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Excessive Indebtedness of LDCs?

by Professor Emil Küng, St. Gall *

Though even in such cases there may be different opinions, it appears fairly obvious under what conditions a business is excessively indebted. However, there is hardly any agreement on the point where an entire national economy ought to be considered as overindebted. The present article discusses this problem.

When there is talk of excessive indebtedness of less developed countries (LDCs), this does not mean that their internal national debt is "excessive". In such cases, the problem adumbrated is that of large external debts, due not so much to over-generous public sector spending but to near-insolvency of the entire national economy. Is it correct to call a given LDC heavily indebted only if and when new capital imports are wholly absorbed by interest and redemption payments, leaving nothing to spare for internal investments? It would be very easy to identify such a marginal case — but on the other hand, in real life, we should hardly be able to find that countries go to such extremes, because both their own governments and creditors would apply the brake long before this could happen.

Yet it is this very fact which demonstrates clearly the importance of agreeing upon a practicable yardstick for excessive indebtedness. If such agreement existed, the desired yardstick ought to be used as an instrument for preventing debtors from ever falling into this pit. In fact, it is, for example, thought that the World Bank ought to be acting before such a plunge occurs. In other words, this Bank should act as a clearing centre of information about the sum total of all loans granted to individual LDCs from all sources and directions, so as to be able to operate the brake when the Bank's experts judge the point of too heavy indebtedness to be near. But in order to act in this way, the Bank ought to be in possession of an operationally applicable definition as to what excessive indebtedness really means.

Debt Service Ratio

To find the desired ceiling limit, it is frequently proposed to determine the ratio between those amounts of foreign exchange that a given economy requires for servicing (i.e. paying both

interest and redemption rates) its foreign debts and the volume of foreign exchange earnings from both visible and invisible exports. It is then said that this ratio should never exceed 10 p.c., which means that at least 90 p.c. of all export earnings ought to be available for buying all kinds of imports, because only in this way would it remain possible to buy indispensable foodstuffs and raw materials as well as machinery and equipment for pushing on with industrialisation.

Examining this hypothetical measuring rod more closely, however, it can easily be seen that it is a purely arbitrary limit. Why should it be only 10 p.c. that can be tied to external debt service, and not 20 or even 30 p.c.? How can it be justified that essential imports must only, or principally, be financed by export earnings instead of continuing to rely on continued foreign capital aid, which would also bring in foreign currency? And would it not be better to have recourse to future foreign exchange instead of past one? Admittedly, such expectations are fraught with a certain degree of uncertainty, *inter alia*, because harvest volumes and the level of world market prices for commodities are always subject to strong fluctuations. But such fluctuations are nothing new, and, in the long term, it should be possible to establish a trend for them.

No End of Objections

Another reason for taking the long view of these problems is the fact that redemption payments do not occur with such regularity as does annual interest. There are often years after years with no amortisation rates falling due, and other ones during which redemption and settlement dates accumulate. This means that it is a highly deceptive method of calculation by which export earnings

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of one year are related to the, more or less arbitrary, import and debt service requirements falling due during the same year. For bridging possible discontinuities, there are always available the government's or central bank's currency reserves. To assess "transferability" of a given country's currency, it is impermissible not to include in the review of available funds this (for external transactions) highly liquid part of that country's total assets, in the same way as it is usual for judging the soundness of a company not only by its profit and loss accounts but also by the degree of its liquidity.

In fact, the familiar method of financial analysis applicable to individual businesses may yield useful results also in cases like ours, by relying on analogy. As is well known, micro-economic investigations use the terms of first, second, and third grade liquidity, depending on whether the analysis compares short-term indebtedness with funds that are liquefiable at call, or medium-term indebtedness with easily saleable assets, or long-term debts with assets whose conversion into ready cash is more difficult. On the other hand, it seems to be a fallacy to use, in analysing macro-economic conditions, either the volume of GNP or that of overall national assets, because they are inconvertible for the purpose of payment to foreign creditors, as huge as these totals may ever be. In this context, only that part may become useful which is actually convertible into cash, in case of need. In general, and apart from currency reserves that "convertible" part is minute. The only other components which may be used for measuring total "convertibility" are normal and possibly also SDRs on the International Monetary Fund.

Causes of Excessive Indebtedness

The analyst who tries to ward off excessive indebtedness and to prevent consequent insolvency crises will naturally also try to search for the underlying causes of such developments. In a good number of cases he will be forced to pinpoint, as the responsible agents for heavy indebtedness of LDCs, their partners among industrialised countries. For is it not a fact that export credits granted to LDCs are frequently far too liberal, especially when serving to finance long-living investment goods? Is there not keen competition between suppliers who try to outbid each other in offering longer and longer repayment periods? Are not also national governments taking part in this kind of competition by supporting manufacturers' easy credit terms?

