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INDEBTEDNESS

A New Round of Rescheduling?

by Armin Gutowski, Hamburg*

The danger that the foreign indebtedness of developing countries will again come to a head has by no means been banished. Prof. Gutowski outlines proposals for concerted action by commercial banks, the World Bank and regional development banks which could help to prevent the outbreak of a new crisis.

Recent data on the situation of the developing countries and the position of their financiers – the banks – at first sight suggest that the threat their debt posed to the world economy has at least receded slightly. In 1984 the developing countries' bank debt increased by only 2 %, a much lower rate than in previous years (6.6 % in 1983).¹ The Bank for International Settlements also notes "a decline in the share of developing countries in new borrowing" in the first half of 1985.²

At the same time, the risks towering over the international banking system have diminished slightly. The US banks, in particular, have improved the ratio of claims on developing countries to own funds; at the end of 1984 loans to developing countries still represented 141 % of equity capital, down from a peak of 186 % at the end of 1982.³

For the moment, real flows of goods and services in the world economy also indicate an easing of the debt situation, which can obviously never be a purely monetary phenomenon. In 1984 the exports of developing countries (only "non-fuel exporters" in the IMF classification) increased by 12 % in volume, a larger expansion than the average for the previous 15 years. In the same year their terms of trade also improved by almost 1 %.⁴ Both the foreign trade position and the domestic growth rate of many developing countries showed an extremely favourable trend in 1984. The current account deficits of non-oil developing countries fell appreciably to only 9 % of exports, the smallest

proportion "since comparable statistics began to be assembled in the mid-1960s", as the IMF states in its latest Annual Report.⁵ At the same time, the real gross domestic product of these countries grew by 5.6 %, a considerably faster rate than in the preceding five years.⁶

Much has therefore already changed for the better since the onset of the debt crisis, or rather since Mexico's inability to meet its payment obligations in 1982 made the world aware that there was an international debt problem. Above all, the developing countries have ceased to use import restrictions as a means to achieving economic adjustment and reducing their current account deficits, as they had initially. The volume of imports of non-oil developing countries had declined by 5½ % in 1982 and increased by only a marginal 1.6 % the following year.

If this trend had continued, the development prospects of the countries in question, and hence their ability to service their debt, would have only grown even worse in the long run, for in the final analysis most of these countries need imports to be able to produce exportable goods with which to earn the foreign exchange needed for debt servicing. The fact that the

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¹ Morgan Guaranty Trust Company: World Financial Markets, July 1985, p. 6.

² Bank for International Settlements: International Banking and Financial Market Developments, Basle, October 1985, p. 11.

³ Morgan Guaranty Trust Company: World Financial Markets, July 1985, p. 8.

⁴ International Monetary Fund (IMF): World Economic Outlook, October 1985, p. 39.

⁵ IMF: Annual Report 1985, Washington D.C., p. 1.

⁶ IMF: World Economic Outlook, op. cit., p. 36.

developing countries' imports increased more strongly again in 1984 and that their current account deficits nevertheless contracted owing to even stronger export growth is a clearly positive development. It is due mainly to the strong upturn in the USA and the accompanying sharp increase in US imports.

With the slowdown in the pace of American growth in 1985, the developing countries' foreign trade position will again deteriorate a little, though not dramatically, according to the IMF forecast published in October 1985. Their growth will slow down slightly, but not by so much as to give rise to concern: the GDP of non-fuel exporters is forecast to grow by 4.6 % in 1986, compared with the forecast of 4.7 % in 1985.⁷

The Role of Rescheduling

Does this turn of events, which many would not have thought possible three years ago, mean that the so-called debt crisis cannot again pose a serious threat, that the developing countries' heavy indebtedness and the problems associated with it will resolve themselves, given time, and that at most a few isolated liquidity difficulties in individual countries have to be overcome by institutions that are now well practised in debt rescheduling? Hardly. The danger that the foreign indebtedness of developing countries will come to a head, with serious implications for the international financial system, has by no means been banished.

A mood of sober scepticism is already becoming increasingly widespread among bankers active in the international financial markets, who rightly suppose themselves to be at the centre of events. After the great shock of 1982, when Mexico – an oil producer, of all countries – suspended payments, swiftly followed by Brazil and then another six countries before the year was out, the banking community had sunk into a state of almost hysterical anguish. However, when the feared crash failed to materialise and rescheduling went relatively smoothly, the banks' worries appeared to evaporate and a general mood of optimism returned. The banking world believed it had a grip on the situation, although the number of multilateral rescheduling operations continued to rise in 1984, as well as the volume of debt in need of rescheduling. In 1984 the commercial banks alone negotiated 21 rescheduling operations involving a total of \$114 billion. In addition, a further \$2.13 billion in public or publicly-guaranteed loans was rescheduled via the so-called Paris Club and development aid consortia.

