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Klaus Didszun*

On the Problem of Negative Net Financial Transfers to Developing Countries

A sudden and radical reversal of financial flows to developing countries has occurred since 1982. Controversy exists, however, as to the scale of the actual outflow of resources and as to whether too much emphasis has been placed in the past on adjustment efforts. The following article attempts to throw some light on these controversies.

A wide variety of publications has long lamented the outflow of financial resources from developing countries. The terms they use are varied, ranging from "net financial transfer from developing countries" via "transfer of resources in the wrong direction" and "perverse capital transfer from South to North" to the "financial draining of the Third World", but all without exception refer to the fact that since about 1984 the developing countries as a whole have paid more to their creditors in interest and repayments of principal on *long-term* debt than they have received from them in the form of new long-term loans. Put another way, the net financial transfer is negative if in any given year the *increase* in indebtedness is smaller than the sum of nominal interest payments. This is also the definition used by the World Bank in the preparation of its World Debt Tables.¹ However, the World Bank advises caution in the use of findings based on this definition.

Scale and Causes of the Problem

The World Debt Tables 1987-88 show that a total inflow of resources of \$140 billion in the years from 1978 to 1982 gave way to an outflow of \$85 billion in the following five years. The corrected figures contained in the 1988-89 edition put the outflow at \$95.3 billion, rising to \$138.3 billion if 1988 is included (see Table 1).²

The figures for the seventeen highly indebted countries are even more alarming (see Table 2). According to World Bank data, the total inflow of funds into these countries between 1978 and 1982 amounted

to \$65 billion and the outflow between 1983 and 1987 to \$100 billion, equal to 2.8 % of their GDP during the same period. It should be noted that the smaller and politically weaker countries had to make relatively larger net transfers than their larger neighbours.³

The changes that have triggered this switch from inflows to outflows differ from one group of countries to another. Taking the *developing countries as a whole*, the following factors are relevant:

- The disbursement of new loans is declining. In 1988 it was \$36 billion lower than in 1981, a fall of 29 %.
- At the same time, principal repayments have increased by just under \$25 billion, or 52 %. These two factors have reduced net inflows by \$60 billion. (In this context it should be borne in mind that the proportion of official development financing has more than doubled since 1980 and accounted for around 80 % of total capital inflows between 1985 and 1988.⁴)
- Interest payments have increased by \$16 billion, or 42%.

In the case of the *highly indebted countries* alone, on the other hand,

- the decline in net lending is more pronounced. In 1987 it was \$46 billion lower than in 1981, a decline of

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¹ World Bank: World Debt Tables 1984-85, p. xii.

² World Bank: World Debt Tables 1988-89, p. x.

³ Jeffrey D. Sachs: Conditionality, Debt Relief, and the Developing Country Debt Crisis, in: Jeffrey D. Sachs (ed.): Developing Country Debt and Economic Performance, Vol. 1, Chicago and London 1989, p. 263.

⁴ Cf. IMF: World Economic Outlook, April 1989, p. 19.

⁵ The reduction in new lending and the resulting increase in the negative net transfer also applies to the group of oil-importing countries.

⁶ World Bank: World Debt Tables 1988-89, p. xvi.

66 %, and is therefore almost solely responsible for the negative net financial transfer. Except in the case of Argentina and Mexico, commercial banks have lent these countries no new money in recent years. Payments of interest and repayments of principal exceeded disbursements by \$19.4 billion in 1986 and by \$14.2 billion in 1987. At the same time, World Bank adjustment loans have increased substantially since 1982. A substitution effect can be observed: debt service payments to private creditors are being met partly out of resources from international institutions. Risks are being collectivised.

□ Principal repayments have declined by \$8.8 billion, or 34 %, partly as result of rescheduling.

□ Interest payments, which surged briefly in 1984 and 1985, are now \$2.6 billion higher than in 1981, an increase of 10 %.

