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ARTICLES

CAPITAL MARKET STANDING

New Proposals for Development Aid

By Dr Wilhelm Hankel, Frankfurt/Main

The following observation is not incorrect: the view that developing countries, precisely because they are in the development stages of their economy, do not have any standing in the world's capital markets forms the common professional "philosophy" of all official—both national and international—development aid authorities. The argument runs like this: since capital markets and commercial capital exports can only very rarely or in purely marginal cases, be called upon for meeting developing countries' capital needs, investment and capital goods that are needed and which are provided by industrialised countries for accelerating the rate of growth in developing countries must be financed from government budgets. And this is believed to be especially so with regard to so-called capital assistance given to developing countries, which is usually offered in form of state-financed credits at conditions that are more or less highly subsidised, which means that their rates of interest, redemption periods, and periods during which no repayment will be made, do not correspond to those created by the market.

Causes of Traditional Financing Arrangements

In most cases, the question remains unanswered why capital exports that have been refinanced in accordance with market requirements pass by to-day's developing countries, which was not the case during the nineteenth century, and why such capital exports nowadays are known only as part and parcel of mutual long-term investment and export financing between industrialised countries. If anybody attempts an answer, he usually argues that "conventional" methods of financing are doubly unacceptable: he will state that neither could creditors in his own country be asked to accept the big economic and political risks of investing their funds in developing countries, nor could developing countries, poor in capital funds and in convertible currencies, be required to carry the burden of the "harsh" conditions attached to commercial financing, i. e. conditions dictated by the market. The further inference is obvious: as commercial funds evade the developing countries, public funds, which are believed to be less susceptible to risks, must be used, and their "softer" conditions would have the added advantage of lightening the

burdens on debtor countries' balances of payments, that are anyway under pressure constantly. Admittedly, nobody demands that such capital aid that is refinanced from public funds should do more than supplement insufficient commercial capital exports; they should by no means be completely replaced.

It will be worthwhile to take this philosophy to pieces, to analyse the reasons adduced for it, and to study closely the conception derived from it for methods of financing, by the way not only of capital aid, with a critical mind. At a first glance, more than six years' experience in giving capital aid might indeed tempt any observer to conclude that the official calculation about "supplementing commercial aid" has been largely vindicated. Thus, Western Germany, as the table supplied shows, has exported annually about DM 2,500 million during the early sixties (1960-1965), using these funds for direct investments, purchases of securities, participations, advances, and other capital transactions. However, only one fifth of this total, which is not large in view of the strong German position in world trade, and held against the entire volume of German capital market transactions, namely just over DM 500 million annually, has made its way into non-European developing countries. On the other hand, Federal German exports to these countries, on average, were valued at about DM 12,000 million annually, and of this total, more than DM 5,000 million, or 40 %, have always been for heavy investment goods (heavy engineering, shipbuilding, heavy electrical engineering and plant, telecommunications, and construction jobs), so that commercial capital exports to the same areas represented only 4 % and 10 %, respectively, of product deliveries. Had they been dependent on private capital export facilities only, they would have been forced to pay cash for 96 % of their total imports and for 90 % of their heavy capital goods imports from the Federal Republic.

Redirection of Capital Exports

This gap, however, has been bridged by capital aid and — it must be added — by long-term export financing which, from 1961 onwards, has been directed mainly to developing countries through a deliberate guarantee policy. During the period under review,

capital aid thus has channelled annual amounts of about DM 1,100 million, and export financing additionally about DM 700 million p.a. (of an annual total of DM 900 million), towards developing countries. Overseas developing countries, therefore, received from the Federal Republic a capital flow totalling annually roundabout DM 2,300 million, and taking the years 1962-64 separately, an average even of DM 2,800 million. The proportion of financial provision for exports generally, and for exports of heavy capital goods, through long-term credits thus grew to 22 % and almost 50 %, respectively.