The art of rescheduling therefore seemed to have been learnt well; not only were redemptions for one

particular year postponed by means of such moratoria, but the amounts due over several years, which indeed makes more sense. For example, at the beginning of 1985 the commercial banks reached agreement with Mexico on loans falling due between 1985 and 1990. Repayments were stretched out over 14 years, lower interest margins were agreed for the early years and the banks waived the rescheduling fees of between 1.25 and 1.5 % that have normally been charged in the past. Similar agreements are under negotiation or have already been concluded with Ecuador, Venezuela and Brazil.

Such multi-year rescheduling agreements are a considerable advance. They bring greater calm to the international financial market and are likely to reduce uncertainty about the future assessment of the debtor, which itself alone may help many developing countries regain their creditworthiness.

The fact that doubts about a possible resurgence of the crisis are beginning to surface again despite improved rescheduling techniques and despite the economic recovery in the developing countries is due primarily to three factors:

- Most developing countries need not only rescheduling but also fresh money, that is to say additional loans to realise their growth potential.
- During 1985 the representatives of an increasing number of debtor countries threatened to mount a payments boycott. Peru, with debts totalling \$14 billion at the end of 1984, announced that in future it intended to use no more than 10 % of its export receipts for annual debt servicing. Cuba has tried to organise a debtors' cartel, though without success so far.
- The possibility that economic activity in the USA will turn down more sharply than had previously been predicted is nurturing the fear that the export prospects of the Latin American countries, in particular, will deteriorate by more than had been assumed, at least in the short term.

Roots of the Crisis

At the same time, there is growing conjecture that the instruments used hitherto to cope with the debt will no longer be adequate. Closely associated with this is the controversy about the nature and structure of the debt problems. "The debt crisis is not one of solvency but rather of liquidity"; this brief and very apodictic judgement pronounced only recently by the Vice-

⁷ Ibid.

President of Citibank, Hans H. Angermüller,⁸ is now viewed with scepticism. It is admittedly not easy to establish whether and to what extent liquidity and solvency problems are interwoven in the debtor countries and what inferences the creditor countries should draw from this.

In any case, a review of the indebtedness of all the countries affected and of various country groups reveals a very inconsistent picture. The debts at the root of the present problem were accumulated mainly in the aftermath of the first oil price shock of late 1973. The next wave of borrowing followed the second oil shock of 1979-80. Nevertheless, it is interesting to note in this context the remark by Otmar Emminger that even shortly before the first drastic increase in oil prices bankers "debated the possibility that bank lending to the Third World was excessive and voiced fears about placing too heavy a burden on debtor countries".⁹

All countries without oil deposits were hard hit by the quadrupling of oil prices in 1973; they were faced with a sudden deterioration in their terms of trade, which translated first into a deterioration in their balance of payments on current account and then, insofar as the ensuing deficits could not be financed by attracting voluntary investments of petro-dollars, into a sharp drop in the level of domestic consumption and/or investment. At the same time, it became imperative that the structure of consumption and production, especially the latter, be adjusted as quickly as possible so that it would again be viable in the context of the changed input price relationships.

Initially, the non-oil developing countries appeared to run a greater risk of having to accept a sudden reduction in the level of consumption and investment than the industrialised countries, since petro-dollars were invested predominantly in the established western financial centres. The recycling of these funds by the banks from 1974 onwards spared them this.

Recycling had several side-effects, however. The developing countries' indebtedness rose meteorically, and by far more than can be attributed to either the first oil shock or the second that followed in 1979-80. Between the end of 1973 and the end of 1982 the total external debt of the developing countries (excluding OPEC) rose from \$130 to 633 billion. According to a

calculation by Otmar Emminger, over the same period the banks lent the developing countries about twice the amount they received in petro-dollars.¹⁰ At the same time, the commercial banks became the developing countries' main creditors.

Concentration of Debt

This produced the combination of circumstances that is now rightly regarded everywhere as dangerous, indeed as the real reason why the credit relations that have developed are considered to be extremely delicate and unstable, in the sense that they are capable of plunging the entire world into disaster. On the borrower side the bulk of the loans were concentrated in a small number of countries. At the end of 1984, bank loans to five Latin American countries – Argentina, Brazil, Chile, Mexico and Venezuela – alone accounted for 43 % of all outstanding claims on developing and Eastern European countries held by banks reporting to the BIS. The bank debt of four Asian countries – Indonesia, Korea, Malaysia and the Philippines – made up a further 14 % of the volume of debt so defined.