The differences between the two country groups are due to the fact that the figures for developing countries as a whole are averages covering a highly disparate collection of countries, ranging from relatively prosperous East Asian states making capital repayments (Hong Kong, Taiwan, Korea and Singapore) to the poorest sub-Saharan countries. For the remainder of this article, it therefore appears to make sense to concentrate on the seventeen highly indebted

countries, which accounted for 46 % of the long-term debt of all developing countries in 1987.⁵

Measured in terms of the debt indicators, their economic situation appears to be critical; in 1988 their debt service ratio was 35.5 %, considerably higher than the figure of 21.5 % for developing countries as a whole. Their debt/export ratio stands at 295 %, compared with an average of 170 % for all the developing countries. It would have been higher still if the dollar depreciation of 1988 had not reduced the value of debt denominated in other currencies and if creditors had not also somewhat reduced their claims. Moreover, the ratio relates only to long-term debt; on the basis of total debt it stood at 357 % in 1987.⁶

Some Findings

What does a negative net financial transfer mean for the countries concerned? *First*, it cannot necessarily be deduced that a negative net transfer harms the country in question. If foreign loans have been used to develop the infrastructure and expand production capacity that yields income, strengthens the country's ability to increase domestic saving and enables it not only to supply the domestic market according to any chosen criterion of adequacy but also achieve current account surpluses, then it can be expected that the foreign currency receipts can be used to pay interest and repay the principal, in other words, that the net transfer will be

Table 1
Long-term Indebtedness and Financial Flows to Developing Countries
(in \$ bn)

	1981	1982	1983	1984	1985	1986	1987	1988 ^a
Disbursements	124.1	116.9	97.2	91.6	89.3	87.7	86.7	88.0
– Principal repayments	47.4	49.7	45.4	48.6	56.4	61.5	70.9	72.0
Net flows	76.7	67.2	51.8	43.0	32.9	26.2	15.8	16.0
– Interest payments	41.4	48.9	47.3	53.2	55.8	54.9	54.0	59.0
Net transfers	35.3	18.2	4.6	–10.2	–22.9	–28.7	–38.1	–43.0

^a Preliminary estimates. Source: World Bank: World Debt Tables, 1988-89, p. xii.

Table 2
Long-term Indebtedness and Financial Flows to Highly Indebted Countries¹
(in \$ bn)

	1981	1982	1983	1984	1985	1986	1987	1988 ^a
Disbursements	69.7	60.3	38.4	33.5	24.5	24.2	23.4	.
– Principal repayments	26.0	25.7	19.3	20.2	18.5	19.8	17.2	.
Net flows	43.7	34.6	19.1	13.3	6.0	4.5	6.2	7.6
– Interest payments	25.4	30.8	29.0	33.2	32.5	30.2	28.0	.
Net transfers	18.3	3.7	–9.9	–19.9	–26.5	–25.8	–21.8	–31.1

¹ Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Ivory Coast, Jamaica, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia. ^aPreliminary estimates. Source: World Bank: World Debt Tables, 1988-89, pp. xvii and 30.

negative.⁷ This, in fact, is the idea underlying the "growth-cum-debt" concept.

Today the four newly industrialising countries of Asia have substantial current account surpluses. They can reduce their foreign debts without curbing the development of the domestic economy. They are entering a repayment phase. The negative net financial transfer is a declared government objective in these countries. It should be noted, above all, that the receipts this group of countries earn from exports of services are sufficient not only to cover their interest payments but also to leave a substantial invisible surplus, in contrast to the situation in the highly indebted countries.

Secondly, it is conceivable that a positive net transfer that is regarded as necessary may give way temporarily to a negative flow. This will occur if the maturing of loans of differing lengths is concentrated in particular years

because of the unfavourable timing of redemption commitments or when loans taken up in larger amounts in crisis years become repayable. This is true at present of IMF and World Bank loans. Other factors that have helped to bring this situation about will not be examined further here.

There has therefore also been a negative net financial transfer in connection with IMF lending since 1986; in the case of the World Bank the change of sign occurred in 1987. The IMF justifies its insistence on repayment with the argument that it grants relatively short-term revolving credits which must be available to all members (the circulating character of Fund resources); it must take care to maintain its liquidity in order to be able to meet possible calls on its resources from industrialised countries.

