

Petersen, Dietmar

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# Investing in Developing Countries — Chances, Hazards, Facts

by Dietmar Petersen, Cologne\*

**From its beginnings on the DEG (German Development Company) has always been working with two aims in mind. Development policy provided one and the external economic relations of the Federal Republic of Germany the other. It is contributing to economic development by supporting investments by German firms in the Third World and by encouraging cooperation between German investors and local businessmen on a partnership basis.**

The wedding is taking place although the bride is reluctant — this is how the commentator of a supraregional German daily summed up the reservations of private industry about the new “state enterprise” when Deutsche Gesellschaft für wirtschaftliche Zusammenarbeit (Entwicklungsgesellschaft) mbH<sup>1</sup> — or DEG (Deutsche Entwicklungsgesellschaft) for short — was founded on September 14, 1962 in the offices of the Chamber of Industry and Trade in Cologne. Its founder was Federal President Walter Scheel who at that time was the Federal Minister for Economic Cooperation.

The need for a separate financial institution to encourage German direct investment in developing countries seemed all the greater in the early sixties because German industry — having witnessed the expropriation of its foreign assets after both world wars — had re-established itself in the world economy mainly as an exporter and less as an investor. It was short of capital, so that medium-sized firms in particular were often unable to make investments in developing countries.

### A Twofold Task

The establishment of a German development bank for the promotion of German direct investments in developing countries was therefore required for the sake of the private business firms concerned as well as in the national economic interest. The DEG stated already in its first annual report in 1963: “The primary aim of Deutsche Entwicklungsgesellschaft is to contribute by its activities to the advancement of the economies of the

developing countries. Simultaneously it is in the interest of the industrial countries themselves as well that private business enterprises should be started in these countries, for the long-term future of our industry will not be labour-intensive productions but it lies in areas where a high capital input and specialized work create products which cannot be made elsewhere as well if at all. The stability and growth of the German economy will in the future depend to some extent upon how well and how quickly those sections of it will be restructured which cannot remain competitive in the long run. Assistance with the industrialization of the developing countries is in this sense consistent with improved division of labour in the world economy.”

From its beginnings to the present time the DEG has always been working with two aims in mind. *Development policy* provided one and the *external economic relations* of the Federal Republic the other. Under development policy aspects it has had the task of contributing to economic development in the poor countries by supporting investments by German firms in the Third World. The business philosophy of the DEG is clear from its full name — German Company for Economic Cooperation: its aim is to encourage cooperation between German investors and local businessmen on a partnership basis.

As far as the domain of external economic relations is concerned, it is the task of the DEG to help to increase the capital exports of German business firms in the form of direct investments.

Owing to this twofold task the DEG finds itself torn by the constant tension between efficiency as an instrument of development policy and profitability as demanded by commercial considerations. On the one hand, it is only to participate

\* Head of the Department for Economic Affairs and Basic Issues of Development Policy of Deutsche Gesellschaft für wirtschaftliche Zusammenarbeit (Entwicklungsgesellschaft) mbH — DEG, Cologne.

<sup>1</sup> German Company for Economic Cooperation (Development Company), abbreviated: DEG (German Development Company).

in profitable investments in suitable countries. On the other, it must strive to create permanent employment and to cut down foreign currency requirements by import substitution and/or augment the foreign currency earnings by increasing the production for export.

As the capital of the DEG is owned in full by the German state, it has to demonstrate its readiness to engage in pioneering projects both as an entrepreneur and as a development agency while it must at the same time make allowance for the long-term nature of its prospective earnings and for the inevitable risk concentration when investments are made exclusively in countries at an early stage of economic development. The DEG has been accurately described as "a cross-breed between bank business and development policy".<sup>2</sup>

### **Making Investing Less Risky**

The DEG encourages investments by German firms in developing countries by taking a capital interest in enterprises in developing countries or granting loans of a similar nature. The DEG thus provides risk capital so as to enable German business firms with a narrow capital basis to set up manufacturing facilities in developing countries and thereby to avail themselves of locational advantages and growing markets and to improve their international competitiveness.

It is essential that the DEG does not help to finance the German enterprise, but the enterprise in the developing country, which is subject to the local law and in which the German entrepreneur as expert and a local partner participate. This involves a special risk: through its capital holding as a business partner the DEG shares the risks of the new enterprise – and this means, all the future hazards and chances of an investment in a developing country – in full.

Besides, the DEG grants long-term investment credits for up to 15 years on fixed terms tailored to the particular amalgam of risks of the private investor in the Third World.

The Federal Government is providing tax monies through the DEG in order to alleviate the risks facing the German investor. No commercial bank would be willing to undertake the hazardous business of investment finance in developing countries by providing risk capital.