There was a similar concentration on the lender side. It was only a limited number of banks, namely the largest, that rushed first into recycling and then into the further internationalisation of credit business. The exposure of individual banks became very large. For example, loans to Brazil extended by the five largest US banks amounted to almost 56 % of their combined equity capital at the end of 1983, and still almost 49 % at the end of 1984. In addition, risks were badly distributed, so that default by just one debtor threatened banks with collapse, and still does today.

This concentration of debt on the one hand and risks in bank balance sheets on the other greatly reinforced the second side-effect of the successful recycling of petro-dollars. The fact that recycling went so smoothly and that the banks also lent the developing countries additional sums to finance their growing current account deficits tempted these countries to postpone the adjustments that the oil shock had made necessary.

They were aided and abetted in this by the fact that bankers did not recognise the sovereign risk and that initially the monetary authorities of many western countries were very hesitant in combatting inflation, with the result that real dollar interest rates were negative well into the second half of the seventies. Hence, even loans merely for balance of payments financing were not only easy to obtain but also cheap. To the regimes of developing countries with internal political difficulties and problems of legitimacy, this was an open invitation

⁸ Hans H. Angermüller: Resolving the Debt Crisis, address to the International Finance Conference in Seoul, Korea, October 1985, mimeo, p. 2.

⁹ Otmar Emminger: The International Debt Crisis and the Banks, in: *INTERECONOMICS*, No. 3, 1985, p. 107.

¹⁰ *Ibid.*, p. 109.

to use the funds flowing into their countries to subsidise private consumption or boost public consumption, as well as to sustain employment in state-owned enterprises that were no longer viable in terms of the new price relationships.

The situation of the debtor countries became increasingly problematic after 1980, as the consequences of the second oil shock were compounded by the onset of the deepest worldwide recession since the great depression of the thirties and the USA began to combat inflation energetically, which was bound to lead to a substantial rise in real interest rates. It should be added that the combination of these three shocks – a second sharp increase in oil prices, an extremely severe recession and unusually high real interest rates – also made life difficult for sound debtor countries. Even those developing and newly industrialising countries that had genuinely used their foreign loans only for investments that had been regarded up to then as viable began to run into difficulties, though they attempted to overcome them by means of austerity programmes and more rapid adjustment of their economies with the help of foreign loans. The Asian NICs were foremost among the countries that chose this strategy.

Structural Adjustment Postponed

With the benefit of hindsight the World Bank now considers that "in many developing countries outside Asia", on the other hand, the greatly increased volume of foreign borrowing between 1979 and 1982 "was used primarily to postpone, rather than buy time for, structural adjustment".¹¹

This finding is also confirmed by a study carried out by the HWWA, which shows that a large group of developing countries used their foreign borrowing largely to sustain a level of consumption that was already financed on credit. Among 36 countries examined in the course of a research project carried out at the HWWA, 17 states were found to have channelled between 30 % and almost 70 % of the inflow of resources from abroad between 1970 and 1980 into consumption instead of investment. These include a number of major debtors, such as Turkey, the Philippines, Egypt and even Korea, but the most prominent in this respect are the Latin American countries of Costa Rica, the Dominican Republic, Ecuador, Paraguay and Peru. There are even

indications that the two largest debtors – Brazil and Mexico – as well as Argentina used part of their foreign borrowing to finance consumption, although not on the scale seen in the countries listed above.¹²

To the extent that developing countries used loans to finance consumption that would not otherwise have been possible, their external debt is not balanced by productive investments yielding income from which debt service could be paid. Instead, income from other sufficiently profitable investments must be diverted to cover these commitments.

In countries with

- ☐ inflation in double or treble figures,
- ☐ long-standing overvaluation of the currency, and
- ☐ interest rates fixed at too low a level

the profitability of investments cannot be particularly encouraging, since countries that have permitted such aberrations over a period of years exhibit serious price distortions. In particular, capital was made available too cheaply, with the result that a greater volume of foreign loans was taken up than if there had been no price distortions. Another consequence in such cases is that industries are established that are far too capital-intensive in relation to the country's factor endowment, so that comparative cost advantages cannot be exploited and the employment effects are smaller than they might be.

The heart of the problem is that projects financed with foreign or even domestic capital appear to investors to be more profitable than they are, as becomes apparent if price distortions must be eliminated because no more money can be raised abroad.

In many cases, the foreign loans from commercial banks were taken up increasingly by state agencies of the developing countries themselves or at least guaranteed by them, which naturally enabled them to have some influence over the use of the loans. This tendency is particularly prevalent among the major borrowers, which are defined by the World Bank as countries with total disbursed and outstanding debts of more than \$ 15 billion towards private and public lenders.¹³ In the case of these countries, loans from commercial banks raised directly or guaranteed by the state rose ninefold between 1974 and 1983. By contrast, foreign liabilities assumed by private enterprises without state guarantees rose by a factor of only three and a half over the same period. A study carried out at the HWWA

¹¹ World Bank: World Development Report 1985, Washington D.C., 1985, p. 69.