The World Bank explains the decline in disbursements by the fact that the reform programmes of some of the major debtor countries do not meet the

⁷ World Bank: World Debt Tables 1984-85, p. xii.

Table 3
Current Accounts of the Four Newly Industrialising Countries of Asia
(in \$ bn)

	1982	1983	1984	1985	1986	1987	1988
Exports (f. o. b.)	83.1	90.8	107.5	108.6	130.2	175.2	218.4
- Imports (f. o. b.)	91.5	94.3	103.8	100.1	111.3	150.1	200.1
Trade balance	-8.4	-3.5	3.7	8.5	18.8	25.1	18.3
Services, net	5.5	4.8	2.8	1.5	3.8	5.0	7.6
Unrequited transfers	0.2	0.4	0.2	0.2	0.5	0.3	-0.1
Current account balance	-2.7	1.7	6.6	10.2	23.1	30.3	25.8

Figures for financial years to 30th April. Source: IMF: World Economic Outlook, April 1989, p. 171.

Table 4
Indebtedness with the International Monetary Fund and Net Capital Inflows
(in SDR bn)

	1981	1982	1983	1984	1985	1986	1987	1988	1989
Disbursements	4.4	7.0	10.2	10.2	6.0	3.9	3.2	4.1	2.1
- Repayments	2.8	1.9	1.5	2.0	2.8	4.3	6.2	7.9	6.3
Net capital inflows	1.6	5.1	8.7	8.2	3.2	-0.4	-3.0	-3.8	-4.2

Source: IMF: Annual Reports 1987, p. 83, and 1989, p. 51.

Table 5
Highly Indebted Countries: Indebtedness with the World Bank and Net Transfers
(in \$ bn)

	1981	1982	1983	1984	1985	1986	1987
Disbursements	2.4	2.8	3.6	4.4	4.1	5.7	5.3
- Principal Repayments	0.7	0.9	1.1	1.4	1.6	2.3	3.0
Net flows	1.7	1.9	2.5	3.0	2.5	3.4	2.3
- Interest payments	0.9	1.0	1.2	1.4	1.6	2.3	2.9
Net transfers	0.8	0.9	1.4	1.6	0.9	1.1	-0.6

Source: World Bank: World Debt Tables 1988-89, p. 30.

Bank's requirements. Feinberg⁸ counters this with the argument that the international financial institutions should "be expected to sustain positive transfers to nations undertaking reform programmes, at least until they resume growth".

Thirdly, it can hardly be demanded that a positive net financial transfer continue in perpetuity or, as the World Bank writes, that borrowers have some kind of "right" to a positive net transfer.⁹ If the net financial transfer must always be positive, but the rate of growth in exports is below the real interest rate, the debt/export ratio will continually rise. The World Bank considers that the extraordinarily high inflow of foreign savings that made possible a high and rapidly rising level of investment and consumption in the seventies was clearly unsustainable over the long term.¹⁰ It must also be borne in mind that if a country fails to meet its interest payments because its trade surpluses are too small and if arrears are refinanced, the total debt rises and thus increases the necessary future abstinence from consumption in the same way as any further new borrowing or rescheduling.

Fourthly, it is conceivable that in a developing country there may be asymmetry between relatively short-term financing and the much longer time required for many investments to reach maturity. The success of such investments depends on the scope for refinancing debt service payments. This necessitates rising total indebtedness, especially if interest rates are high. A sudden swing from a positive net financial transfer to a negative one will dash this expectation and jeopardise the success of the investments in question.¹¹

Fifthly, it must be considered highly questionable for countries whose economic development is downwards and whose level of poverty in terms of nutrition, health and education is becoming increasingly serious to make net financial transfers to creditor countries, even if it must be conceded that part of the problem is due to inefficient use of credit in the past. This is a point seized upon by the critics who lament the net financial transfers being made by developing countries.

Outflow of Resources

Some authors, however, have expressed doubt that an outflow of resources is occurring on the scale indicated. According to Holthus,¹² a negative net financial transfer does not necessarily mean that there is an actual outflow of resources. He uses balance-of-payments statistics to prove his point (see Table 6).

