

Guth, Wilfried

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FINANCING

Sources of Finance for Development

by Wilfried Guth, Frankfurt*

The foreign capital requirements of less developed countries (LDCs) are basically the result of their huge volume of investment which far exceeds their actual saving potential. In addition, their capital needs are steadily rising owing to inflation and – not least – to the higher cost of energy. As there is no standard recipe for development finance, the following article gives a survey of the major sources of capital.

There are two main channels for the transfer of foreign capital: official aid and private credits or investment. It is above all the poorer developing countries which are, for obvious reasons, dependent on the first type in the form of grants and credits on concessional terms; private development finance – mainly bond issues and loans at market rates, but also private direct investment – is generally speaking only at the disposal of the more advanced LDCs. But there are also combinations of official aid and private development finance, e.g. co-financing by international development institutions and private banks, or World Bank loans which are refinanced on international capital markets.

The purpose and effectiveness of official aid depend to a large extent on the recipient country's level of development. In countries which have achieved a position allowing them also to mobilize private credits or capital, official development aid is primarily intended to cover basic needs such as the import of essential raw materials and foodstuffs and to promote investment projects, principally in infrastructure, which are necessary for development but not remunerative in a commercial sense. Official aid thereby lays the basis for private financing as it helps (together with other factors, especially the recipient country's own efforts) to create the pre-conditions for the participation of foreign private capital. In addition, official aid reduces the total financing costs for the countries involved, as the terms and conditions of official aid are more favourable than those of market funds. Thus, official aid alleviates the refinancing worries and debt service quotas of the already more advanced countries and thereby possibly increases the scope for the use of private capital.

In contrast, for the group of least developed countries who lack creditworthiness in the commercial sense and therefore have little attraction for foreign private capital, official aid is, as a rule, the only major source of capital. In these countries official aid must cover both the basic human needs, including food, clothing, housing, medical care, etc., and the most pressing investment requirements – especially in agriculture.

Unsatisfactory Official Aid

The industrial nations have more than doubled their official aid in the past ten years to over US \$ 18 bn in 1978. Last year, for the first time since 1975, official aid rose not only in nominal but also in real terms. Furthermore, the terms and conditions have been continually improved. Nevertheless, the official aid figures cannot be called satisfactory, for three reasons:

□ Firstly, the target for the United Nations' First Development Decade to transfer 0.7 % of Gross National Product (GNP) of the industrialized countries in the form of official aid, was not only missed by a long way, but in fact the percentage share of official aid in GNP contracted from 0.53 % at the beginning of the 1960s to 0.32 % in the years 1976-78¹. The repercussions of this development on the poorer LDCs were somewhat lessened by the fact that from 1974 the OPEC nations (Organisation of Petroleum Exporting Countries) increased their official aid to over 2 % of their GNP (in 1978, however, it amounted to only 1.5 %).

□ Secondly, it has been the largest donor countries which have made the smallest contributions, measured in terms of their respective national products. In 1978 the share of official aid in GNP

*Member of the Board of Managing Directors of Deutsche Bank AG. – Shortened version of a paper delivered by Dr. Wilfried Guth at the 32nd International Banking Summer School in Cambridge, August 1979, organized by The Institute of Bankers, London.

¹ See OECD: Development Co-operation, 1978.

amounted to 0.23 % in the USA and Japan, and 0.31 % in the Federal Republic of Germany.

□ Thirdly, the development aid given by Communist countries was far more modest even than that of the Western industrialized countries. Between 1973 and 1978 it contracted from US \$ 1.3 bn to US \$ 0.8 bn (state-trading nations including China); the 1978 figure would be equivalent to 0.04 % of these countries' GNP. The official aid of the Netherlands alone exceeds that of all Communist countries together.

Narrowed Scope for Official Aid

Understandably, the unsatisfactory volume of official aid has not escaped criticism. Even before the Fifth United Nations Conference on Trade and Development (UNCTAD V) last May in Manila, the USA, Japan and the Federal Republic of Germany were called upon to increase their official aid by 25 % p.a. in the years 1980-82, more or less doubling nominal aid in this period. I doubt whether this will be possible. Nevertheless, the Federal Republic of Germany has, for example, promised to raise its official aid from 1980-82 at a higher rate than the 9 % p.a. originally foreseen in the Federal Government's medium-term financial planning.