Operating like a commercial enterprise, the DEG must cover its expenditure by achieving adequate earnings from its engagements. It will therefore only participate in the financing of investments if there is a reasonable prospect that they will earn profits after an appropriate initial period. As a recompense for taking on the risk the DEG lays

claim to a share of the profit and charges loan interest at the customary market rates in the developing country.

The investments of the DEG consist currently as to 47 % of participations and as to 53 % of loans. These figures show that – compared with similar financial institutions elsewhere – the DEG accepts a remarkable measure of direct entrepreneurial risks. It has to be borne in mind that any capital investment in the form of a participation on average yields no dividend income in the first five years.

### **An Efficient Institution**

After 16 years of experience in investment finance in the Third World the DEG may be said to have proved its proficiency as a marriage partner. The bride had not to discard him quickly on the ground of general exhaustion. Since 1962 the DEG has played a part in the establishment or enlargement of 216 enterprises in 60 developing countries and invested about DM 600 mn (June 30, 1978). The total investment by enterprises which the DEG has helped to finance is by now over DM 3.7 bn. DEG commitments have had the effect of mobilizing five times the amount of finance which it has provided itself. The present DEG engagement totals DM 463 mn in 171 enterprises in 56 developing countries.

The expansion of the DEG's activities is reflected by the increase of the capital stock used to finance its participations and loans of a similar nature. Between 1974 and 1976 this was doubled, from DM 300 mn to DM 600 mn. In 1977 it was raised by a further DM 100 mn to DM 700 mn. It is the main purpose of these repeated capital additions to enable the DEG to offer increased support to German firms when investing in capital-intensive raw material-processing industries and to extend its commitments in the development bank sector.

In the current year the basic capital has been increased once more, to altogether DM 1 bn. On the strength of this increase the DEG will devote larger funds to German investments in South European countries – in Portugal, Spain and Greece.

The DEG insists invariably on thorough feasibility studies and gives continuing close attention to its financial interests in order to make sure that it can eventually dispose of its engagements also in the long run. By the end of 1976 the DEG had incurred actually realized losses (since 1962) of about DM 12 mn involving 15 project companies. About 54 % of these losses were due to com-

<sup>2</sup> Frankfurter Allgemeine Zeitung, August 24, 1977.

mercial causes; 46 % only were attributable to political reasons.

### **Difficulties for the Investor**

What difficulties are facing the businessman who wants to invest in a country of the Third World? Although most investment failures in developing countries are due to a combination of causes, two factors stand out in the experience of the DEG:

- Weak management in the new enterprise and
- Misjudgment of the (local) market.

Developing countries have their own time scales. This may seem a trite observation but can lead to grave consequences for a business enterprise. It happens again and again that the time needed for the implementation of an investment decision – from planning to crossing the profit threshold – is underestimated. But if the time schedule is wrong, the finance plan will not work out either. Owing to a number of special factors – a labour mentality inherited from pre-industrial days, inadequate training and low technical qualifications and proficiency – project planning and implementation take much more time than would a similar investment in the home market.

Legal provisions based on alien law categories, cumbersome licensing procedures, strange consumer habits, functional shortcomings in the local money and credit markets and inadequacies of transport and communications, etc., also create difficulties. Most planning mistakes are therefore related to the time schedule and thus to the financial planning, with the result that the effective financial needs are often far in excess of the forecasts.

Additional financial arrangements will in such cases have to be made later, chiefly because of planning mistakes concerning the fixed assets and underestimation of the equity capital requirements. It is a fact that the finance for any investment in a developing country has to be tailor-made. It can therefore only be suggested that financial dispositions should be on the generous side.

German business firms often underrate the economic and political importance for the developing country of setting up a subsidiary company. An operation with a labour force of 200 or 400 may be insignificant compared with the manpower employed at home but in the developing country it may well be the major employer in a region, and its potential influence on the social and political life will be correspondingly great. Factors "beyond supply and demand" have therefore to be considered together with the economic conditions pertaining in the investment country.

More and more Third World countries promulgate regulations on minimum participation of native interests in the capitalization and management of foreign enterprises. This trend towards national ownership does not normally reflect any animosity to foreigners or opposition to the profit motive. Most developing countries want foreign investments because they are convinced of the advantages of private entrepreneurial initiative for the industrialization of their economies. But they wish to have a say in the decisions on the forms in which foreign enterprises contribute to the development of their economies. This trend towards national ownership is by now irreversible, and foreign investors can only be advised to reconcile themselves to this fact.