Nobody can, in fact, deny that such things exist. Under these conditions, it would be unjust to

reproach recipient countries, because they are frequently pressed to help themselves from the rich bounty offered them, and to draw heavily on proffered credit lines. Is it possible to expect that they should reject such splendid opportunities? Should they perhaps refuse to take up advances made by IDA (the International Development Association), which are given for periods of up to 50 years and at the ridiculously low rate of interest of 0.75 p.c.? The analyst would be foolish to expect such self-denial. But he will also have to admit that such goings-on will cause some recipient countries, without intending to do so, to skid down the slippery slope into over-indebtedness, especially those which are placed in the middle between eastern and western competitors who make competing offers of aid. Therefore, it is anything but an exaggeration to pass a verdict of guilty on the USA, in numerous cases, for bringing on undesirable conditions, by supplying investment goods on credit, without demanding any deposit payment, and letting credits run on for 20 years.

It is easy to foretell the effect of such ill-advised generosity. Servicing such debts through the payment of interest and redemption rates constitutes a comparably rigid component of LDCs' balances of payments, and especially of their outgoings of foreign exchange. In line with growing indebtedness, the share claimed by debt servicing in total foreign exchange payments rises higher and higher. More and more of available foreign exchange balances has to be earmarked for this purpose, and less and less of them will be available for other purposes. It is a sad fact that some LDCs are now obliged to use 25 p.c. or more of their export earnings for repaying their creditors. Naturally, this will have a highly adverse effect on LDCs' imports, which have to be reduced, frequently to such a level that actual harm is being done. In extreme cases, even the capacity of the debtor countries to export may be reduced, after it has become impossible to import sufficient raw materials and spare parts. It is therefore not impossible that, in this way, a truly vicious circle will be created.

After such a state of affairs has been reached, debtor countries occasionally threaten to stop payments, at least temporarily, causing a conference of most important countries to be convened for setting up a consortium which, jointly with the debtor country, seeks to hammer out a scheme for breaking through the bottleneck. Questions like these will be posed: should creditors cease to throw good money after bad? Would a moratorium be the best way out of the dilemma? Will it be possible to postpone due dates for re-

payment? Or would it be advisable to sink new capital into investments, for saving past ones? — All these questions are familiar from micro-economics when individual debtors fall upon hard times. There is, however a major difference: neither debtors nor creditors will plump in favour of a national bankruptcy on international payments account.

Mitigating Circumstances

Closer scrutiny of LDCs' balances of payments will usually reveal that most of them are in deficit. Orthodox economists will criticise this state of affairs. To be just, however, we must acknowledge the causes and sources of such deficits, for they may be due to the fact that present-day imports consist, in part, of capital goods which will never produce immediate profit yields but, at best, tomorrow or, rather, after some years have passed. Only after the phasing-in period of new production has ended is it possible to expect larger export earnings or savings in past import volumes. The time lag is, of course, much longer in cases of large investment for education and schooling: it will then not be unusual to measure this lag between spending and higher earnings in decades, and twenty years may not be exaggerated for the length of a phasing-in period.

For all these reasons, not only the problem of foreign debts but also the overall question of development as such can never be evaluated in the short run. The decisive question is whether transferred capital is being invested productively or not. Foreign creditors, however, cannot possibly be satisfied by a reasonable yield earned only in terms of a LDC's local currency or by a sufficient increase in the national GNP. Their attention must needs be focussed upon whether interest earned by their capital is transferable or not. This means that individual profitability of a given investment as well as productivity in terms of the national economy are a necessary but not a sufficient condition. What is required is that foreign investments also strengthen the capacity of the debtor country to earn, and repay, foreign exchange either selling its goods and services for foreign currency or saving by former outgoings. Only this enables LDCs to service foreign debts from their balances of payments.

Dividend Yield of Direct Investments

This again leads to the question whether dividends earned by direct investments must be treated in the same way as are interests. Both loans and direct investments are part and parcel of capital imports. In either case, debtor countries are enabled to make investments of their own

without having to use, for the purpose, savings of their own. Why should earnings of the one type of investment be treated differently from the other one?