This opinion is certainly not meant to discourage potential borrowers. On the contrary, it should rather be considered a challenge for both sides, not only for potential borrowers but also for issuing houses and the secondary market to have the courage to make "pioneer issues" for new developing countries. More than a dozen countries from the Third World have already stood the market test and I am sure there will be further additions to the list of newcomers within the next couple of years. The desirability of bond financings will hopefully reinforce efforts in LDCs to strive towards political and economic conditions which are satisfactory to investors. Conversely, competition will induce issuing houses to search continuously for new borrowers in order to gain lead management positions and to satisfy the interest of investors in spreading their risk and diversifying their portfolios. An important prerequisite for increased bond financings for the purpose of development is, of course, continued growth of the international bond market and this is most likely to materialize in an environment of relative stability of the international monetary system.

In spite of the, hopefully, expanding role of the international bond market, we can and must assume that the Eurocredit markets will have to continue to

provide the larger part of private financing for LDCs. In all likelihood the demand for private credits in these countries will remain high. There are not only rising requirements for project financing but also for broad balance of payments purposes. After a remarkable reduction in the last years, balance of payments deficits in these countries will increase again as the new rise in oil prices has aggravated the situation. The international credit markets will also be faced with rising demands because of the high repayment obligations for funds borrowed earlier. In its latest World Development Report, the World Bank estimated the developing countries' medium-term and long-term net capital requirements at market terms and conditions in 1985 at US \$ 78 bn, compared with US \$ 25 bn in 1975. Of this, according to the Bank, more than four-fifths will have to be provided by private financial institutions, i.e. chiefly by banks.

On the supply side the market prospects for a continued flow of market funds for development financing are reassuring. It is true that, theoretically, Eurocurrency markets could dry up if the US balance of payments turned around and strong domestic credit demand arose in major industrial countries. But even then, a considerable amount of funds would probably flow to the markets from oil producers and other surplus countries.

I still think that the 0.7 % target, which I helped to formulate as a member of the Pearson Commission, should be maintained. However, to be fair one should not ignore the fact that the scope for increasing official aid from the industrialized countries has narrowed in the last few years, for two reasons:

- Firstly, the steep rise in the price of oil since 1974 has also placed an increasing burden on the payment balances of industrialized countries, the majority of which – first and foremost the USA – are struggling with balance of payments difficulties.
- Secondly, in view of newly mounting inflationary pressures many industrialized countries have to make serious efforts to reduce their high public deficits. As tax increases are hardly appropriate at a time of insufficient growth, it is on the expenditure side that the search for curtailments has to begin.

I would, nevertheless, maintain that development aid has such a high priority that its share of budgetary expenditure ought to be increased.

If there is disappointment that official development aid has fallen so far short of the 0.7 % target, it should be pointed out that the flow of private capital to

developing countries has "over-fulfilled its norm". Including private funds, the capital flow to developing countries is higher than the 1 % of GNP which has also been established as the target for total development financing.

Private capital flows into the LDCs in the last few years accounted for a growing share of their external resources. While at the beginning of the 1970s capital exports from DAC countries (Development Assistance Committee of the OECD) at market conditions (predominantly international bank loans, export credits, and direct investment) only accounted for close to half of total (net) resources transferred to non-oil LDCs, since 1975 this share has risen to two-thirds².

This was mainly the result of a strong expansion both in export credits and in international bank lending. Export credits from DAC countries to non-oil LDCs increased from an annual average of US \$ 2.2 bn in the years 1969-71 to almost US \$ 5 bn p.a. in 1975-76. During this period the LDCs (including OPEC) increased their share of total export credits extended by industrialized countries from 60 to 66 %. The main recipients of export credits were Brazil, Indonesia, Korea and Mexico, accounting in 1976 for almost a third of total export credits to developing countries.

