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# The International Finance Corporation and its Role in the Development Process

by Hans Heinrich Peters, Hanover\*

Measures of different kinds are needed to cope with the manifold tasks arising in international development finance, and a variety of instruments, models and concepts have been suggested in the international discussion. The International Finance Corporation (IFC), a subsidiary of the World Bank, plays a particular role in this connection: according to the objectives laid down in its Articles of Agreement it is to concern itself exclusively with private investments in productive enterprises in developing countries. The following article indicates the problems faced in the institutional promotion of private enterprises and explains why the operations of the IFC have so far yielded somewhat meagre results.

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To the observer trying to gain an overall view of the development of the International Finance Corporation it soon becomes clear that this institution has been beset throughout its history, and is still confronted, with a wide range of problems and difficulties of various kinds. The reasons for this were already evident at an early stage of its development when a very onerous and protracted process was necessary to give effect to its concept.

It was at the Bretton Woods conference in 1944 that the idea of promoting private enterprises through a multilateral international organization was for the first time discussed thoroughly. The discussion was then concerned with the plan to provide the newly to be created International Bank for Reconstruction and Development (World Bank) with appropriate powers.

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\* Legal Counsellor of the Lower Saxony Stock Exchange in Hanover. – The problems encountered in the institutional promotion of private enterprises and especially its legal aspects, which are not discussed here, are considered in detail in the author's monograph: "Internationale Entwicklungsfinanzierung – Die Rolle der International Finance Corporation im Entwicklungsprozeß" (International development finance – The role of the International Finance Corporation in the development process), Tübingen 1978.

The states involved at that time dropped the plan in the end because several delegations – including the British delegation under Lord Keynes in particular – felt that such powers might be abused for risky business deals. It was only in 1956 that an international organization with the object of the promotion of private enterprises in developing countries was set up.

## Bad Starting Position

As long as the USA, the largest source of capital, was unwilling to make any contributions, the pressure of those who wanted new institutions to be established remained without effect. It must not however be inferred from this that the USA had a general aversion to development aid. Of major importance was the predilection of the USA for support of developing countries through other channels than international organizations because it feared that the latter would not offer adequate control facilities over the invested capital and it also thought that the creation of the World Bank went far enough in this direction. This thesis is borne out by the extensive promotional activities

undertaken at that time by purely American institutions and programmes.

In this initial phase it was also extremely difficult to pursue the idea of institutionalized stimulation of private investment; the opposition to this idea by influential business associations in the USA is explained by their fear that it would lead to strong competition and impair their own interests.

Unaffected by these events in the USA and recurrent setbacks, the World Bank persevered in its support for a model which had been evolved and elaborated entirely in its own quarters and thereby played a decisive role in initiating a process which is without parallel in the history of international organizations. The divergence of views between the USA which adopted for a long time a negative attitude and the World Bank which was after all crucially susceptible to US influence and nevertheless stuck to its own concept seems to controvert the frequently voiced charge, especially of the socialist countries, that the World Bank was utterly dependent upon the USA. The World Bank certainly maintained its interests against its biggest capital contributor as the IFC had been intended primarily as an instrument for the complementation of the World Bank's other operations. This idea alone would not however have led to the establishment of a new organization had the developing countries not brought so much pressure to bear. Not the least of the reasons for the support of the developing countries was that the other models had little chance of succeeding.

### The IFC's Tasks

The prospects of the IFC, it will thus be seen, were anything but auspicious when it started. Having shown its disdain for years by dilatory tactics and minimal capital assignments, the USA took an extremely sceptical view of the experiment. The developing countries which were to be beneficiaries of the new organization continued to be much more interested in a fund from which they could obtain grants. The World Bank was alone in working hard for the new institution as was shown *inter alia* by the fact that the Vice President of the World Bank was appointed President of the IFC.

According to Art. I of the IFC Agreement it is the task of the institution to support the economic development of member countries by contributing to the financing of productive private enterprises, more particularly in the less developed areas. The IFC was thus not conceived as a profit-orientated banking institution engaging

primarily in activities aimed at self-financing but it was designed to pursue a common aim the achievement of which had been the purpose of its foundation by the members. The sphere of its activities and intended associates were indicated in general terms; this information was complemented by the remark that the IFC was to supplement the work of the World Bank.

In addition to the "official" tasks set out in Art. I of the IFC Agreement there is an "Explanatory Memorandum" describing the objective of the IFC. The institution is to demonstrate to private investors in capital-exporting countries by its activities how attractive the profits are which can be derived from capital investments in less developed countries (Art. VI).

The programmatic identification of IFC tasks is particularized in Art. I of the IFC Agreement which specifies three main areas of operations:

In cooperation with private capital the IFC is to help to finance the establishment, modernization and extension of productive private enterprises. The IFC is thus not to compete with private capital but cooperate with it and encourage its use. It is to develop activities only where sufficient private finance is not available on adequate terms and it is not to act as the sole provider of capital when it supplies finance. If one takes a purely commercial view of this arrangement, he sees easily the difficulties which can arise under such a scheme: On the one hand the IFC is enjoined to support enterprises for which private capital is not available in an adequate form, which means that they are not sufficiently attractive to private investors; on the other hand these enterprises are however to be "productive" and yield profits.