Holthus explains: "Country A is in a situation that was typical of most capital-importing Third World countries until about 1982/83. Current account deficits were very high owing to large trade deficits and higher interest rates, but capital inflows exceeded total debt servicing obligations. The net transfer of resources as defined by the World Bank was positive. The situation of country B corresponds more to current circumstances. Debt servicing is higher than new borrowing, so that the net transfer of resources is negative."¹³ Nevertheless, there will not be an outflow of resources, because country B has a current account deficit, in other words it is receiving more resources from the rest of the world than it is exporting. Holthus proves this with the following equations from the national accounts:

$$(1) \text{ GDP} = Y = C_p + G + I_p + I_g + (X - M)$$

$$(2) \text{ GNP} = Y' = Y - iD = C_p + S + T$$

He then replaces the Y in the left-hand expression of equation (2) by the right-hand expression in equation (1), thus obtaining an equation relating to GNP.

$$(3) \text{ } C_p + G + I_p + I_g + X - M - iD = C_p + S + T$$

Table 6
Balance-of-payments Statistics

	Country A	Country B
Exports	100	100
- Imports	110	95
- Interest payments	10	10
Balance on current account (A)	-20	-5
Capital inflows (new loans)	100	100
- Capital outflows (repayments)	80	95
Balance on capital account (B)	+20	+5
Overall balance (A + B)	0	0
World Bank debt statistics		
New loans	100	100
- Repayments	80	95
= Net inflow	+20	+5
- Interest payments	10	10
= Net transfer	+10	-5

⁸ Richard E. Feinberg: Defunding Latin America: reverse transfers by multilateral lending agencies, in: Third World Quarterly, Vol. 11, No. 3, July 1989, p. 84; see also Stephany Griffith-Jones and Lucy Nichols: New Directions in Debt Management, in: Case Western Reserve Journal of International Law, Vol. 19, No. 1, 1987, pp. 70 and 72.

⁹ World Bank: World Debt Tables 1984-85, p. xii.

¹⁰ World Bank: World Debt Tables 1988-89, p. xvi.

¹¹ World Bank: World Debt Tables 1984-85, p. xii.

¹² Manfred Holthus: Die Auslandsverschuldung der Entwicklungsländer, Federal Ministry for Economic Co-operation, Materialien No. 76, Bonn 1987, p. 44.

¹³ Ibid.

where

C_p = private consumption

I_p, I_g = private and government investment expenditure

X, M = exports and imports

iD = interest payments on foreign debt

S = saving

T = tax payments

G = government consumption.

(4) restatement: $X - M - iD = (S - I_p) + (T - G - I_g)$

(5) restatement: $I_p + I_g = S + (T - G) + (M - X + iD)$

where

$(T - G)$ = government saving

$(M - X + iD)$ = current account deficit.

Equation (5) shows that investment can be financed out of total saving and the current account deficit. Hence, as long as developing countries have current account deficits they can achieve a larger volume of investment than would be possible on the basis of their own savings alone, even if a negative net financial transfer occurs in the same year.

The current account balances of the seventeen highly indebted countries on the basis of World Bank data are set out in Table 7.

Statistics published by the OECD contain information on the fifteen heavily indebted countries that were to benefit under the Baker initiative, that is to say the seventeen in the World Bank definition less Costa Rica and Jamaica (see Table 8).

The current account balances of heavily indebted countries shown here as well as those in other groupings show that the equations chosen by Holthus for countries A and B accurately reflect the situation of heavily indebted countries and that one can speak of a net transfer as defined by Holthus only in exceptional cases. From the balance-of-payments point of view one can agree with him when he writes that critics using the net financial transfer argument are confusing aspects of the current account and the capital account. The negative sign suggests an outflow of resources, which in his opinion does not actually need to take place.

Different Concepts

The reason why these results differ from those previously expected is that both the above current account calculation and the equations are based on gross national product (GNP), stemming from the *national* concept. Here the interest on foreign loans earned by the productive use of the financial resources within the country cannot be counted as part of national

Table 7
Current Account Balances of the 17 Highly Indebted Countries

(in \$ bn)

	1982	1983	1984	1985	1986	1987
Current account balance ¹	-52.3	-13.9	+1.0	+0.7	-11.8	-7.5

¹ Including interest and dividend payments.