Even more dynamic was international bank lending in the form of syndicated medium-term Eurocredits to non-oil LDCs. They rose from rather low levels (US \$ 1 bn to US \$ 4 bn annually) in the early 1970s to a total of US \$ 27 bn in 1978 and US \$ 14 bn in the first half of 1979 (European LDCs excluded). Since 1975 the share of the non-oil LDCs outside Europe in total publicized Eurocredits has been of the order of 30 to 40 %. However, the concentration of these funds on certain countries was even stronger than in the case of export credits. Of the US \$ 73 bn total gross borrowing of these countries on the Euromarket between 1975 and mid-1979, almost one-half (US \$ 34 bn) went to Brazil and Mexico alone, and almost 70 % were taken up by only five countries (the two already mentioned plus Argentina, South Korea and the Philippines).

Role of International Bond Markets

Compared with the impressive figures for international bank lending, the corresponding figure for bond issues floated by developing countries on international capital markets looks rather modest. From 1975 to 1978 publicized new international bond

issues of LDC borrowers outside Europe amounted to US \$ 9.8 bn. That was equivalent to only 8 % of all international bond issues and 12 % of Euro-loans taken up by these countries during the same period. But if one includes the bond issues floated by the World Bank during this period (approximately US \$ 12 bn, excluding placements with central banks and governments), the proceeds from which are made available to the LDCs, the total amount of capital market finance and the respective percentages become considerably higher.

LDCs' Access to Bond Markets

The desirability of bond financing for a developing country is obvious. First and foremost, it is an additional source of longer-term funds which are always urgently needed. And, equally important, it is an attractive source as far as costs are concerned. Although developing countries generally have to concede coupons between 0.5 and 1.25 % over prime terms, they still fare well when bond financing is compared with the effective cost of alternative Eurocredit financing. Moreover, there is an advantage of fixed-rate over variable-rate financing with regard to planning and budgeting. Even more decisive, if a country has already obtained substantial amounts of bank credits, an international bond issue hardly impairs its further borrowing capacity as it will not be counted against the banks' country limits, provided, of course, it was priced correctly and sold in the market. A successful bond issue will always be considered a sign of creditworthiness and may even lead to an increase in bank lending limits. In this way, dynamic developing countries of the more advanced type, such as Brazil, Mexico or Argentina, have learned to play with virtuosity on the various market instruments. In recent years, an increasing number of LDCs found access to the Eurobond market, i.e. Venezuela, Algeria, Malaysia, Thailand, Indonesia.

However, the problem remains that only relatively few non-oil LDCs satisfy the conditions for successful access to international capital markets. What are these conditions? This is not the time to lecture on economic policy but one can put it quite simply: the economic and political conditions must be such as to give reasonable assurance that the issue can and will be duly served and repaid. The emphasis has to be as much on political as on economic factors. Thus, typically, Argentina disappeared from the market for an interval of 8 years until the improvement in its economic and political conditions permitted a successful comeback in 1977.

² See OECD, op. cit.

This leaves us with the obvious question of what could be done to improve the LDCs' access to the international capital markets. This question is of such importance that the Development Committee (a joint committee of the World Bank and the IMF) examined it in a special study published in November 1978. Its suggestions and recommendations range from the preferential treatment of LDC bond issues to the extension of guarantees by existing development institutions or even a new multilateral guarantee fund. This is not the place to assess the ideas and suggestions of this very useful and thorough analysis which deserves careful study. But let me say that I am sceptical with respect to proposals which aim at artificially increasing the flow of capital market funds to the LDCs. You cannot fool the market. The effect of artificial moves may be no more than to divert funds from one development issue to another without any increase in the overall amount of capital allocated for development purposes.

This becomes very obvious if one thinks of the proposal to have guarantees of development institutions extended to countries which otherwise would not find access to the bond market: such guarantees would be applied against the guarantor's own borrowing potential in the market (which is never unlimited), with the result for the guarantor of reducing the future availability of funds or at least impairing his ability to secure optimal conditions for subsequent financings.

The conclusion I am inclined to draw is that either a country's standing is good enough to permit direct access to the market or it is not, and then the country's government should rather work to improve it, instead of trying to circumvent the market's admission test.