¹² Manfred Holthus, Klaus Stanzel: Die internationale Verschuldungskrise – Ursachen und Lösungen (in preparation).

¹³ Cf. World Bank: Coping with External Debt in the 1980s. An Abridged Version of World Debt Tables, 1984-85 Edition, Washington D.C., March 1985, especially pp. 22 f.

shows that countries which financed an above-average proportion of the current account deficits accumulated in the seventies by means of public or publicly-guaranteed loans recorded lower growth rates and made less progress towards industrialisation than those that did not.¹⁴ Public or publicly-guaranteed loans were clearly used primarily to expand the state's share of the economy, leading to a substantial decline in efficiency.

Capital Flight

Apart from the use of foreign capital to finance extra consumption, bad investments and state profligacy, a fourth category of misallocation has been observed which, in contrast to the other three, is generally condemned by the representatives of the developing countries themselves. This fourth category does often involve using the foreign resources for investment, but an investment of a singular kind. In a number of developing countries, part if not almost all of the funds raised abroad has flowed out of the country again via capital flight. It is very difficult to estimate the extent of capital flight in individual cases, so that figures must be treated with caution. According to a very recent study of this problem by Dieter Duwendag, almost 90 % of the net foreign credit raised between the beginning of 1970 and the end of 1983 by Venezuela, a major borrower, was re-exported via capital flight. The corresponding proportion for Argentina was 77 %, while in the case of Mexico and Peru almost 30 % of foreign credit was used in this way.¹⁵ Despite the repugnance with which capital flight is sometimes regarded, it should not be forgotten that using foreign loans to finance capital flight is less harmful than many other uses, indeed that it sometimes precludes other, worse alternatives. Henry Wallich deserves to be endorsed when he says that, "The diversion of borrowed funds into capital flight is less detrimental to world development than if the owners had chosen to consume these resources".¹⁶

In addition, capital flight generally ceases, and in many cases the funds even return home, if economic policy improves in the country in question, making it possible to invest the capital profitably. The IMF believes that it has already detected a decline in capital flight in the last two years.

Inappropriate Analogy with the Firm

What is to be deduced from this catalogue of sins with which the developing countries can be reproached regarding the use of external loans? In many cases part of the borrowed capital has gone, because it has been literally consumed or squandered on bad investments or the accumulation of state consumption capital.

However, this finding alone does not indicate whether the debtors are in a smouldering solvency crisis, a situation which can be covered up with liquidity assistance for a while but which is bound to lead to ultimate collapse, as in the case of a hopelessly over-indebted company.

The analogy with the firm does not carry far here. With hindsight, we now know that it was never a very helpful parallel when it came to lending. Since the criteria that are generally in the forefront with regard to corporate lending were also applied to loans to countries, one particular group of states found it particularly easy to obtain a very large quantity of foreign capital. These were the countries that had tangible assets such as raw materials or particularly good farmland. Countries in which oil was discovered were particularly sought after as borrowers in the seventies, as it was supposed that they would always earn sufficient foreign exchange from oil exports to service their debt. As we now know, that calculation proved wrong. The countries that have been wrestling with payments difficulties for the past few years include three countries in which significant oil finds were made – Mexico, Venezuela and Nigeria.

Developing countries with no tangible resources such as oil deposits but a hard-working population and which in principle pursue market-oriented policies, such as some of the Asian countries, have had greater success so far in clearing the obstacles placed in their way by oil price shocks, world recession and high interest rates.

The analogy with the firm is not appropriate to the present situation of debtor countries either. A considerable number of these countries – 57 at the latest count – are having problems servicing their debt. At present they are not earning enough foreign exchange to meet their interest and repayment commitments denominated in foreign currency and they cannot find any lender who believes in their potential future ability to pay and is willing to provide additional loans. However, this alone does not prove that given appropriate domestic economic policies and sufficient additional capital they will not once again become solvent.

¹⁴ Cf. Susanne Schattner, Klaus Stanzel: The Role of the State in Foreign Borrowing by Developing Countries, in: INTERECONOMICS, No. 1, 1985, pp. 27 ff.

¹⁵ Dieter Duwendag: Kapitalfucht aus Entwicklungsländern: Schätzprobleme und Bestimmungsfaktoren, in: Armin Gutowski (ed.): Die internationale Schuldenkrise, Ursachen – Konsequenzen – historische Erfahrungen, to be published shortly by Duncker & Humblot, Berlin.