Average figures, however, can be deceptive, and in this case, they conceal the fact that during the time under review, export lendings to developing countries through capital aid and through the practice of issuing export credit guarantees rose steeply after 1960, from DM 800 million in 1960, to DM 2,200 million in 1965, whilst commercial investments declined steadily during the same period from DM 900 million in 1962 (there are, unfortunately, no complete figures available for 1960) to DM 400 million in 1964. The impressive rise by DM 1,400 million per annum shown by publicly financed capital aid and publicly managed export credit guarantees, was unfortunately accompanied by private commercial capital exports dropping by at least DM 500 million — the drop was probably even steeper, in a period when long-term mobilisation of funds in Western Germany, known as the so-called capital market volume seeking investment via banks, other institutional investors, and the investing public, has more than doubled from DM 20,000 to more than 44,000 million.

Declining Competitiveness of Commercial Capital Exports

There is no easy and simple explanation for this decline, both in relative and absolute terms, of commercial capital exports (that are refinanced through

the capital markets) to developing countries in the context of capital market volumes that have been incessantly expanding up to 1965, and of an export drive that has gained more momentum even after 1965. It is, however, certain that this decline is to be considered in connection with the terms of capital aid as well as the methods of issuing guarantees used by the Federal authorities, which are granted for suppliers' and buyers' credits only. From 1961, the gap between the conditions laid down, on the one hand, for commercial capital exports, and those for government-financed capital aid has progressively widened: in 1962, the weighted average rate of interest for capital aid was just under 5 %, but in 1966 it had dropped to fractionally above 3 %; redemption periods, at the same time, on average, grew longer by more than five years. On the other hand, interest rates in German capital markets have simultaneously increased from about 6 % to more than 8 %, and redemption periods for loans have grown progressively shorter.

This simple comparison between costs thus supports the suggestion that commercial capital exports to developing countries are no longer competitive both for the German investor in foreign countries and the German supplier of capital goods, in the age of capital aid. A policy of "soft" (that is, designed for supporting ailing balances of payments) conditions for capital aid, the motivation of which is easily understood from the point of view of the world markets and the global economy, have set in motion a new form of Gresham's Law: cheap, publicly-financed capital aid credits have driven out expensive commercial credits from capital markets. Capital aid, when being used for financing the export of investment goods from the Federal Republic, has become an indirect subsidy to German exports. But at the same time, without the intention of doing so, this method has also hemmed in commercial capital exports and restricted them to

Pattern of German Capital Exports 1960-65
(in DM million)

	All countries						Annual averages	Annual averages	Non-European Developing countries						Annual averages	Annual averages	Column 16 in % of column 8
	1960	1961	1962	1963	1964	1965	1960-65	1962-64	1960	1961	1962	1963	1964	1965	1960-65	1962-64	
	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17
Direct investments	740	681	1,113	1,115	1,134	1,112	983	1,121	298	267	421	281	205	251	287	302	27
Purchases of securities (shares, bonds, etc.)	715	205	733	475	833	1,046	668	680	.	.	169	69	45	.	.	94	14
Participations (not by acquisition of shares)	267	300	325	393	434	406	354	384	.	.	118	50	74	.	.	81	21
Advances, Loans	329	423	99	150	382	226	268	210	.	.	218	6	56	.	.	93	44
Miscellaneous	124	179	225	176	166	217	181	189	.	.	7	—9	—9	.	.	—3	.
Commercial investments (lines 1-5 together)	2,175	1,788	2,495	2,309	2,949	3,007	2,454	2,584	.	.	933	397	371	.	.	567	22
Export finance through AKA and KW *	643	589	1,000	826	1,051	1,208	886	959	542	483	700	656	762	896	673	706	74
Capital aid	272	970	1,363	2,008	1,073	1,254	1,157	1,481	272	970	1,363	2,008	1,073	1,254	1,157	1,481	100

Sources: Statistisches Jahrbuch für die Bundesrepublik Deutschland; KW-Geschäftsberichte; AKA-GB; Rhein.-Westfäl. Institut für Wirtschaftsforschung, Issue No. 10, 1965: Die Direktinvestitionen der Bundesrepublik Deutschland im Ausland 1952 bis 1964; Bundesanzeiger, 14. April 1966: Vermögensanlagen in fremden Wirtschaftsgebieten (31st March 1966).