However, in the real world, we find discrimination between the two types of investment yield extremely frequent. Discussing the servicing of debts, people often only think of loan interest but not of earnings from participations. Foreign exchange control agencies of LDCs are, far too often, inclined to allow only the one type of repayment but to block the use of foreign currency for the other one. Strictly speaking, they do harm, in this way, to their own long-term interests, because, on principle, direct investments yield to them much greater advantages than credits, since direct investors always do not only import capital but also technological and organisational know-how. Remittances home, moreover, are never made before a direct investment starts to earn a net profit. And it occurs also very rarely that direct investors try to remit the entirety of their invested capital back home — similarly as loans have to be gradually redeemed. Taking all in all, direct investments are likely to become a much smaller burden upon the local balance of payments than loans. Therefore, any LDC's competent authorities should be much more interested in attracting direct investments, and this means that profits earned must become transferable, instead of their way home being blocked. Dividends must be treated similarly as the servicing of loan debts.

Gross or Net Aid?

Some LDC representatives put forward the curious argument that annual capital aid is only the net balance of capital imports into their countries. In other words, gross capital imports would have to be diminished by remittances which flow, at the same time, back to creditor countries, because only this balance is the sum total available for new investments. The latter observation is obviously correct. But it is a moot question whether gross or net capital inflow is the more meaningful datum. On the basis of net capital imports, LDCs then demand of their industrialised partners that these ought to disburse regularly aid to such an extent that net aid remains constant or even grows steadily. What should we think of such requests?

It is clear that, by meeting these wishes, the creditors could make the problem of excessive LDC indebtedness disappear. No matter whether a given economy carries on its shoulders large or small foreign debts — its debt servicing would always remain deductible from gross capital imports, or: the larger the capital sums that had

been pumped into a LDC in the past, the better would be its present and future position in regard to new aid, for it would be the case that creditor countries themselves would, in some way, have to finance repayments and interests due to them, and additionally a margin which would then count as net aid. It can easily be shown that such an arrangement would destroy every kind of control over whether imported funds are being invested sensibly or not, because no genuine repayment from earned profits would ever be made. If the authorities of the debtor country tried to add to debt servicing the flight of local capital, the result

would grow even more disastrous — for, as is well known, there are authorities who assert that this capital outflow, e.g. from South America, is at least as large as the imports of capital which enter debtor countries in the opposite direction.

In this context it is clear that such requests have not a chance to be met with, and they should not have one. Should any creditor agree to such a scheme, it would be an open invitation to use new and incoming funds without discrimination and to contract as many debts as humanly possible. Efficient capital aid would thus be made even more difficult than it actually is.

Dollar Overhang and Development Assistance

by Professor George J. Viksnins, Washington, D.C. *

Although according to the media, the theme for last fall's meeting of the International Monetary Fund and World Bank Group was all "sweetness and light", the February dollar crisis demonstrated the instability of the international monetary system. Now is the time for technicians to do the difficult task to work out the basic reform principles — giving dates, amounts, and other specifics.

Since President Nixon's August 1971 step to suspend the gold convertibility of the dollar, and its subsequent devaluation, we have seen the development of a love-hate situation. On the one hand, Europeans complain about having to hold dollars against their will. This so-called "dollar overhang" can be variously estimated, but as of the end of June, 1972, U.S. liabilities to foreign official institutions and short-term liabilities to "other foreigners" added up to \$ 74 bn.

These liabilities take the form of deposits in U.S. banks, Treasury bills, and other assets owned by foreign holders. Of this amount, \$ 54.6 bn was owed to official institutions, mainly central banks in Western Europe and Japan. These statistics represent an enormous increase over the end of 1970, for example, when the total short-term indebtedness of the U.S. stood at \$ 47 bn (and only \$ 23.8 bn was owed to official institutions). Even if one feels that the dollar balances held by central banks at the end of 1970 were roughly "normal", i.e., actual dollar holdings were equal to desired dollar holdings, the very large buildup of 1971–72 is surely excessive. Actually, foreign central banks

have been complaining about having to hold unwanted dollars for longer than most people care to remember. Thus, \$ 30–40 bn in central bank holdings is probably a reasonable estimate of the size of the dollar overhang. And besides the central bank dollar holdings, there may exist a fairly large private demand for dollar balances, currently low due to fears about their future, that may serve to reduce the official overhang.

The "Dollar Overhang Problem"

On the other hand, foreign governments resist suggestions that they get rid of these unwanted dollar balances by using the normal channels of trade and investment. Although this may be short-sighted from a long-run economic point of view, it is understandable that any foreign government would resist a sudden large increase in imports from the U.S. As a ridiculous example, Germany could close down Volkswagen and use their unwanted dollars to buy Vegas. The income and employment effects of such a move would quite possible have serious political repercussions. Of course, it is expected that the effects of the dollar devaluation and the revaluation of the strong currencies will lead to an increase in U.S. exports in future. As is pointed out by the 1972 *Annual*

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