¹⁶ Henry Wallich: The International Debt Situation in an American View: Borrowing Countries and Lending Banks, in: Armin Gutowski (ed.), op. cit.

The countries whose situation may remain problematic for decades even if they follow exemplary economic policies, that is to say the 34 poorest countries in Africa and Asia, account for only something over 11 % of foreign lending to the Third World. Their share of commercial loans comes to only just over 2 %.

Rescheduling Not Enough

The great majority of debtor countries in difficulties definitely have the potential to realise substantial income opportunities in future and hence to be in a position to service their debt. This is particularly true of the newly industrialising countries of Latin America.

Rescheduling alone is probably not enough to enable them to realise their potential, and indeed that has not been the objective up to now. The primary aim is decidedly short-term: to prevent a collapse. Many a banker may also harbour the thought that rescheduling may delay the inevitable insolvency of a country long enough for his institution to write off its claims.

Normalisation of lending has not occurred,

- even though rescheduling, which usually involves hundreds of banks for each debtor country, settled into its stride relatively quickly and the techniques of rescheduling have been improved,
- even though the banks have reduced and further diversified the risks of their exposure towards heavily indebted countries by raising fresh equity capital, building up reserves, writing off and swapping claims,
- even though debtor countries have bowed to the stabilisation and austerity conditions demanded by the International Monetary Fund and
- even though under these constraints, reinforced by a revival in world economic activity and falling interest rates, current accounts have improved considerably, trade balances are even showing large surpluses in some cases and GNP is again growing in real terms.

Normalisation would not signify a return to the rates of credit growth of the seventies. Since 1982 the banks have shown little inclination to provide fresh money. The additional credit they have granted in recent years was essential to ensure successful rescheduling. These loans have therefore been termed involuntary lending.

There is scarcely any prospect of the banks granting voluntary loans that would increase net lending. They fear that if they were to do so they might simply be throwing good money after bad and would therefore only place themselves in greater jeopardy, for it can be foreseen that the debtor countries will be unable to

adhere to the austerity policy without adversely affecting investment and hence harming their growth and export prospects. Moreover, the slowdown in economic activity in the United States and possibly somewhat later in the rest of the world will cause their current account deficits to rise again, so that new debt crises will occur.

It is therefore understandable that most banks have decided to err on the side of extreme caution, but it is also true that rescheduling alone cannot provide a permanent solution to the predicament of the heavily indebted developing countries. They undoubtedly need new loans, though not on a massive scale. It would be a tragedy if the banks were as cautious in lending in the next few years as they were reckless in the seventies, for if most banks behave in accordance with their sombre forecast it will inevitably prove self-fulfilling.

Co-operation the Only Way Out

Nor is there any sign of a third party coming to the rescue. Direct investors, who also need to borrow, will not be queueing up to invest immediately, despite the establishment of the new Multilateral Investment Guarantee Agency.¹⁷ Nor can or should international organisations spring into the breach, which is far too wide. The lenders of last resort, the central banks, would do what was necessary, despite repeated denials, but the international financial system would be shaken for a long time to come and, to put it politely, creditor banks would no longer belong to their shareholders.

But why should a bank suppose that if it is granting new loans other banks are doing the same? If it is not one of the very large banks it could just as well hope to keep out of trouble and leave others to provide the necessary money. Even if all the banks know that success is conditional on the provision of fresh money, they cannot be certain that it will be used for promising schemes.

Co-operation offers the only way out of this dilemma. The creditor banks, which have already tested their ability to work together in the rescheduling negotiations, could try to agree on the volume of new loans they are prepared to extend jointly to developing countries still in difficulties despite rescheduling and on how this commitment should be shared among themselves. Such an agreement would probably not succeed if the recipient countries did not undertake in return to pursue an individually specified policy aimed at promoting stability and growth. A rather loose alliance of creditors is hardly likely to induce individual developing countries

¹⁷ The Multilateral Investment Guarantee Agency (MIGA), Documents submitted to the Board of Governors of the International Bank for Reconstruction and Development at its 1985 Annual Meeting, October 1985.

to make, let alone implement, such a commitment. A third party is therefore needed who can lend weight to the conditions for granting bank loans by virtue of its own contribution and above all by virtue of its authority anchored in international agreements. This role was generally taken by the International Monetary Fund in the rescheduling operations. Fund participation would also be an advantage in the agreement mooted here. However, the leverage it can exert by means of monetary, fiscal and exchange rate policy conditions attached to stand-by credits and drawings on special tranches is probably not sufficient. It would therefore be desirable if the World Bank, in particular, were to declare its readiness to extend increased credit for structural adjustment to supplement the new voluntary lending by the banks if the borrowing developing countries committed themselves to individually negotiated policies to promote growth.

