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# External Borrowing, Capital Formation and Growth in Developing Countries

by Rainer Erbe, Hamburg\*

Since the summer of 1982 the banking community has been faced with an international debt crisis of unprecedented dimensions. The debt rescheduling agreements that have been negotiated since then involve sums totalling no less than \$ 100 billion. However, they give the international financial system no more than a breathing-space. The following two articles deal with different aspects of this crisis. Rainer Erbe examines the question as to what growth effects were associated with external borrowing. Can a lack of growth effects be made responsible for the crisis or were other factors more important? This is followed by an article by Anton Konrad who discusses the proposals which have been made for long-term crisis management. What are their chances of success?

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For many years it was regarded as a necessary and sufficient prerequisite for a successful process of growth-cum-debt that external borrowing by developing countries be used to boost domestic investments and finance reasonably profitable projects. This would culminate in an increase in the borrowing country's overall rate of growth. Up until the early 1980s this precondition appeared to the creditors to be met, particularly in the case of the newly industrialising countries (NICs) and of mineral-rich developing countries, countries which had received the lion's share of foreign loans. Had this not been the case, the developing countries in question would hardly have been able to find public lenders and, in particular, private banks willing to finance an increase in total debts from approx. US \$ 85 billion in 1971 to approx. US \$ 650 billion (at a conservative estimate) at the end of 1982.

However, by 1982 many of the highly indebted developing countries found themselves unable to meet interest and debt repayment schedules. The rapidly rising number of countries in payments difficulties led to the frequent conclusion that the growth of external debt had not in fact been accompanied by the expansion of an adequately productive capital stock. The countries of the Third World which, only yesterday, were solvent and welcome borrowers were now compared with entrepreneurs who, at best, made investments in

extremely dubious projects and who, at worst, had quite simply consumed the borrowed capital – or even fraudulently declared a state of bankruptcy after having transferred their capital to Switzerland.

This drastic change in the assessment of the role of external debt in developing countries prompts a number of questions:

- ☐ What impact has external borrowing had on real capital formation in developing countries and which were the accompanying growth effects?
- ☐ Do the current debt problems result from the fact that loans obtained abroad in the past were not to a sufficiently large extent utilised productively?
- ☐ Assuming that such borrowed capital has in fact been used for consumption, can this be considered the primary reason for debt crises?
- ☐ Which other factors have contributed towards the current crisis?

## Past Debates

The question as to whether capital imports, in other words borrowed foreign capital, in fact supplement savings in developing countries, i.e. contribute wholly towards increasing real capital formation and thus accelerating growth, is not new. It was the subject of lively discussions during the sixties, centring around the then frequently applied capital requirement models. A number of authors felt that economic development was only slightly, or not at all, stimulated by capital imports, with a large proportion of external resource inflow being

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\* HWWA-Institut für Wirtschaftsforschung-Hamburg. This article is an abridged and slightly altered version of a paper presented to the annual conference of the Association of German Economic Research Institutes held in Bonn on May 5/6, 1983. An unabridged German version of the paper was published in the Beihefte zur Konjunkturpolitik, No. 30 (Kapitalbildung und Wachstum in den 80er Jahren).

used for consumption rather than for additional investments.<sup>1</sup>

A series of regression analyses confirmed the related hypothesis of a negative correlation between savings and capital imports.<sup>2</sup> In so far as there was a complete substitution between national and foreign savings (i.e. the increase in capital imports was wholly reflected in a decline in national savings), it could be concluded that there was only a marginal, or in extreme cases a zero, contribution to growth. Applied to the current situation, i.e. to capital imports in the form of credits, the implication would in fact be a negative contribution to growth. Assuming that the trend of gross domestic product (GDP) remains unchanged, the growing external factor payments over time mean that the borrowing country's future gross national product (GNP) would – *ceteris paribus* – be lower than if it had not incurred external debt.