### **Joint Venture**

The DEG regards the idea of partnership between an investor in the Federal Republic and a local enterprise ("joint venture") as basic to successful engagement in the Third World and has treated it as a guideline for its business policy ever since it was established. A joint venture is in the experience of the DEG the most suitable means of bringing the interests of the German investor into accord with those of the developing country and integrating the new enterprise into the host country. Not the least of its advantages is that it is an effective means of protecting the investment against political hazards.

The local partner, it is true, will not always fit in with West European ideas of modern industrial management: the dominant mentality in quite a number of developing countries is still to aim at a quick trading profit rather than to invest for the long term.

It certainly has its advantages for the foreign investor to have a local partner who complements the outside partner's commercial and technical know-how by his own know-how of the local market, financial conditions and administrative set-up. Provisions for part-ownership can create a problem for the young enterprise if the local partner insists on his (majority) participation but is not able to raise enough capital for the operation.

The result is that many new industrial ventures are from the very beginning undercapitalized or else take so much longer to reach the profit threshold that the foreign investor is compelled to provide long-term credits – to be serviced regularly from the first year onwards and thus presenting an immediate charge on the financial results – instead of making a larger capital contribution.

A problem which medium-sized investors often find especially difficult to solve is the provision of

suitable management personnel willing and able to work abroad and capable of negotiating in the foreign language as well as in their mother tongue. Needed are leadership qualities to be applied in alien surroundings and in the face of alien mentalities, the capacity to cope with foreign laws and authorities and the ability to withstand the strains of life in a tropical climate with unfamiliar foods. If the German firm has employees with such qualifications on its staff, they can often not be spared at headquarters in Germany.

Many medium-sized firms are aware of the specific advantages of operating in the foreign market but dare not take the decisive step across the border, mainly because of their limited capital base, management potential and ability to negotiate successfully with foreign administrations. There are various ways of coping with these problems. Thus a sound investment concept need not fail for lack of capital. The DEG is ready to provide risk capital for investors in the Federal Republic.

#### **An Extended Joint Venture Model**

There is, moreover, a new concept for financing business enterprises which may develop into a promising model for direct investments in Third World countries in the future. It is aimed at extending the "traditional" joint venture model (which may for instance involve a firm in the Federal Republic, the DEG, an entrepreneur in the developing country and a local development bank) by bringing in more than one German investor. To give an example from the DEG's own experience: Several medium-sized German engineering firms, each with its specialized know-how, start a joint venture with a local partner and the DEG in which components for their various machine-building programmes are made by common fabricating processes. In addition the German firms set up individual local firms in the developing country for the final assembly of machines from components made and supplied by the joint venture enterprise.

The advantages of such an arrangement are obvious: Several business firms with limited financial resources and production ranges are enabled to cooperate with one or more local partners as well as a local and a German financial institute. Their previous exports can in this way be replaced by local manufactures at more favourable unit costs as optimum use is made of a plant and management capacity of minimum size; the participating firms could not operate such a plant were each to act on its own. Not only is the capital risk involved "parcelled out" among the partners but the problem of installing the smallest technically practicable and yet profitably operating plant size is solved as well.

#### **Financial Interests of the DEG**

The substantial DEG engagement in national and multinational development banks is of special interest to the German investor. The DEG has currently shareholdings in 33 development banks, including three supraregional financial institutes for business investments in Africa, Asia and Latin America and 30 local development banks in 27 developing countries. The DEG takes an especially active part in the financing of local development banks in developing countries which have been ignored by German firms in the past or were not easily accessible to them. Active cooperation in the management boards enables the DEG to spot investment opportunities and project ideas for German partners, to offer additional consultancy services to them and to dovetail their investments in the best possible way into the local development planning. Its direct interest in such development banks also enables the DEG to draw on these institutes increasingly as financial partners for other DEG projects. German investors are availing themselves more and more of this means of access to local finance and local partners.

If the capital engagement of German industry in the developing countries is to be increased with lasting effect, further financial concepts will have to be devised or perfected for its direct investments in the Third World. One model which has already proved its value is that of a financial consortium for business investments in developing countries which links the DEG with other European financial institutes pursuing similar commercial policies.

It is the aim of such a consortium to Europeanize or internationalize the financing of direct investments in Third World enterprises by a kind of concerted action. This financial concept is especially well "matched" to investment projects of a size exceeding not only the financial resources of the individual investor (even in conjunction with a local partner) but also the capital-investing and lending capabilities of a single financial institute. Not only can the consortium spread the risk but the investor is able to draw on the cumulative know-how of several experienced development banks for his project.

Participation by a consortium of several specialized banks can keep the investor's risk within reasonable limits and yet allow him to make full use of attractive market opportunities in developing countries where investment risks are often greater. Last not least, cooperation with such an international consortium provides greater political security against arbitrary interference in the developing country.