* KW = Kreditanstalt für Wiederaufbau (Reconstruction Loan Corporation), AKA = Ausfuhr Kredit AG. (Export Credit Company)
GB = Annual Report

special transactions which can still but only just bear the burden of "hard" conditions derived from the market.

Not a Chance for Developing Countries

But unfortunately, this is by far not everything. After the dividend coupon tax had reopened the German capital market somewhat brutally, and its not being applied to issues launched by foreign companies has given it international importance, this market has become a grazing ground that attracts, judging from what is known about the direction of the world's capital flow, debtors who are literally doing harm there: foreign local government authorities of very highly developed countries who desire to balance their budgets, and well-known companies from the United States, to whom financing their European and overseas investment and expansion programmes in the American capital market is not possible any more or has been forbidden. There is no question that the freedom of capital movements which enables investors to carry out such transactions is to be welcomed unreservedly, but it should not be used as an unlimited general licence for promoting such one-sided developments, for it does not only tie up funds that are needed for the financing requirements of the German export industries but those who are really robbed of indispensable imports of investment goods are the developing countries that suffer from a perennial scarcity of capital of their own. It is self-understood that investors and project managements of their developments have not a chance to compete with the gilt-edged loan bonds of such foreign local government authorities or with the resounding names of giant international concerns — except at fantastic rates of interest, which destroy any reasonable calculation.

The Method of Issuing Guarantees Unsatisfactory

How did all this come about? But what is more important: how could we reverse a development that is so conspicuously harmful to developing countries? One decisive factor, unfortunately hardly seen, is a completely outdated feature of our export credit guarantees, which originates in the past, when the German capital markets had not yet been revived: the guarantees are onesidedly tied to suppliers' and buyers' credits. This is a specialised form of capital export which inadvertently helped to reinforce the trend towards degeneration of this business. The guarantees, a tool originally designed to improve the credit standing in which the potential debtor is lacking, had discriminated against raising funds in the capital markets by simply ignoring this form of investment. If there existed a payment and transfer guarantee, drafted after the models of the Berne Convention and the Brussels Accord on Consultations, and, applicable to selected loan issues made by developing countries, developing countries would enjoy the chance to find refinancing credits in the German capital market. To sum up: that the German capital

market never sees loan issues of developing countries is not only due to their admittedly low credit standing, based on the big economic and political risks to which their guarantors are exposed, but also to a series of omissions by the authorities issuing guarantees: it must not be forgotten that such guarantees have hitherto covered the uncalculable extra risks for certain forms of credits only, and not for all of them.

This now leads to another conclusion: it would certainly be possible to draw on the German capital market for considerable sums to finance capital aid. But as has been shown, one condition that has to be met for this purpose is complete competitive neutrality of official capital aid towards commercial capital exports. Such neutrality has been frustrated up to now through the inadequacy of the official conditions. A second indispensable condition is the extension of guarantee issues, so that they will include loans raised in the capital market, and such guarantees obviously did not exist in the past. But the two structural faults of German capital market policies can easily be repaired.

Credit Conditions Made Easier by Differentiating between Credit Types

Instead of restricting assistance to capital aid credits only by subsidising the conditions attached to them ("soft" rates of interest for countries with weak balances of payments, and "hard" rates of interest for projects that promise to become highly profitable, and the possibility to "split" the rate of interest), it should be possible in future to issue two completely different types of capital aid, that are distinguished also by their conditions:

☐ Project credits, supported by a state guarantee in the same way as export credits have been helped, to be refinanced from capital markets and offered at rates of interest determined by the market.

And then:

☐ Balance of Payments credits, to be refinanced directly from the Federal Budget under the Federal Government's own guarantee, and offered at "soft" rates of interest and conditions.

In other words, easier credit conditions, which have hitherto been offered for standard credits, in order to protect the developing countries' balances of payments, should no longer be used, but two different types of credit ought to be mixed, and interest subsidisation only carried out where needed. Whereas subsidies have hitherto not been competitively neutral, "softening" of credit conditions, which is indispensable for developing countries, should be offered through two different types of credit, that will not compete against each other, existing side by side in line with the market. This may look like a highly theoretical construction at first glance, but its practical effects would be: refinancing could be carried out under a clear division of labour between state aid and commercial aid through the capital market.

