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GROWTH PARTICIPATION UNITS:
A PROPOSAL FOR A NEW LONG-TERM FINANCIAL
INSTRUMENT FOR DEVELOPING COUNTRIES

Tamir B. Agmon

October, 1974

WP 744-74

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The financing of long-term growth in developing countries has become more of a problem every year. The recent crises in the international money market have emphasized the more basic problem of long-term funding of development. To maintain their economic goals the developing countries should find a way to approach the major private capital markets including the external currency markets. The necessity to find new long-term financial instruments becomes more evident in the face of the dwindling supply of the traditional long-term subsidized funds.

In the following pages one particular new financial instrument is discussed as a potential way to attract private sector long-term financing of development. This proposal should be viewed as only one possible idea. Implementation will require much more detailed work, particularly with regard to the financial institutions to be involved.

Growth Participation Units - The Proposed
New Long-Term Financial Instruments

Growth Participation Units (GPU) are somewhat like a convertible bond in reverse. More accurately, it is a share issued with a put which may be exercised at a certain future date.

A GPU entitles the investor to a given proportion of a portfolio of privately placed investments in a particular developing country. The redemption date and the redemption value (or the striking price and the exercise date of the put), are predetermined. The assets in the portfolio are, for the most part, privately placed minority interest in existing enterprises within the developing country. The Growth Participation Units are denominated in terms of convertible currency and they are supported by a risk sharing program with regard to political risk. (The nature of the guarantee and the risk sharing mechanism are discussed below.) The redemption value and the redemption dates are set in such a way to assure the investor of a fixed nominal rate in his own currency. Obviously this rate will be lower than the market rate for comparable straight debt instruments issued by the same issuer.

The GPUs will be traded in a secondary market. In countries where such a market does not exist, the issuer of the GPU will create a secondary market by being ready to buy GPUs at any date at a minimum price which reflects their yield to redemption value.

Given an economic success of at least a part of the enterprises whose shares are included in the basic portfolio, the market value of the GPUs will be higher than the price based on their future redemption value only. The owners of the GPU will participate in the growth of the portfolio by an increase in the market value of their GPUs.

Dividends received by the issuing firm may either be reflected by an additional increase of the market value of the GPUs, or will be passed to the owners of the GPUs in the form of bonus units, dividends, rights or any other means as the case may be. The additional bonus unit will also have a floor value set by a fixed redemption date and price.

Growth Participation Units - Tracing the Desired Characteristic

The best way to present the proposed new financial instrument - Growth Participation Units (GPU) is by posing the following two questions:

- (a) what are the desired characteristics of a long-term financial instrument from the point of view of a typical developing country?
- (b) what are the desired characteristics of such an instrument from the point of view of an investor (institutional or private) in the international capital market?

A viable long-term financial instrument of a developing country should combine as many characteristics of both (a) and (b) as possible. This may seem contradictory as, for example, the country would like cheap money whereas the investor likes high yield. However, a long-term instrument can be tailored to fit some of the desired characteristics on both sides at the same time.

To the issuing country or the issuing institution, the desired characteristics are:

- (i) long-term instrument
- (ii) low fixed contractual payments
- (iii) enlarging the scope of financing, attracting funds from new sources
- (iv) minimum direct control and management by foreign investors
- (v) increase in foreign exchange reserves

To the international investor the desired characteristics are:

- (i) opportunity for international diversification in relatively small amounts
- (ii) low exchange and political risks
- (iii) a mixture of fixed income plus an opportunity for growth
- (iv) possible preferential tax treatment

The proposed GPUs combine the desired characteristics for the potential investor as well as for the issuer. Basically the issuer is selling something in which he has a comparative advantage - the added dimension of increased international diversification. The proposed GPUs are aimed mostly at institutions and private investors who may be willing to consider an investment of a small proportion of their portfolio in a developing country and, by this, introduce to their portfolio a small amount of international diversification which they cannot obtain elsewhere. In addition to that, in some countries the GPU may qualify under tax regulations for direct investment in developing countries.

As for the developing country (or the developing country's financial institution) the new instrument appeals to a segment of the market which was hardly approached before for this purpose. The country may acquire equity type funds while the mutual fund character of the GPU leaves complete management and control in the hands of the local management. This last point assumes more and more importance as developing countries become increasingly uncomfortable with the controlling element associated with direct foreign investment.

Guarantee Swapping - International Sharing of Political Risk

One of the main hindrances for international investment is the existence of political risk. Political risk is a rather vague notion to include many different contingencies. Political risk can materialize in the shape of outright expropriation, delayed conversion, special discriminatory taxes on foreigners, ban on repatriation of profits or any other device to impede the free return of capital to the foreign investor.

Most of the developing countries recognize the problem as a valid one and are trying to reduce the risk by offering guarantees to the investors. The guarantees usually cover repatriation of profits, convertibility and, in the case of pegged exchange rate, they may include fixing the rate for a particular type of transaction. The main problem with these guarantees is that they are issued by a foreign government in which the investor in another country may not have faith. If the political risk is associated with political instability, then a guarantee by a presumably unstable government is rather cold comfort. Consequently it is proposed that the GPUs will be guaranteed against political risk under a plan of guarantee swapping.

An example may be the best presentation of the proposed program. Suppose that a financial institution in Ruritania has decided to float an issue of GPUs based on a portfolio of privately placed equity investment in Ruritania. Also assume that the government of Ruritania has agreed to guarantee the foreign buyer of the GPUs free convertibility, free repatriation of funds and equal taxation. Suppose that the GPUs are sold on the German, Dutch and Belgian markets. Under the guarantee swapping plan

the Ruritanian government or some agency like the central bank, will negotiate guarantee swapping with say the German, the Dutch and the Belgian central banks. The local institutions will guarantee the local investor in each one of the three markets mentioned and, in return, will receive a similar guarantee from the government, or the bank, of Ruritania.

The advantages to the local investor of guarantee swapping are obvious. Political risk is reduced to a minimum. The GPUs become less risky and thus more attractive. As for the guarantor there are two arguments in support of the guarantee swapping.

- (a) In many cases, the perceived political risk by an individual investor is larger than the actual risk. Governments or central banks can judge the political risk better than an individual investor. Thus the sharing of risk by local institutions (or even international institutions) can decrease the real cost of risk bearing from a macroeconomic point of view. Also governments or central banks are better equipped to deal with the consequences of political risk than individual investors.
- (b) Developing countries can argue that guarantee swapping is an efficient and inexpensive way for the major industrialized country to provide aid for development. Technically there is no transfer of funds involved nor has it any current effect on the budget of the developed country.

