedom of action.

It has therefore become clear that, if the Bank is to assume the broad functions in the field of economic development that its experience to date suggests are desirable, it must seek new means to promote private foreign investment. Consideration of this question suggests that perhaps the best method of achieving this purpose would be to create a new institution under the Bank's auspices designed primarily to make equity investments in participation with private foreign investors but also with the power to make non-guaranteed loans to private enterprises. This new institution, which is here termed for reference purposes the International Development Corporation, would be a separate corporate entity, financially distinct from the Bank, but otherwise under its direct control and therefore guided by the same general aims.

The following paragraphs describe in greater detail the present limitations on the Bank's operations and the proposed nature of the Corporation.

2. Limitations on the Bank's operations

(a) The requirement of a government guarantee

Although the Bank's experience has not yet been comprehensive, it is already possible to discern certain effects which the requirement of a government guarantee has and will in likelihood continue to have on the nature of the Bank´s operations.

First, the requirement tends to discourage loans to private enterprises. There have been numerous instances of potential borrowers who welcomed Bank participation, but were extremely apprehensive of a Government guarantee. Borrowers fear that a Government guarantee may lead to demands for Government representation on boards of directors or to Government participation in or control over management in other ways. Although this fear has not been justified by the Bank´s experience to date, that experience is not a reliable basis for judgment since the Bank´s only loans to private enterprises in underdeveloped countries have been to public utility companies which are already so fully subject to normal regulatory powers that they have relatively little to fear from increased Government interest. Whether the fear is justified or not, however, the significant fact is that it exists.

Equally important is the fact that Governments are frequently loath, for entirely understandable political reasons, to guarantee loans to private enterprises. If a Government extends its guarantee to a particular private company, it lays itself open to charges of favoring that enterprise over its competitors and, what is often more important, over various public projects. This is apt to be the case, however well-advised the choice may be. The situation is aggravated by the special advantages attached to Bank loans such as their low interest rate.

The need for a government guarantee also affects the choice of types of projects. Because of the length of time required to obtain enabling legislation for such a guarantee, and the political debate which is likely to be provoked, there is always a tendency to restrict consideration to those projects which are largest in amount and most spectacular in nature and which will bring the most immediate return in political goodwill. This emphasizes large construction projects of a public works type which, although they may be highly beneficial, do not necessarily meet the real first-priority development needs of the country.

In general, therefore, it may be said that the requirement of a Government guarantee discourages loans to private enterprise and tends to restrict the Bank's lending operations to the public works field.

(b) Equity financing

The financing of enterprises which involve an appreciable degree of commercial risk frequently demands a high proportion of equity capital. Equity financing is therefore desirable over a wide range of economic activity, including almost all industry and distribution. The commercial, managerial and technical skills necessary for the efficient conduct of undertakings in these fields are commonly found only in private enterprise and normally can be attracted only in association with private capital investment. Very often these skills are not available at all in underdeveloped countries, especially in industries that are new to the country, and they must then be sought abroad. Even if they are available, foreign equity capital may still be needed: first, in order to cover the foreign exchange costs of the necessary equipment, when exchange control regulations do not permit its purchase by local investors; and secondly, in order to maintain close contact with established centers of production overseas.

In a number of instances the Bank has had to refuse to consider projects which had good prospects of success and promised to be of substantial benefit to one of the Bank's members, because they required a greater proportion of equity capital in relation to debt capital than the proposal offered. It is typical of proposals of this kind that they present the Bank with an overwhelming share of the risks involved and the promoter with substantially all of the profits, if the project turns out to be successful. If the Bank had equity funds, it could fit its financing to the needs of the project and could accept proposals which it cannot now consider.

Another important consideration is the effect of equity financing on a country's balance of payments. Foreign equity financing, like foreign debt financing, involves a burden on the balance of payments; and if new investment is to be encouraged the aggregate amount of transfers required in the one case may be at least as great as in the other. But with equity financing profits and consequently transfers are closely related to movements in trade and net receipts of foreign exchange. In export industries the correspondence is obviously direct, but even in industries manufacturing for sale locally there may well be a fairly close correspondence. The burden of transfers under equity financing thus tends to be heaviest when it can most easily be borne and lightest when the difficulties are greatest.

Furthermore, transfers required under equity financing permit of far greater flexibility in handling. There are no fixed dates on which transfer must be effected under penalty of confessing a default. A country which is experiencing a severe foreign exchange stringency can postpone transfer of profits without the serious danger to its credit standing that would result from failure promptly to transfer service of debts.

This aspect of equity financing is important to the Bank since there are, among the Bank's undeveloped members, several which offer interesting development prospects but which have already assumed foreign debt burdens which are out of proportion to their present foreign exchange revenue. Equity funds would tend to put the Bank in a position to help even the most impoverished of its members, and thus prepare the ground for larger investments on a credit basis in the future.

(c) Local currency financing

As the Bank has gained experience in undeveloped countries it has become more and more evident that nearly every case presents extraordinarily difficult problems in finding funds to finance the local currency requirements of projects. Although the provisions [Article IV, Section 3(b)] of the Bank's Articles of Agreement authorize a certain degree of flexibility in this respect "in exceptional circumstances", practical considerations make it difficult to give effect to these provisions. The Bank does not have these currencies freely available and must usually acquire them by selling dollars. In that event, the Bank must require repayment in dollars which in turn means that the undeveloped countries would have to assume a dollar debt for expenditures which could be met in local currency. When that course appears inadvisable, the only alternative often is to raise the money by central bank advances or similar means which may involve equally grave dangers by adding to inflationary tendencies. Any means of creating or attracting savings in local currency would therefore give a valuable impetus to development in general and to the Bank's operations in particular.