Government-to-government loans, on soft conditions, would be subject to the necessities of developing countries' poor balance of payments and transfer situation, and capital aid credits, refinanced through the capital market, geared to individual projects, and sometimes also tied to supply contracts, would be offered at the rates the market will bear. Clear market conditions would replace the odd duplication, and frequently completely chaotic mixture, of capital aid and export financing. The two forms of raising credits by developing countries would be carried out on separate levels which would not — and this is the focal point — compete against each other. In the one case, the debtor is a government or its central bank—an authority which does not act as investor; in the other case, the debtor will be the author of, or the agency responsible for, a given project, that is, even if the debtor should be a state entity, he will be an investor (not his legal form but his function or task—to earn profits—will be decisive).

Only by clearly and cleanly separating the functions of the basic tasks of capital aid, the operation of a new "Gresham's Law" can be prevented: when one type's main task is to finance investments in the developing country, the other one mainly strengthens the recipient country's balance of payments and thereby helps to cover internal development against external influences. Putting it differently: only by adapting the forms of financing to its functions will it be possible, in the long run, to combine the advantages of both commercial capital export and publicly-financed capital aid and to carry out the grand design of development aid without inadvertently making destructive inroads into worldwide economic co-operation.

State Guarantees for Government Loans of Developing Countries

A second measure of reform would have to be the setting-up of state guarantees for DM loans to developing countries. As shown before, it is only a half-truth to say that developing countries have to be "spoonfed" with public funds, called development aid, because they lack creditworthiness. It ought to be within the grand design of a development and export financing policy based on market principles, for the Federal Government, for example, to issue the necessary remittance transfer and redemption guarantees to back up loans to selected developing countries that are tied to purchases from the Federal Republic. The advantages of such a method are obvious: much more effectively than by preaching and moralising, educational principles would influence the developing countries' economic policies. They would be pressed to act as worthy recipients of capital aid, by behaving in a way that safeguards and increases, instead of risking, their capital market standing. The

German Federal budget could also shed some useless burdens that had in the past to be shouldered for the good of development aid. And even the guarantee budget would not grow, because extending the volume of guarantees, actually, does not mean that the Federal Republic increases its net engagements. All that happens is largely an exchange of labels: export guarantees would be replaced by loan guarantees for the identical transaction. Instead of being deflected to the short-term expedient of suppliers' credit business, projects, according to their type, would get adequately long-term finance, with highly beneficial effects on most developing countries' balances of payments and levels of indebtedness.

Benefits

Practically, this would mean the demolition of the high and generally uncrossable threshold between different risk levels applying to home investments and foreign investments, or foreign investments considered to be "gilt-edged". It would thus become possible that the German federal guarantee supporting a loan made to a good debtor country transforms these loan bonds, by degree of risk and reliability, into a quasi-German security. To place such bonds, once this idea has become widespread, would be no more difficult than to sell German federal or local authority loans. There is hardly any doubt that the changed structural situation for investments, which is likely to prevail for at least another ten years, will cause institutional investors—banks, insurance companies, savings banks, etc.—to like such securities, particularly as they have to look to their own profitability and to earning interest for their deposit accounts, for which they have to remain competitive.

It will, however, be decisive, over and above the lifting of a heavy burden from the federal budget which, in future, needs only to guarantee risks which in the past had to be refinanced, that gradually a new DM capital market for developing countries will grow up. Ultimately on the day when the full remittance transfer and redemption guarantee, after a transition period, can begin to be gradually dismantled, developing countries could learn from this market (from the *agio* or *disagio* of their loans), how good or bad their credit standing is, and thus to work out what are their chances of being accorded further credit. Conversely, those developing countries whose issues have not yet been admitted to this market could work out how much such credit standing might be worth to them. This would be the first step towards replacing capital aid by capital exports under market conditions. This would also be the first step towards integrating developing countries in a free exchange and flow of capitals, that will no longer be controlled by civil servants, a first step towards development without aid.