It is an entirely different question whether central banks or banking supervisory authorities could deliberately bring about a greater scarcity of credit in international markets. Discussion on the potential dangers of the Eurocurrency market and the feasibility of controlling it has become very intense recently, but it has not been altogether clear. Most of the confusion has arisen from the unqualified use of the word "control". Now that the fog has lifted, two main – and conflicting – concepts among central banks have become apparent. Some central banks, headed, so to say, by the Federal Reserve, are aiming at the introduction of minimum reserves on international deposits which would have to be applied uniformly in all important countries and international monetary centres. This would act, so the argument goes, as a sort of tax.

Other central banks, such as the Bank of England or the Swiss National Bank, are clearly in favour of an improved application of what is called in Anglo-American terminology, prudential control. The way to achieve this in their view is to impose capital ratios on the consolidated credit figures of individual banks. This would, in the opinion of this group of central banks, have the double salutary effect of keeping the banking structure sound and putting a certain brake on further Eurocredit expansion.

To my mind, the latter method is the more appropriate one and the more realistic at the same time. As of today, at any rate, it seems highly unlikely that agreement on the imposition of minimum reserves could be reached among the authorities concerned. And if they could be imposed, how could the necessary decisions be arrived at once it appears desirable to ease or intensify the effect of this monetary instrument?

There is a third aspect of this discussion on which it is easy to find agreement: there is a need to improve actual information on type and maturity of borrowing on the Eurocurrency market. Efforts in this connection, particularly by the Bank for International Settlements, find general support. But also the developing countries themselves could help to provide better information.

Future Demands

All in all, we can certainly be satisfied if the potential dangers of the Eurocurrency market, which nobody can deny, are minimized by the general application of sound banking rules. But at the same time I share the viewpoint of those who devote their attention mainly to the fundamental causes of currency uncertainties and the inflationary expansion of liquidity, and not so much to their symptoms on the Eurocurrency market. This market is not an end in itself; it serves international trade and investment worldwide. Its ability to function lies primarily in its flexibility and its freedom from rules and regulations. Control of the market's potential risks and dangers will, in the end, always depend on the self-discipline and awareness of their responsibility of the banks operating in the market. If these should at any time be lacking, even comprehensive regulations would not protect us from drastic consequences.

Having said so much about possible measures to bring the rapid growth of the Eurocurrency market under better supervision it seems important to stress once more that the drastically changed world energy situation undoubtedly represents a new great challenge to this very market. Great care must,

therefore, be taken that an application of new rules does not lead to an untimely contraction of international bank lending. Otherwise, central banks could easily find themselves complaining about "under-recycling" after having criticized what they have called "over-recycling", i.e. the building up of currency reserves by way of borrowing.

But also, if this important objective is kept in mind, it cannot be ignored that more official funds will be needed in the future to bridge unavoidable balance of payments gaps and to prevent chain reactions which would arise out of a withdrawal of private credits due to a sudden worsening of debtor countries' political or economic situations. It would be inexcusable if the official international system were not prepared for such emergencies.

Potential Dangers

There is almost no need to add that there is one major objective of monetary authorities which would assure the greatest possible protection against the emergence of critical payments situations, both in the industrialized and the developing countries: the continuing fight against inflationary tendencies. No doubt, this fight has again become more difficult after the second oil shock which was caused by the events in Iran. But this does not give any excuse to central banks and governments, nor to the social partners in fixing prices and agreeing on wages. All would have to bear the burden of a new inflationary upsurge.

The other potential danger for the Eurocurrency market is the excessive accumulation of debt. Total debt of the non-oil LDCs outside Europe is, at approximately US \$ 265 bn, currently more than four times as high as at the beginning of the 1970s. But this massive increase must be seen in its proper perspective: i.e. against the equally impressive rise in the non-oil LDCs' export revenues and the strong increase in their currency reserves, which have more than doubled since 1974. Viewed in this perspective the debt situation of LDCs must not be considered as alarming. Yet, it has to be remembered that Third World indebtedness is not a global problem, but a problem of individual countries.