The Baker Plan

Anyone who has followed the recent discussions will have little difficulty recognising that the action suggested in the light of the present dilemma essentially coincides with the proposals made by the US Treasury Secretary, James Baker, on 8th October 1985 at the annual meeting of the World Bank and International Monetary Fund in Seoul.¹⁸

Initially there were many sceptical voices to be heard coming from the banks' camp, particularly as the proposal was only an outline and left many questions unanswered. It still needs considerable refinement and many concrete details have yet to be determined, but it is now gaining increasing acceptance among banks and other governments, albeit with some reservations about the aspects that remain to be settled. The IMF and World Bank are ready to play their part. In fact, the banks should be grateful that Baker took the initiative, so that the United States does not first have to be won over to a solution for which the banks or the international organisations would otherwise have had to campaign, as no other way out of the dilemma presents itself if the danger of a new wave of debt crises is to be banished.

Under the Baker plan, private banks should grant the heavily indebted middle-income developing countries net new credit totalling around \$20 billion over the next three years. The beneficiaries do not include the poorest developing countries – some of which are in Asia but most in sub-Saharan Africa – which are mainly the

recipients of public loans on preferential terms. They will not be dealt with here, although they were and still are problem cases, with regard to borrowing and in other ways. The successful developing countries in Asia, some of which are already NICs, are also excluded; these countries can obtain loans without concerted action and some of them also have access to western capital markets. However, even though it has emerged from subsequent discussion that the Baker initiative concentrates on only fifteen countries – apart from three African countries, the Philippines and Yugoslavia they are all Latin American countries, though they do include four of the five countries most heavily indebted to commercial banks (Mexico, Brazil, Argentina and Venezuela) – \$ 20 billion is a relatively modest sum, which would mean an annual increase of only just under 2½ % in the 15 countries' net foreign indebtedness to banks, less than their national product will increase in real terms, at least so it is hoped.

In addition, Baker's proposals provide for an increase in disbursements by the World Bank and the Inter-American Development Bank to this group of countries over the next three years; the amount involved is smaller in absolute terms – \$9 billion – but the percentage increase is substantially larger, namely 50 %.

A further provision of Baker's proposals is that the heavily indebted developing countries in question should have access to the funds only if they undertake to follow policies geared towards stability and growth. This aspect, which is probably the most important ingredient in the concerted action by commercial banks, the World Bank, other regional development banks and the heavily-indebted middle-income developing countries, was not put into sufficiently practicable terms in Baker's proposals, though he did call upon the IMF to complement the monetary, fiscal and exchange rate conditions it imposes in connection with balance-of-payments financing by according "higher priority to tax reforms, market-oriented pricing, the reduction of labour market rigidities and to opening economies to foreign trade and investment", perhaps within the framework of "enhanced surveillance", and to co-operate closely with the World Bank in this respect.

The World Bank should "actively promote the development of the private sector" and provide both technical and financial assistance in the privatisation of state-owned enterprises. The proposal also points to the urgent need for increased co-financing with commercial banks.

This all seems right and sensible. However, it is in need of interpretation. The commercial banks that are to

¹⁸ Statement by the Hon. James A. Baker III, Secretary of the Treasury and Governor of the Bank and Fund for the United States, at the Joint Annual Discussion, Board of Governors – 1985 Annual Meetings – Seoul, Republic of Korea, Press Release No. 13.

risk fresh money must gain confidence in the economic policy programmes to which the developing countries are to commit themselves.

The World Bank and the IMF must take the first step by working out a basic programme that should in principle apply to all debtor countries. In addition to the usual IMF conditions, it should provide above all for the elimination of price distortions, not only between different domestic goods but also between domestic and foreign goods. The same applies to factor prices, in other words interest rates and wage structures, which must reflect conditions of relative scarcity. It also entails pruning the responsibilities of the state on the principle that as much as possible should be left to private markets.

Improvement of Domestic Resources

One aspect that is unfortunately often overlooked but which is of considerable importance for successful development is the need for a policy to improve the quality of domestic resources. In less heavily indebted countries, let alone those with a massive burden of existing debt, growth can be achieved only if increasing amounts of domestic labour and domestic means of production can be used profitably for investment, that is to say to build up the country's physical capital stock and expand the infrastructure.¹⁹ It is inevitable that the foreign exchange flowing into the country in the form of new external loans will be used to pay interest and repay the principal of existing loans, because in the initial stages the domestic market will grow and it will still be unprofitable to export many of the goods that these countries are already able to produce. However, this will do no harm only if the equivalent of the foreign exchange needed for interest and redemption payments has been earned in domestic currency and if the quality of domestic resources has been raised sufficiently to be used for investments that are profitable and can be financed with domestic currency.