However, serious doubts were expressed about the results of these empirical studies and the conclusions derived from the regression analyses. The main point of criticism was the causal interpretation of the negative correlation between the development of savings and external resource inflows.<sup>3</sup> Indeed, the falling savings ratio in a number of the cases examined at that time would seem to be the cause of growing capital inflows rather than the result. In any case, both developments were induced by a third factor, such as economic crises or a government monetary policy which, via negative real rates of interest, reduced the propensity of nationals to save. Attempts to examine the effects of borrowing by developing countries during the seventies find themselves up against exactly the same problem of correctly interpreting the nature of negative correlations which may have existed.

### Borrowing and Capital Formation

Nevertheless, the analysis of the development over time of macroeconomic factors such as the savings and investment ratios in relation to the capital import level

(or the current account deficit) appears to be the only practicable way of obtaining at least an indication of the extent of consumptive or investive utilisation of external resource inflows. Microeconomic approaches, which concentrate on the utilisation of individual loans, are inadequate due to lack of data. What is more, they do not seem to make much sense in view of the fungibility of capital.<sup>4</sup>

In order to allow the drawing of tenable conclusions the macroeconomic time series approach must generally be backed up by detailed country analyses, focussing in particular on government economic and fiscal policy. This is the only way to avoid the same kind of criticism levelled against earlier time series analyses. A brief survey of the development of investment and savings ratios as well as of capital imports in several of the major debtor-countries is presented below. This survey is based on the – in some cases extensive – country studies which have been conducted at the HWWA-Institut.<sup>5</sup> The picture which emerges is a most differentiated one:

□ To begin with, in a number of the currently highly indebted countries the increase in credit-financed current account deficits was initially paralleled by a clear increase in investment ratios, which in some cases was greater than the increase in debt. This suggests an investive utilisation of borrowed capital. This country group included NICs such as South Korea and Brazil as well as oil exporters such as Algeria.

□ In a second country group, the time series analysis only shows a loose connection, or none at all, between savings or investments and the level of capital inflows. During the 1970s Mexico, Chile, Argentina, Venezuela, Thailand and India could be found in this group. Many countries in this group exhibited strongly fluctuating external trade balances and considerable changes in economic policies.

□ A third group of countries reveals a significant negative correlation over time between the level of national savings and external resource inflows as a percentage of GDP. During the sixties this was already the case for a number of the middle-income and low-income countries which usually received loans on soft terms, among them Egypt, Pakistan, Indonesia, and also for the Philippines, a country which had resorted to

<sup>1</sup> Cf. Keith B. Griffin, John L. Enos: Foreign Assistance: Objectives and Consequences, in: *Economic Development and Cultural Change*, Vol. 18, 1970, pp. 313-327; Anisur Rahman: Foreign Capital and Domestic Savings, A Test of Haavelmo's Hypothesis with Cross-Country Data, in: *Review of Economics and Statistics*, Vol. 50, 1968, pp. 137-138; Thomas Weisskopf: The Impact of Foreign Capital Inflow on Domestic Savings in Underdeveloped Countries, in: *Journal of International Economics*, Vol. 2, 1972, pp. 21-38.

<sup>2</sup> Some authors, however, came to quite the opposite conclusion, confirming a positive correlation between capital imports and savings. A run-down on the results of the various regression analyses can be found in: Gustav F. Papanek: The Effect of Aid and Other Resource Transfers on Savings and Growth in Less Developed Countries, in: *The Economic Journal*, Vol. 82, 1972, pp. 934-950.

<sup>3</sup> Cf. Gustav F. Papanek, *op. cit.*, pp. 938 ff.

<sup>4</sup> Cf. on this point, Rainer Erbe: Foreign Indebtedness and Economic Growth: The Philippines, in: *INTERECONOMICS*, No. 3, 1982, pp. 125 ff.

<sup>5</sup> Cf. on the methodology of the country studies. Arbeits- und Ergebnisbericht über das Teilprojekt 5 des SFB 86 der Deutschen Forschungsgemeinschaft "Die Verschuldungsfähigkeit von Entwicklungsländern im Zusammenhang mit Wachstumschancen und Ressourcentransfer".

a large number of commercial bank loans. Some of these countries were forced to reschedule during the sixties or early seventies. During the 1970s this negative correlation was particularly clear among mineral-exporting countries.