One special problem in connection with LDCs' indebtedness which I should like to mention is the maturity structure of their foreign debt. Despite recent improvements the maturity structure of the debt of some developing countries is still very unsatisfactory and gives rise to potential roll-over problems. Longer average maturities would thus be one of the main

contributions to easing financial relations with developing countries. However, the scope of the international banks for longer-term lending is restricted by their deposit structure, and under sound banking principles there are limits to maturity transformation. Commercial banks can therefore not be blamed for trying to resist the trend towards longer Eurocredit maturities. So maturities can only be extended via more official funds or more bond financing as already mentioned.

In this whole context I would like to say a word on the connection between the LDCs' creditworthiness and trade policy – an aspect which is too easily overlooked. The industrialized countries can very effectively strengthen the LDCs' creditworthiness by conducting liberal trade policies. To put it in negative terms, further spreading of protectionism would cut the non-oil LDCs' export revenues and thus their debt servicing capacity, and would therefore hold the danger of greater difficulties for international financial markets. Thus, efforts to remove and gradually abolish all forms of protectionism in the industrialized countries – and that means promoting the necessary structural adjustment in these countries – is an essential part of a convincing development aid policy. Otherwise, many financings for new industrial projects in LDCs would be almost pointless.

Institutionalized Co-ordination

So far I have spoken of public and private financing separately, although in the utilization of the proceeds from World Bank issues for development financing the two sectors automatically merge. But for some time now, the question of whether, and in what form, the two sectors can cooperate has also been under discussion. Such cooperation does already exist, for example with the IMF. But, up to the present – apart from an exchange of views and information – it has been restricted to the handling of problem cases, i.e. of countries with acute balance of payments difficulties. The most recent example of such cooperation has been Turkey.

In such instances the banks co-ordinate the necessary rescheduling and the provision of new funds with the IMF's stabilization programme. In other words: the banks usually make any new credit dependent on the conclusion of a stabilization agreement between the debtor country and the Fund. The objective of this *parallel financing* by the IMF and private banks is to restore the international creditworthiness of the country concerned and thereby enable it to resume a policy of sound economic growth.

The usefulness of such cooperation between banks and the IMF is undisputed and it is therefore not surprising that suggestions are sometimes being made to exercise it on a more regular basis, i.e. before real trouble has arisen.

Yet, as convincing as this may sound, it is unfortunately impracticable. The Fund is neither willing to express opinions on the creditworthiness of member countries (which consider the Fund as their confidant) nor for the same reason can it possibly advise banks on extending or not extending credits, not to mention the impossibility of assuming any kind of responsibility vis-a-vis the banks. What should be established instead is close cooperation between borrowing countries and the IMF. After the decision on the Fund's new function of "surveillance" I fail to understand the argument the bank credits without strings attached tend to „crowd out“ the Fund which seems to imply that the Fund is only entitled to give recommendations to a country if and when it actually borrows from the IMF. In my view the Fund has been given greater authority in order to apply it even if it is not in a position to enforce it by withholding needed credit.

Another form of cooperation between official institutions and commercial banks in which encouraging progress has already been achieved is the *co-financing* of projects in LDCs by international development institutions and private banks. Such co-financing has advantages for all three parties involved:

- For the LDCs it enlarges the potential for attracting private funds.
- The commercial banks profit from the expertise of the development institutions in assessing, preparing and monitoring the project concerned. They also see an advantage in obtaining in most cases a cross default clause specifying that a default on the commercial bank loan would be a default on the World Bank loan and *vice versa*.
- The international development institutions for their part are able to promote projects in the LDCs while employing relatively little of their own resources, which permits them to widen the radius of their activities. In this way they can truly play a catalytic role.

After a somewhat slow start, co-financing now seems to have become more widespread. According to the World Bank, about one-third of the more recent loans were co-financings. The World Bank and its subsidiary, the International Finance Corporation (IFC), which specializes in mobilizing private equity

capital for projects in the Third World, consider the energy sector of the non-oil LDCs as an important field for co-financing in the future. The World Bank Group plans to step up its lending in connection with energy projects in the non-oil LDCs in the years 1978-82 to close to US \$ 7 bn or by 50 % compared with the preceding five-year period.