If a policy is pursued that raises the level of education of the population as a whole and the skill level of the workforce, brings to the fore people with business acumen and management abilities and promotes the creation of a transport and communications infrastructure, then the national product will grow, direct investment will increase and foreign loans will be

granted voluntarily, even though it will take time for the country to develop the ability to produce sufficient goods that it can offer competitively on world markets.

The idea that all that matters is to establish sufficient export capacity as quickly as possible so that foreign debt service commitments can be met from the proceeds of sales must be dispelled once and for all. Applied worldwide, such a structural policy could easily lead not only to a glut of raw materials but also a price collapse due to world markets being flooded with textiles, fibres, simple consumer goods and products from assembly plants even if the deplorable protectionism whereby the industrialised countries shield themselves from such imports did not exist.

The criterion for assessing the long-term creditworthiness of a country is not the speed with which plants are constructed, often with the benefit of subsidies, to produce simple mass products for the world market without considering whether they can be sold at a profit; the true criterion is steady growth without price distortions or official direction of foreign trade at market interest rates and exchange rates. As this can be achieved only if the quality of domestic resources constantly improves, every programme for heavily indebted developing countries reliant on fresh money must include a policy to promote the development of domestic resources. This is a lesson that must be learnt not only by the developing countries but also by their creditors and lenders.

Burden-sharing among Lenders

The international organisations should be able to agree quickly on the basic principles for economic policy programmes for heavily indebted developing countries. Negotiations could then be opened with each developing country individually, preferably before further rescheduling becomes necessary, on the granting of loans by the World Bank (and other development banks) with the participation of the IMF; in the course of these negotiations the country in question would have to agree with the institutions on an acceptable, concrete economic policy programme. Parallel to this, the banks could negotiate in the well-proven way on the level of new loans they were to grant. At the conclusion of both sets of negotiations the developing country would have to undertake to adhere to the programme.

Concerted action to provide fresh money for heavily indebted developing countries would have to take this or a similar form unless individual developing countries resolved to adopt the recommended policy of their own

¹⁹ Cf. in this context Armin Gutowski: *Auslandsverschuldung der Entwicklungsländer, realer Kapitaltransfer und Investitionen*, in: Wolfram Engels, Armin Gutowski, Henry C. Wallich (eds.): *International Capital Movements, Debt and Monetary System*, Mainz 1985, pp. 171-200; Armin Gutowski: *Foreign Indebtedness and Economic Growth: Is there a Limit to Foreign Financing?* in: Armin Gutowski, A. A. Arnaúdo, Hans-Eckart Scharrer: *Financing Problems of Developing Countries*, Houndsmills, Basingstoke, Hampshire and London 1985, pp. 249-267.

accord, made this decision sufficiently credible and then received the necessary funds as voluntary loans from individual banks and other sources. This is highly unlikely, however, in the present tense situation.

Such a solution is still a long way off and speed appears to be of the essence. The major creditor banks, which have now endorsed the Baker initiative in principle, are arguing about the apportionment of the proposed volume of credit. Since word has gone about that banks in the United States hold rather less than one-third of the outstanding debt of the developing countries involved,²⁰ US banks are insisting that new lending be distributed in the same proportion between American and non-American creditor banks. European banks in particular are resisting. What is more, when negotiations with developing countries open it will rapidly become clear that the global sum of \$ 20 billion is not enough.

There will also be fierce skirmishing behind the scenes on the *manner* in which the fresh money should be made available.²¹ European banks, and especially those in Germany, are lobbying strongly for future interest due on existing debt to be capitalised and added to the existing debt but repaid later, which would initially ease the burden on debtors. The US banks cannot agree to such an approach because of the different nature of their banking supervision. The European banks now suspect that the main object of persuading them to provide fresh money is to enable the debtor countries to pay interest punctually to American banks.

The argument is superficial, because it matters not what will be paid with whose money but solely whether viable projects in debtor countries will be financed on an equivalent scale, even if they will have to rely predominantly on domestic labour and suppliers. The possibility of accepting part of the accrued debt service in local currency, which has also been considered, would come to the same thing, though with the exchange risk reversed. The banks must learn that the form in which the new loans are granted is not so important, provided the debtor countries pursue the agreed policy of promoting growth.

To complete the picture, it should be mentioned that the international lending organisations could also encounter difficulties with their contribution, particularly if this proved too small as well; the only solution would then be to make capital increases and have greater recourse to international capital markets.

Pessimism Uncalled For

The world need not take a pessimistic view, even if all these factors are taken into account. As the Baker initiative has given an impetus for action at a time when most of those involved were aware of the need to act, it is to be hoped that the discussions will lead to more or less concerted action of the kind described.