The complementary role of the IFC in relation to the work of the World Bank is emphasized once more by a reference to the IFC's authority to make capital investments even when the member governments concerned do not guarantee repayment. The IFC need not take general economic aspects into consideration as criteria for aid allocations; instead the reference to "productive" enterprises indicates an interest in the realization of profits.

The IFC is to act as a kind of clearing house, pointing out investment opportunities for foreign private capital and experienced managements and to try to bring the various parties together. Its narrow capital base makes this an area of particular importance.

The IFC is to concern itself with the removal of barriers hampering the unimpeded flow of private

capital so as to enable the latter to support private investments.

On June 30, 1978 the IFC had a capital subscribed by 108 member countries of about \$ 144 mn. As it was able to draw on the World Bank for funds for its own purposes, a total of \$ 975.2 mn was available to the IFC for the granting of loans.

In its practical work the IFC is trying to keep faith with quite a number of precepts: Projects are only to be considered for promotion if

- the economy of the host country is thereby benefited;
- there are prospects of profitable operation;
- private capital is unavailable from other sources on adequate terms;
- the government of the host country does not object; and
- native investors have an opportunity to participate in the project from the beginning or at a later stage.

#### Motives for Cooperation

The partners of the IFC had different motives for cooperating with the institution.

Cooperation with the IFC is of interest to enterprises and investors in *developing countries* because it is in a position to provide long-term capital. Cooperation by an international organization in which the host country can assert its views up to a point is regarded as a protection against the overwhelming power of multinational corporations. Besides, it is hoped to achieve greater economic growth by constant contact with the IFC and to interest other investors from the industrialized countries by bringing the IFC into a project.

The partners of the IFC in the *industrialized nations* have other motives. The most important consideration for them is probably what the Corporation itself described as "the IFC umbrella": It pictures the view that the IFC participation is expected to provide protection against nationalization and expropriation measures in developing countries, especially because of its contacts with the governments of these states. Besides, the IFC has meanwhile through its activities gained a detailed knowledge of the conditions for private capital in developing countries and cooperation with native investors. Experts on all the questions arising in this connection, e. g. on technical and legal aspects, are available on the IFC's staff, and use can be made of the experience accumulated by the entire

World Bank group. IFC willingness to participate in financing an enterprise signifies to other investors that this enterprise meets a number of prerequisites. These are considerations of particular benefit to first-time investors in developing countries.

#### Meagre Business Results

Seen in the overall framework of multilateral financial cooperation the business results of the IFC are meagre. Almost all other international organizations and many national institutions engaging in this sector of development promotion have produced better results. This is shown clearly for instance by the long time which the IFC needed to deploy the funds available for its practical work. This also shows with what excessive caution it has been operating for a long time. There are widely differing reasons for this. Some of them are of general validity: growing indifference to questions bearing on the promotion of economic development, the necessity of countries concerning themselves with their own economic problems, lack of interest in multilateral institutions. Others are specific to the IFC.

The essential argument which can be advanced against the activities of the IFC arises from the dangers attending importation of foreign capital. To illustrate these one need not refer to the writers in socialist countries who have criticized the IFC concept as a design to facilitate the penetration of the developing countries by foreign capital which makes them dependent upon the industrialized nations; a restatement of some of the arguments recently put forward against shareholding of oil exporting countries in German firms is sufficient.

Problems of another kind arise when in rebuttal of the first argument it is reasoned that the developing countries' need for capital is so immense that private foreign capital cannot be dispensed with. If this is the case, it must be asked whether setting-up an international organization is really a suitable means of attracting foreign investors. It could be objected, as happened in the initial phase of the IFC's development, that so strongly institutionalized assistance does not suit the character of the private sector of the economy and is from the outset doomed to failure.

Another point to be borne in mind is that an organization of this kind is always in danger of turning into a perpetual private capital lobby in developing countries; and if it is nevertheless recognized that there is a need for an institution, there still remains generally the question which tasks should be assigned

to an organization of this kind, what resources are to be provided for it, and whether the IFC has adequate facilities for the task on hand.

### **Built-in Conflict**

In discussions about the operational methods of the IFC and, in this context, the question whether its existence is justified it has often been asked whether it can in the light of its practices still be counted among the institutions furthering economic development. It is being realized that there seems to be a built-in conflict in the IFC's Articles of Agreement. The profit orientation of the IFC deriving from its exclusive cooperation with private capital could indeed come into conflict with its task as an institution intended to further economic development. This conflict is only apparently one and can be solved if traditional notions of capital-based development cooperation are relinquished. Such notions are associated in the main with direct subsidies or the soft loans of other organizations working in this field. In considering the whole range covered by the term "financial cooperation" one must certainly include the support provided by the private sector. Seeing that the IFC aims at exclusive cooperation with private capital as a partner on as equal terms as possible – a concept dictated by its obligation to treat its financial resources as a revolving fund – it is only logical that it should focus on purely commercial interests and the profit motive. Other criteria, including that of usefulness to the general economy, must necessarily be deemed less important; it is in any case very difficult to check whether they are being met. If the IFC is subjected to very strong attacks

from some quarters, their criticism is directed less at the organization itself than at those who evolved the concept on which its work is based.