Classical Instrument: Direct Investment

To conclude my survey on sources of finance for development I would like to make a few remarks on the role of private foreign investment in the process of development.

Direct investment is something like a classical instrument of development finance. It is an ideal means of combining the provision of risk capital with the transfer of technical know-how. In many cases the capital is probably not even the decisive component. The transfer of know-how, technology, entrepreneurial initiative, modern training methods, etc. is often of greater importance. Direct capital investment makes it possible for the recipient countries to utilize their comparative cost advantages in the form of an abundant labour supply and of raw materials, to enlarge their export capacity and thereby relieve their balance of payments.

In quantitative terms, however, direct investment in the LDCs in the last few years has been substantially lower than international bank lending to these countries. Direct investment (including reinvested profits) of the DAC countries in the LDCs amounted to about US \$ 7 bn p.a. in the years 1974-77. Leaving aside transactions with tax havens and those of the petroleum companies, direct investment in the LDCs has stagnated since 1974 at around US \$ 4 bn p.a. It is also noticeable that, here again, investments are largely concentrated in a limited number of countries. According to data from the OECD at the end of 1976 (more recent figures are not yet available for all countries) two-thirds of direct investment in the LDCs were in 16 countries, and almost one-third in four countries – Brazil, Indonesia, Spain and Mexico³. In the case of Brazil, for instance, foreign direct investment (including reinvested profits) covers about 20 % of the country's current account deficit.

The geographical distribution of direct investment reflects the different conditions foreign companies are confronted with in the individual host countries. The main prerequisites are sufficient political and economic

³ See OECD, op. cit.

stability and a favourable investment climate for foreign investors. This requires, above all, that the respective government has a clearly defined policy towards foreign investment which is not basically hostile and is not changed at short notice. If bureaucratic obstacles are put in their way, or if the role of multinational companies is constantly being questioned publicly, foreign investors will hardly commit themselves on any larger scale.

Thus, the decisive factors for more direct investment in the LDCs are confidence and good-will on both

sides. I am, therefore, in favour of efforts, such as those undertaken by the International Chamber of Commerce, to establish a code of conduct as a basis for mutual trust and a secure investment climate.

In the long run, however, borrowed capital from outside can never be a substitute for a secure internal capital base. Therefore the more advanced LDCs in particular must make every possible effort to encourage domestic savings and to build up effective capital markets – parallel to the capital inflow from foreign sources.

TRANSNATIONAL CORPORATIONS

The State of Preparations for a UN Code of Conduct

by Hartmut Scheele, Geneva*

In the United Nations an Intergovernmental Working Group tries to cope with the phenomenon of transnational corporations by working on a code of conduct. Hartmut Scheele, who participated in this work, reviews the results the Group has achieved up to now.

It seems that transnational corporations are a potential source of conflict since they invest and operate commercially on a world-wide scale while the scope of legal systems and executive powers of host and home countries do not, as a rule, extend beyond national frontiers. Such incongruity of political and economic spheres of influence may give rise to problems. Lacking ease of making the positions of some transnational corporations easy to grasp as well as their sizes and complex organizational set-ups have caused concern on the part of host and home countries, trade unions, consumer organizations and others. In this connection it is not much amazing to learn that several international organizations are dealing with aspects and problems concerning transnational corporations, e. g.:

□ The Organization for Economic Cooperation and Development: The 1976 Guidelines for Multinational Enterprises have just been reviewed by the OECD Council of Ministers in June 1979.

□ The International Labour Organization: In 1979 the Tripartite Declaration of Principles concerning Multinational Enterprises and Social Policy was made by the ILO.

□ The United Nations Conference on Trade and Development: The ongoing work in UNCTAD regarding an International Code of Conduct on the Transfer of Technology (second negotiating conference: November 1979) and regarding a Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices (first negotiating conference: November/December 1979) will have an impact on transnational corporations as well although these exercises cover other businesses, too.

*Permanent Mission of the Federal Republic of Germany to the Office of the United Nations and to the other international organizations in Geneva.