□ Finally, in some countries increased external borrowing is only partly reflected in greater investment and/or more consumption. Here, we above all find rising capital exports taking the place of absorption. Capital imports primarily served to compensate for, or even finance, the capital flight by economic and political elites closely connected with the state. One notorious example is Zaire; yet high external borrowing also appears to have triggered greater private capital exports in Mexico and several other countries.

### NICs

A closer look at the first country group shows that it consists mainly of countries which have already progressed to a more advanced stage of economic development. Increased external borrowing in this group was closely connected with intensified industrialisation efforts and, in most cases, began during the 1960s. Both net borrowing and savings reveal an increase over time in relation to GDP. This country group, therefore, bore out the traditional viewpoint of a process of growth-cum-debt: resorting to additional external resources would enable an accelerated setting-up and extension of the infrastructure and production capacities.

The assignment of individual countries to this group varies. Brazil, for example, after having overcome its debt problems in the mid-sixties clearly belonged to this group for more than a decade. However, since 1977 Brazil has revealed a steady decline in its national savings ratio, which dropped from 20 % in 1977 to approx. 15 % in 1981. Brazil used its loans less and less to increase investments, and more and more to delay the unavoidable adjustment of the economy necessitated by external shocks. Not only was there an increase in the extent of external borrowing in percentage terms of GDP during recent years, but also a change in the composition of the group of borrowers. Up until 1975 most requests for loans from international capital markets came from the corporate sector. Since then the state, with its financing of government budget deficits, has become a more and more important international borrower. Brazil's budgetary deficits, which reached approx. 9 % of GDP in 1981<sup>6</sup>, have been balanced to a great extent by the government's external

borrowing. As opposed to domestic borrowing or the pure creation of money, this mode of financing had the advantage of being able at the same time to meet the growing foreign exchange and import needs of the public and private sectors.

### Mineral-rich Economies

The third country group includes many countries of the middle and low-income categories, in particular those exporting raw materials. Regression analyses conducted by the HWWA-Institut<sup>7</sup> reveal a significant negative correlation between capital imports and national savings for these countries. However, this still does not confirm a causal link or indicate the direction of a possible causality. Closer examination shows that this negative correlation is mainly due to the development of government budgets. Public finances in this country group are extremely dependent upon the profitability of the mining industry. Boom periods on raw materials markets go hand in hand with substantial increases in public revenue. This led to an increase in government consumption levels, leading to expectations which could only be curtailed with great political difficulty, if at all, when prices fell. This explains why many governments, following such high-price periods, looked to external borrowing to finance the then irreversible current expenditures. Government saving dropped. During the last decade this trend was observed in countries such as Morocco, Guyana, Sierra Leone, Bolivia, Zambia, Peru und Jamaica. If the relationship between debts and GDP is taken as a point of reference rather than absolute debt levels, these countries can be classed as being among those most heavily indebted abroad.

Since the beginning of the 1980s a negative correlation between the development of national savings and the level of external borrowing was not only to be observed in developing countries exporting raw materials but in almost all developing countries. Climbing interest rates and oil prices, combined with a deterioration in the terms of trade in the wake of the international economic lull, pressurised more and more countries into crisis borrowing. The loans served not so much to build up investments but rathermore to compensate for the drop in real incomes caused by unfavourable terms of trade, to stabilise consumption levels or to finance growing government deficits (which, for example, in Mexico figured at more than 15 % of the GDP<sup>8</sup>).

<sup>7</sup> Cf. Susanne Schattner: Mineral Economies – Indebtedness without Growth, in: INTERECONOMICS, No. 5, 1982, pp. 234 ff.

<sup>8</sup> Statement by the Mexican Minister of Finance, Jesus Silva Herzog, quoted in: Frankfurter Allgemeine Zeitung, 12 Nov. 1982, p. 14.