If the right conditions are created in debtor countries for a policy aimed at stability and growth and if new loans are granted on an appropriate scale, many of even the heavily indebted developing countries can probably adopt a course that will allow them to service their new and old debts, even if further rescheduling must be carried out here or there because the time-scale of the previous operations was too short.

The question remains whether the intended therapy will not work for some of these countries because too large a proportion of the capital already borrowed flowed into consumption, was badly invested or simply squandered and because debt servicing simply constitutes too heavy a burden, even after it has been lengthened and spread out by rescheduling and other measures. In other words, cases in which the correct diagnosis would be a solvency crisis rather than a liquidity crisis.

In such cases the analogy with bankruptcy or at least composition under company law again springs to mind. There have been any number of such cases in history, and even today it is conceivable that a country that expects to receive no further net transfer in its favour in the foreseeable future will suspend payments, even if it were in a position to meet its obligations.²² However, this is not very likely to happen.

Even leaving that aside, the analogy should not be taken too far. A *company* that applies for composition with its debtors must demonstrate that it can no longer pay its employees and suppliers in full if it services its debt in full but that the company can be salvaged if part of its debt is cancelled. A country, which differs from an enterprise in that it can tax all its citizens earning an income, could claim a situation comparable to composition only if after exhausting all rescheduling possibilities current debt servicing were still so high that it could not leave its citizens with the minimum subsistence if it serviced its debt in full; expressed in

²⁰ Morgan Guaranty Trust Company: World Financial Markets, July 1985, p. 6.

²¹ On the various methods of expanding and securing credits, see C. Fred Bergsten, William R. Cline, John Williamson: Bank Lending to Developing Countries: the Policy Alternatives, in: Institute for International Economics: Policy Analysis in International Economics, No. 10, April 1985, pp. 33 ff. and pp. 95 ff.

²² Niehans shows that where claims arising from international loans are assumed to be unenforceable it pays debtor countries to suspend payments if the cash value of future payment flows becomes negative. Cf. Jürg Niehans: Internationale Kredite bei nicht durchsetzbaren Forderungen, in: Armin Gutowski (ed.): Die internationale Schuldenkrise ..., op. cit.

more realistic terms, this means if it had to tax its citizens so severely that a revolution would break out or, in more peaceful cases, if the income remaining to citizens offered so little incentive to work that all prospects of growth evaporated.

In none of the borrowing countries examined here is the relationship of debt service payments to national income likely to be so high after exhausting all possibilities for rescheduling that this situation would obtain. Without new loans, however, there could be a danger that several of these countries could find themselves in such a position.

Obviously there is nothing to be said against thinking about the possible instruments for such a "composition", but it remains to be seen in each individual case whether the cancellation of part of the debt really were inevitable one way or another. To anticipate such cases would only provoke "moral hazard" – many a debtor country would use every

means at its disposal to present itself as a candidate for debt cancellation.

If ways and means of granting the necessary amount of new loans to the heavily indebted developing countries that are willing to co-operate are found in time, which appears to be a possibility since the meeting in Seoul, there is not a high probability that we shall run into another round of debt crises.

One final remark in conclusion. It goes without saying that it would be far easier for the developing countries to move onto a steady growth path if the highly industrialised creditor countries themselves would improve their own climate for growth and full employment and, above all, would abandon protectionism. However, shortcomings in the economic policies of lending countries should on no account be accepted unreservedly as an alibi for further mistakes by the heavily indebted developing countries, not least for their own sake.

EAST-WEST TRADE

Technologies of the Future: Security and Competition Aspects

by Rolf Hasse, Hamburg*

The SDI technology initiative, which is directed towards military ends, and its civil counterpart Eureka pose a challenge to relations between East and West and within the Western world. Professor Rolf Hasse analyses their implications for security and competition.

One issue is coming increasingly to dominate discussions at the national and international levels: the technologies of the future. It is a subject that reaches into all areas of social life, affecting political, cultural, economic and security considerations. It is firing the imagination of futurologists and causing a boom in scenarios and predictions. It is thus exercising optimists and pessimists alike and arousing hopes and fears. It has thrown down a challenge to politicians and spurred them to compete even more keenly in determining the strategies and policies for the decades to come. The following article sheds light on a number of aspects

arising from the interdependence of the commercial and military exploitation of the new technologies. The Federal Republic of Germany is directly affected in both spheres:

□ economically, because the expected spin-offs from research in the civil and military fields may trigger a new Kondratieff cycle in the Schumpeter sense. The competitiveness and hence the real income of firms and economies will – in view of the high intensity of foreign trade – be determined partly by whether or not they participate in developing the new technologies or have access to them.

□ from the point of view of security, because the Federal Republic's membership of NATO, its

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