The authors of the IFC's Articles of Agreement are also open to criticism on the ground that they have produced a broad mixture of partly contradictory ideal concepts for guidelines to cover the Corporation's operations – ideals and concepts which cannot be adhered to simultaneously. It would certainly have been better to formulate two or three clear principles. This would have saved the IFC from the unwarranted charge that it was failing to fulfil its tasks. To economists it also became clear at an early stage that the IFC concept was from the outset quite unsuitable for the poor and poorest developing countries which have no private capital and even less chance of offering attractive investment opportunities to foreign investors.

### **Overcautious Behaviour**

Apart from these "programmed" difficulties of the IFC, the Corporation, its management and its executives have given cause for criticism, especially by their overcautious behaviour in the initial phase which, together with other factors, gave rise to the argument that the very meagre business results proved that there was no need at all for the Corporation or its efforts. In recent years the internal targets were still not reached, it has been learnt from staff of the World Bank group. The IFC should be prepared to take the common risks in its sphere of business and in that of its partners, even though it would thereby invite the charge of competing with private capital. It also needs

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adequate publicity in the circles with which it could cooperate. This would help it to emerge from the shadowy existence for which it has itself been partly responsible. It is most important for this purpose that, in addition to improving its capital supplies and personnel, it should settle its relationship with the World Bank and improve its position within the World Bank group. The IFC could be helped greatly to play a more significant role if it made more consistent use of the instruments available in the World Bank group.

### **Difficulties among the IFC Partners**

Difficulties also arise among the partners of the IFC. One of the basic facts is that many countries in the Third World and the enterprises in various areas of these countries are not yet able to provide the economic or practical financial prerequisites for cooperation with the IFC. Among the reasons for this are infrastructural shortcomings, capital outflows, inefficient use of what finance is available and legal restrictions and checks on private investments by foreigners; such investments are only in rare cases actually encouraged by legislation. Foreign private capital is treated quite generally with a distrust which is by now almost traditional. Investors from industrialized countries therefore tend to keep aloof, especially if not allowed to acquire majority holdings. Many of the prospective host countries make extensive use of central economic planning, and foreign investors must submit to very high taxation and are frightened off by the threat of expropriation. Finally, qualified personnel is in short supply, especially for management.

Many private enterprises in developing countries are owned by members of one family who are reluctant to share with other investors or admit outsiders to the management of their enterprise. Accounting methods often give no real insight into the financial status of an enterprise, with the result that on occasion costs which have arisen cannot be contained. Problems are in some cases created by inaccurate information about market prospects and the duration of financial work. All these circumstances make it difficult for the IFC to evaluate projects and their prospects in the future. Few enterprises are able to meet the investment criteria of the IFC.

The close cooperation between the World Bank and the IFC planned by the initiators of the institution did not progress in practice as hoped. This was largely because there was a sort of rivalry between the two organizations; the staff of the World Bank and the IDA were not particularly interested in the work of the IFC

but many of them thought that a department integrated with the World Bank could have coped better with the tasks of the IFC.

### **Future Prospects**

The continued existence of the IFC will depend in great measure on its ability to cope with the new kinds of difficulties which will face it in the immediate future. Basically the prospects for private foreign capital seem to have become more favourable again. Finance from foreign private investors was universally frowned upon during the sixties, but this has changed now as is shown clearly by the huge sums which the developing countries have been borrowing in the Eurodollar market. There is by now a wide-spread apprehension that the repayment of these borrowings will cause difficulties.

For the IFC a great deal will depend on the sources for additional finance for its current business. Additional drawings on the World Bank can only aggravate the present dependence of the IFC on its parent. Thought should be given to a direct approach to the stock markets by the IFC or the underwriting of a sale of bonds. Of special interest are ways in which the IFC can involve itself in the recycling of the funds at the disposal of the oil exporting countries since the drastic price increases for crude. Of importance will also be the effect of the attitude of the developing countries to foreign private capital as expressed for instance in the UN debates on "collective economic security".

Finally, it has to be considered whether and what structural changes are called for. The proceedings in this context in UNIDO show how far the reconsideration of the overall concepts of other international organizations extends and what great doubts are entertained about their validity. The discussion about additional resources for the IFC may provide an occasion for debates about changes to be effected within the organization, as happened once before, in 1968. It would be of the greatest importance if the standing of the IFC in the World Bank group were enhanced. It would enable the IFC to turn the experience of other parts of the group to use, to obtain more generous supplies of capital and to perfect its instruments in all fields. A decision could perhaps be taken to incorporate the IFC in the World Bank as an independent department, similar to a previous proposal which was made before the institution was set up. This may not be the worst solution for the International Finance Corporation.