<sup>6</sup> Cf. International Currency Review, Vol. 14, No. 3, 1982, p. 115.

### Growth Effects

This brief survey is enough to show that, looking at it realistically, most of the approx. US \$ 600 billion net amount of debt incurred by developing countries abroad since the beginning of the seventies was not used for stepping up capital formation or growth. However, the extent to which additional debt-financed consumption can be determined varies considerably from one country to the next, and strongly depends on the investment concept used. But even if a broad definition of capital formation is chosen – for which a great deal can be said in the case of developing countries – and all potential productivity-raising investments included, especially public-sector investments in human capital in the fields of education, training and health, the proportion of external debt attributable to consumption is still high. What is more, in the case of countries which have in fact (apart from during the past few years) primarily used net borrowed capital to step up capital formation, there is sufficient reason to doubt the long-term growth effects of capital inflows. This, for example, applies to the Philippines and Brazil, where ample capital inflows have benefited ambitious investment programmes, almost always encompassing large capital-intensive prestige projects with lengthy gestation periods, whose profitability is now considered to be questionable. The ambitious nuclear energy and hydroelectric power programmes in Brazil or the forced setting-up of the steel industry, which today runs at a loss, are prime examples of such investments.

On the whole, it is fair to draw the conclusion that the contribution of external borrowing towards accelerating growth in developing countries has, in fact, been a most modest one. There are two main reasons for this:

□ Firstly, the actual contribution of external debt towards the formation of real capital in the Third World has been much lower than the potential contribution. Taking an average annual net borrowing figure of 4-5 % of GDP and an investment ratio of 25-30 % of GDP, the maximum potential contribution during the 1970s comes to 15-20 % of annual real capital formation. If, on account of the lack of comprehensive and sufficiently reliable quantitative data, the assumption is made that in most developing countries capital imports and national income are split in a similar way between consumption and savings, and taking a marginal propensity to save of 20 %, external borrowing is found to have increased investment activities by only 3-4 %.

□ Secondly, the growth effects of this modest expansion of capital stock were diminished even further

by the lack of profitability of many of the investments made. On the one hand, some investments were misallocated right from the start; on the other, projects which initially seemed quite promising later proved obsolete due to external shocks and shifts in relative commodity and factor prices.

### An Alternative Approach

The afore-mentioned development of savings and borrowing in some of the major debtor-countries would suggest rethinking previous approaches to the problem of indebtedness in developing countries.<sup>9</sup> Up to now, the commonly used growth-cum-debt model was marked by the basic assumption that the investment ratio (and thus the long-term rate of growth) depends on the level of capital imports whereas savings are a given exogenous variable. We shall now examine the implications of discarding this assumption in favour of the premise that the investment ratio is the given variable and that a direct negative correlation exists between capital imports and national savings. This change of premise would seem reasonable in view of the fact that most external debt is incurred and utilised by the public sector; public-sector institutions, however, take the volume of expenditure as a planning variable. Government savings, on the other hand, is a residual factor, which depends on available financing alternatives. Recourse to readily obtainable foreign loans, therefore, is a politically attractive proposition, for it means that unpopular tax increases and/or cutbacks in consumption expenditure can be avoided.

This approach implies that the real motive and objective of external borrowing is not to increase capital formation in borrowing countries, but to release internal resources to raise current consumption levels. In such a case, external borrowing involves an associated drop in national savings and only brings about intertemporal distributional effects rather than growth. There is no additional capital formation, only a greater debt-servicing burden for successive generations. However, this observation is not to be viewed as criticism of the borrowing process in itself – as was the case in the debate on this issue during the sixties. All that a falling propensity to save possibly reveals is that, from the point of view of the borrowing country, the decisive factor necessitating external borrowing is not a "savings gap", i.e. an unbridgeable difference between the politically desirable or economically profitable volume of