3. The International Development Corporation

(a) Purposes and activities

The fundamental purpose of the Corporation would be to promote economic development by encouraging foreign private investment. The Corporation would try to accomplish this by seeking possible business opportunities in member countries - primarily underdeveloped ones - and by placing those opportunities before both foreign and local capital in order to interest them in the formation of new enterprises. The Corporation would normally participate in these new enterprises by subscribing to capital stock or by making loans (other than short-term accommodation) or both, but it would not attempt to take a controlling interest nor to supply the management. On the contrary, one of the objects of obtaining private capital would be the attraction of capable management in association, without which the Corporation would not proceed.

The participation of the Corporation in an enterprise should serve to give private investors confidence that they would be fairly treated by foreign governments and should thus bring about investments which would not otherwise be made. For the Corporation could exercise its influence to assure fair treatment, not merely at the late and difficult stage when a dispute has come to a head, but as the occasions of disagreement arise. The mutual suspicion which exists today and which creates an unsatisfactory "climate" for investment can probably be cleared away more effectively by day-to-day discussion of specific cases than by general declarations of policy, since it is as often the administration of laws that causes difficulties as their content.

The more experience the Corporation accumulated on the precise nature of the differences between governments and foreign investors and on the most suitable ways of reconciling these differences, the more foreign capital it could attract by its prestige. And it might well make an even greater indirect contribution to the development of a country, if the "climate" could be so improved by its efforts that foreign capital would enter without the particular protection afforded by the actual participation of the Corporation.

When any enterprise had passed the development stage and was a going concern established on a sound footing, both economically and politically, the Corporation could sell its interest either wholly or in part to private investors, local or foreign. The proceeds of the sale could then be used for reinvestment, either in the same country or elsewhere. In other words, its capital would be used as a catalyst transferred as often as possible to new enterprises.

The Corporation could also perform the useful service of encouraging the growth of a local capital market. The Bank has frequently found the necessity for this in underdeveloped countries but the Bank's operations do not lend themselves so directly to this as would the Corporation's.

The general character of the Corporation would thus be similar in a number of respects to the U.K. Colonial Development Corporation and Mr. Nelson Rockefeller's International Basic Economy Corporation. It would, like these two, operate on commercial lines. While it would be operated on a profit-making basis, it would be willing to take from time to time somewhat greater or long-run risks than would be commercially justified. Its profits, furthermore, would be primarily devoted to reinvestment.

(b) Relationship with the Bank

The Corporation, although a separate financial entity, would be wholly owned by the Bank. Its operations would be guided by the Bank and the officers of the Bank would be Directors of the Corporation. The Corporation's staff would not need to be large initially, since the services of the various departments of the Bank would be available to it. It would be, in essence, a specialized department of the Bank.

While the Bank and the Corporation would undoubtedly carry out numerous independent operations, it seems likely that there would be a number of cases when the operations of the one would be materially affected by those of the other and simultaneous, if not actually joint, financing of certain projects might often prove feasible.

There will, for example, be occasions when the financing of a utility project is dependent on the growth of demand for the services of that utility. The power-cum-industry type of project, which the Bank encounters frequently, is a typical example. In such a case investment of Corporation funds in industrial developments utilizing the power might well provide a necessary justification for the power project for which Bank financing is sought. It is thus possible to conceive of the development of a country taking place in part by such successive jumps forward, which would not necessarily be on a large scale but would be well coordinated.

Projects which lend themselves to a combination of loan and equity financing could be jointly financed by the Bank and the Corporation together with other local or foreign capital. There is also the possibility of having the Corporation provide a portion of the equity funds for local development institutes or industrial credit companies in various countries, with the Bank providing additional capital in the form of loans.

(c) Capital structure

The projects undertaken by the Corporation should initially be reasonably conservative and small in size. It should resist pressure to undertake anything too spectacular. The initial capital, therefore, need not and should not be large.

On the other hand it must be remembered that the Corporation's sphere of operations is potentially worldwide and it might be advisable to plan ahead for investment on a somewhat larger scale than would initially be the case. It is suggested that the order of magnitude of the initial capital should be $250 million, whether all paid in or not.

The Bank would wish to have control of the Corporation, which could be achieved by a nominal common stock subscription, if the remaining stock were non-voting. It is assumed, for purposes of this memorandum, that the Bank is entitled to make such a nominal subscription under its Articles of Agreement. As regards the remaining capital, it would seem clearly inappropriate for the Bank to make so large an amount available from its own resources for, irrespective of legal considerations, such action would radically change the nature of the Bank's financial responsibilities.

It is plain that, in view of the general character of the Corporation, the only possible source of funds would be governments, and the only major source the U.S. Government. For the U.S. Government to subscribe to the Corporation's stock would certainly seem to be in line with the general objectives of President Truman's Point IV program. And it is clearly desirable that other governments should also make a contribution. These contributions might be in the form of non-voting common stock, non-cumulative preferred stock or income bonds. The precise form can be discussed at a later stage.