<sup>9</sup> Cf. on the following, Rainer Erbe: Die öffentliche Auslandsverschuldung von Entwicklungsländern und ihre Wachstums- und Verteilungswirkungen, in: Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik, Vol. 28, 1983, pp. 245-255.

investment and the existing low savings capacity caused by the lack of income, but a "consumption gap". Just as there are differing definitions of the savings gap<sup>10</sup>, the term consumption gap can also be interpreted in different ways:

□ Firstly, external borrowing by the public sector can take place in accordance with the "pay-as-you-use" principle. The aim here is to effect intertemporal distributional effects in line with the benefit-received principle. The size of the consumption gap, and subsequently the extent of external borrowing, depends on the volume of expenditure, which will primarily benefit future generations.

□ Secondly, external borrowing can be used as a means of temporal redistribution in favour of current generations and at the expense of successive – more prosperous – ones, in line with the ability-to-pay principle.<sup>11</sup> The extent of borrowing in this case is either politically determined or depends on the willingness of creditors to grant the loans.

### Consequences

This theory of distribution approach has two main consequences for the analysis of the process of indebtedness in developing countries:

□ First of all, it means that the relationships involving credit and the capital flows which have emerged between capital-exporting and capital-importing countries are not so much a result of a higher productivity of capital in developing countries, but the result of varying social rates of time preference. Current consumption in developing countries is more important than in industrialised countries and more important than the future debt and interest burdens (assuming that this factor is considered at all). This also implies that the image of Euromarkets as highly efficient institutions which guarantee that capital is brought to those areas in the world where it is assured the best returns, is also in need of revision.

□ Secondly, on the basis of the premises described external borrowing can lead to growth losses on a world economic scale. The unchanged levels of real capital formation in the recipient countries may be

accompanied by reduced capital formation in capital-exporting countries. However, as growth maximisation (even on a global scale) is not a self-justifying objective, this cannot be regarded as an argument against external borrowing by developing countries.

### Borrowing for Consumption – the Cause of Crisis?

From the viewpoint of a borrowing country, therefore, external borrowing with the aim of raising the level of current consumption rather than of investments (and thus future consumption) may quite well be an economically rational course of action. However, creditors view such behaviour as unsound. Prevailing opinion is that external debt is only then economically justified if it can be serviced by returns from the investments for which borrowed capital is used. In an effort to examine the extent to which such reservations regarding debt-servicing capacity are justified, the premise that borrowing only induces intertemporal distributional effects and not growth effects will be retained throughout the considerations which follow.

To begin with, it is essential to gain some idea of the order of magnitude of intertemporal distributional effects in the "most unfavourable case" (from the creditor's point of view). A simple model similar to that used by Domar in discussing the limits to government borrowing<sup>12</sup> comes to our assistance. If  $D$  is taken to represent the absolute level of external debt (or in the basis period  $D_0 = 0$ ),  $I$  the level of interest payments,  $i$  the interest rate,  $Y$  the gross domestic product, and  $w$  its growth rate (assumed to be independent of the level of external borrowing), and assuming annual net borrowing to be a per cent of respective GDP, the following equations can be drawn up:

$$\begin{aligned} (1) \quad Z &= i \cdot D \\ (2) \quad Y &= Y_0 \cdot e^{wt} \\ (3) \quad \frac{dD}{dt} &= a \cdot Y \end{aligned}$$

and, resulting from (2) and (3):

$$(4) \quad D = \int_0^t \frac{dD}{dt} \cdot dt = a \cdot Y_0 \int_0^t e^{wt} \cdot dt = \frac{a \cdot Y_0 (e^{wt} - 1)}{w}$$

It then follows from (1), (2) and (4) that:

$$(5) \quad \frac{Z}{Y} = \frac{i \cdot D}{Y_0 \cdot e^{wt}} = \frac{i \cdot a (e^{wt} - 1)}{w \cdot e^{wt}}$$

This Domar model enables us to describe the order of magnitude of borrowing and interest payments (both in

<sup>10</sup> Cf. Armin Gutowski, Manfred Holthus: Limits to International Indebtedness, in: Donald E. Fair (ed.): International Lending in a Fragile World Economy, The Hague, 1983, pp. 237 ff.

<sup>11</sup> If the fictitious idea of clearly delimited generations is abandoned, external borrowing becomes an instrument for the optimisation of the intertemporal consumption path of any particular country.

<sup>12</sup> Cf. Evsey D. Domar: The "Burden of Debt" and the National Income, in: American Economic Review, Vol. 34, No. 4, 1944, pp. 798-827.

terms of GDP). In the example which follows we have assumed a long-term real interest rate of 5 %. An automatic debt repayment via international inflation, as took place in some cases during the 1970s, is thus ruled out. As regards the other parameters, the orders of magnitude selected are typical for the 1970s for today's main debtor-countries, namely an annual net borrowing figure of 5 % of GDP and an average GDP growth rate of 6 %. After a period of twenty years, for example, the annual external interest payment level reaches 2.9 % of the then GDP level.

If the borrowing process, maintaining the same assumptions, is continued towards infinity the interest ratio approaches a limit which at approx. 4.2 % of GDP is relatively low. Interest burdens of this magnitude have already been reached by several countries without having caused debt-servicing problems.

However, the result of the calculation is extremely dependent on the assumed growth rate of GDP. If, in our example, this growth rate only reaches an annual 1 %, the interest burden will already be in excess of 4.5 % of GDP by the end of a twenty-year period. The continuation of the calculation ad infinitum takes us into double figures for interest burdens, even though (at the same  $Y_0$ ) the level of debt in absolute terms is much lower than in the first case. What is more, GDP in the second case has grown by only 22 % over 20 years, over a quarter of this growth being needed to cover the interest on external borrowing. In the first example, on the other hand, GDP has more than tripled after 20 years, the share of the production increase required for interest payments on foreign loans in the final year amounting only to about 4 %.

These examples show that the dislike shown by creditors towards external borrowing motivated by intertemporal distributional aspects is not entirely unjustified. Creditors will obviously have doubts as to long-term debt repayment capacity if a large percentage of GDP growth is already needed for interest repayment during periods of poor economic performance.

### Future Ability to Pay

The question of a country's future debt-paying ability is likely to be closely connected with the question of that country's willingness to pay, i.e. in terms of economic policy, avoiding debt crises is a matter of counterbalancing competing demands within the debtor-country. Domestic absorption must give way to external payments. Assuming a fast-growing economy and a rapid growth in income this will, in general, not pose too many problems – a debt-financed anticipation

of future income is, from the point of view of the creditors, relatively unproblematic in this case.<sup>13</sup> However, in cases where "... external borrowing can be a convenient mechanism enabling one regime to eat the cake while its successor is expected to tighten the belt"<sup>14</sup>, as an OECD report has put it, the outlook for the creditors is somewhat more grim. In a stagnating economy or assuming only a slow growth in incomes, the willingness of successive generations to service their predecessors' "consumption credits" will be very limited in the long run if intertemporal distributional effects reach an appreciable order of magnitude. However, this also applies to cases in which foreign loans have been utilised for investment, yet failed to bring about any, or slight, growth effects.

The use of borrowed capital is not therefore the crucial problem when it comes to the question of the future debt-servicing ability or the current creditworthiness of any particular country. The decisive factor is the country's overall future economic potential. Although this is also influenced by the way in which loans are used, in view of the magnitude of capital import levels during the past the utilisation of borrowed capital for investment in additional profitable projects is neither a necessary nor a sufficient condition for long-term borrowing capacity. Of course, the lower the level of other resource endowment in the economy and the more questionable the efficiency of resource allocation as a result of specific economic policies and development strategies appears to be, the greater the importance of this criterion.

### Other Crisis Factors

The often expressed opinion that the current increase in reschedulings primarily results from the inadequate past contribution of external borrowing to capital formation and growth in debtor-countries can therefore only be regarded as superficially correct. Only in some of the smaller countries, usually by-passed by public interest, has the lack of growth effects led to interest payments and debt levels (in terms of GDP) which could warrant any claim to overborrowing. In most developing countries, and in particular in the major debtor-countries, both the levels of debt, at 25 - 50 per cent of GDP, and of interest payments, at 2, or at most 5, per cent of GDP, can be regarded as economically acceptable.

<sup>13</sup> Cf. Manfred Holthus: Verschuldung und Verschuldungsfähigkeit von Entwicklungsländern in: Hamburger Jahrbuch für Wirtschafts- und Gesellschaftspolitik, Vol. 26, 1981, pp. 239-255, here p. 249.

<sup>14</sup> Cf. OECD: Debt Problems of Developing Countries, Paris 1974, pp. 40.

The crisis facing such countries cannot be explained by reference to the levels of debt and interest payments or to the way in which borrowed capital has been used in the past. The decisive factor is that they have failed to use their own resources efficiently. This is above all due to mistakes in the sphere of public finances and government domestic and foreign economic policies.<sup>15</sup>

□ In many countries, inappropriate development strategies and hasty industrialisation programmes have created production structures not geared towards comparative cost advantages.

□ Direct and indirect subsidising of the use of capital has increased the demand for capital and created capital-intensive production structures at the expense of the factor labour. Administered rates of interest, which at a time of high and steadily increasing inflation rates led to long-term negative real interest rates, encouraging wastage and misallocation of capital or capital flight, have also played their part.

□ Rising rates of inflation, one of the major reasons for which was the expansion of government deficits and the subsequent financing of the latter via money creation, were only rarely compensated for by adequate devaluation moves. Due to progressively overvalued currencies, the producers of tradable goods, i.e. from the export and import substitution sectors, were placed at a disadvantage. This additionally exacerbated balance-of-payments difficulties, following the first oil price shock. In addition, the subsequent return to import substitution and import controls and the associated elimination of foreign competition have, in the long term, reduced the efficiency and speed of economic growth.

□ Borrowing has often been a convenient means of delaying rather than encouraging the necessary processes of adjustment to changing international economic conditions. Government-owned enterprises working at a loss were subsidised, as were individual goods. This was particularly true of imports of foodstuffs and oil, preserving obsolete structures of investment, production, consumption and foreign trade.

A number of unfavourable changes in the international economic environment complemented such national misdevelopments in worsening the crisis or speeding up its outbreak:

□ Firstly, mention must be made of the rapid increase in nominal and real interest rate levels on international capital markets as of 1979, in the wake of the USA's tight monetary policies and the renewed surge in oil prices at the end of that year.

□ Secondly, the continuing economic recession facing industrialised countries and the stagnation of world trade have restricted export opportunities for developing countries, even in cases where the latter had proved internationally competitive. Due to falling prices, exporters of raw materials were confronted with drastically deteriorating terms of trade – a development which is now causing problems for oil exporters too.

□ Thirdly, the growing protectionist trend exhibited by industrialised countries has also adversely affected the growth and export prospects of developing countries. Voluntary export restraint agreements with successful debtor-countries together with other forms of protectionism and a multiplicity of subsidies in fields such as agriculture, textiles, steel or shipbuilding, are increasingly regarded as a kind of “non-acceptance policy” on the part of the industrialised countries.

### Curing the Crisis

The importance attached to the internal and external crisis factors discussed in brief above varies according to one's point of view and interests. Correspondingly, there is also a wide range of suggested therapies. The developing countries particularly blame external factors and see a solution in more loans with even better terms, a new international economic order and debt cancellations; the latter move now also being advocated in some industrialised countries. Keynes and the transfer debate in the context of Germany's reparation problems during the 1920s are celebrating a comeback.

Such a comparison, however, is questionable: it is based on the pessimistic assumption that protectionism and the international economic crisis will intensify and that debtor-countries will thus permanently remain unable to pay up their debts. Furthermore, today's developing countries are not faced by a reparation problem, as opposed to the former German Reich. There is currently no political need for a real transfer, i.e. for debt repayment before a fixed date. The comparison with the transfer problems of the 1920s must, therefore, be classed as a false analogy and would appear to be an expression of a general insolvency panic. It harbours the fatalistic implication that no effective therapy exists. All that need be said on this point is that almost all the factors which have contributed towards the current debt problems can be influenced, and thus changed, by

<sup>15</sup> Cf. Wissenschaftlicher Beirat beim Bundesministerium für wirtschaftliche Zusammenarbeit, Ausschuss für internationale Verschuldung: Stellungnahme zur Auslandsverschuldung der Entwicklungsländer, Hamburg, April 1983, and Hans H. Glismann, Peter Nunnenkamp: Die Entwicklungsländer am Rande einer Verschuldungskrise – Überlegungen zu den Ursachen und Folgen am Beispiel Lateinamerikas, Kieler Diskussionsbeiträge, No. 91, January 1983.



those involved in this process. There is therefore no call for resignation at the present time.

The industrialised countries must give priority to creating the conditions for a non-inflationary upswing of the world economy and world trade. In addition, they will have to open up their markets further to products from developing countries. Private lenders must resist the temptation to withdraw from their commitments or to pass the buck of existing risks to the IMF, the central banks or individual governments.

It goes without saying that the main contribution towards overcoming existing problems must be made by the developing countries themselves. A first step in the right direction would be to stop passing on the responsibility for their problems to creditors alone. Developing countries will only be able to re-establish their creditworthiness if they appreciate that there is a direct link between inefficient economic and fiscal policies, inadequate growth and payments difficulties. An important move in this respect is to make up for the failure to adjust to the changed international economic setting as soon as possible. This can be achieved by finding a way back to market-conforming output price and factor price relationships and rectifying unrealistic exchange rates. In addition, developing countries should, in future, support paths to growth which harbour

less risk and are less capital-intensive, avoiding long gestation periods and circuitous routes of production. Assuming that industrialised countries cease to continue or even intensify their opposition to changes in the structure of the world economy, labour-intensive and export-oriented development strategies hold the key to long-term successes at a lower risk. A successful reorientation of economic policies would help many debtor-countries to regain access to the currently blocked capital markets and thus facilitate economic recovery.

However, the necessary economic consolidation represents a process which is in some cases socially painful and which is accompanied by substantial political risks for domestic policy-makers. It is still not clear whether the understanding of the debtor-countries and/or the pressure of creditors and the IMF will suffice for these countries to embark upon such a course. There is still a danger that individual debtor-countries or groups of debtor-countries with sufficient negotiating powers will try to take a more convenient (at least in the short run) path, namely that of "solving" their internal problems at the expense of (external) creditors. No-one would benefit from this in the long run, not even the developing countries. They would be cut off permanently from capital inflows and their internal problems would continue.

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## **DEBT CRISIS**

# **Ways Out of the Debt Crisis**

by Anton Konrad, Munich\*

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**T**hanks to collaboration between creditor banks, western central banks and the IMF, the danger of the financial collapse of numerous developing countries and consequent chain reactions in the western banking system has been kept at bay for the present. However, a number of circumstances give cause to doubt the durability and strength of the solutions adopted so far:

□ The rescheduling agreements concluded so far relate only to debts falling due in 1983 and, for a small number of countries, 1984. It is to be feared that further debts will have to be renegotiated in the near future, given the hesitant recovery in the world economy.

□ The rescheduling agreements merely delay the due dates of the debts by six or eight years, creating the danger of another bunching of maturity dates in the second half of the eighties.

□ The burden of high interest rates, one of the main causes of the financial crisis, has not been alleviated by the rescheduling agreements but further increased, for interest premiums of more than 2 % and rescheduling fees of up to 3 % on the rescheduled loans have been agreed. This interest burden prevents a reduction in the balance of payments deficits and contributes to a further increase in indebtedness.

□ The banks reacted to the onset of the crisis by drastically reducing their lending to developing

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