Source: World Bank: World Debt Tables 1988-89, p. 30.

product for distribution within the country. Instead, it constitutes factor income accruing to the rest of the world from the use of capital. Accordingly, the rest of the world must be granted an equivalent claim on total domestic output.

In the current account of debtor countries this appears as an expenditure or as an import of services. If surpluses on merchandise trade and deficits on services cancel one another out, the current account balance is zero. According to this definition, no outflow of funds has taken place; this would happen only if there were a net redemption of foreign loans out of current account surpluses.

The World Bank, on the other hand, bases its definition of net financial transfer on the *domestic* concept, whereby the resident production units generate the total product. It also includes factor incomes to be paid to foreigners for the use of capital. If net interest payments are made on foreign loans, the scope for domestic consumption is reduced.

The equations corresponding to this concept are as follows:

(6) $GDP = Y = C_p + G + I_p + I_g + X - M + iD$

(7) $GDP = Y = C_p + S + T$

(8) restatement: $C_p + G + I_p + I_g + X - M + iD = C_p + S + T$

(9) restatement: $I_p + I_g = S + (T - G) + (M - X) - iD$

Equation (9) relating to GDP produces a different result from equation (5): investment can be financed out of total saving less the trade surplus and interest payments on foreign loans. The part of domestic saving available for investment is therefore reduced by the amount of net interest payments on foreign debt.

By contrast, the equation based on GNP suggests that increased interest payments on foreign debt (as a result of a general increase in interest rates, for example) and a correspondingly growing current account deficit would increase the scope for domestic investment and consumption. An absurd result.

NORTH-SOUTH RELATIONS

The concept of net financial transfers based on GDP, on the other hand, uses a different systematic approach that brings together the sub-aggregates determining investment. It advances to one of the important key variables for macro-economic growth.

Aggregate Net Financial Transfer

A further criticism arises from the fact that by confining itself to long-term debt the World Bank definition of net financial transfers ignores inflows of other important

resources into developing countries, namely net direct investment, net portfolio investment and official and private transfers less net payments of dividends.

A further argument in favour of using this wider concept is that the World Bank concept gives a false picture of the scale of the net transfer if substantial use is made of debt-equity swaps. A reduction in the foreign debt of developing countries via such transactions would show up as a transfer to creditor countries, even though old credit claims had simply been replaced by the ownership of shares and the net claims on developing countries remained unchanged.¹⁴ The resulting costs are merely deferred to a later date. A

¹⁴ David Gordon and Ross Levine: A Note on "Transfers", in: U.S. Federal Reserve Board, International Finance Discussion Paper No. 341, January 1989, p. 14.

Table 8
Current Accounts of the 15 Heavily Indebted Countries

	(in \$ bn)							
	1981	1982	1983	1984	1985	1986	1987	1988
Exports (f.o.b.)	127.0	112.2	111.1	123.4	118.8	99.4	112.8	127.1
Imports (f.o.b.)	132.6	107.8	82.4	79.9	78.1	79.0	86.5	96.6
Trade balance	-5.6	4.4	28.7	43.5	40.7	20.4	26.3	30.5
Services ¹	-47.9	-57.4	-47.3	-48.6	-45.0	-41.5	-40.7	-45.1
Unrequited transfers	3.1	2.2	3.2	3.6	4.2	5.1	4.8	5.7
Current account balance	-50.4	-50.8	-15.3	-1.5	-0.2	-16.0	-9.5	-9.0

¹ Including interest and dividend payments. Source: IMF: World Economic Outlook, April 1989, p. 171.

Table 9
Developing Countries: Aggregate Net Transfers, 1981-87

	(in \$ bn)						
	1981	1982	1983	1984	1985	1986	1987 ^a
Net flows on long-term debt ¹	34.0	17.6	7.0	-7.4	-20.8	-25.0	-21.8
+ Official grants	13.0	12.4	12.7	15.0	16.5	15.7	15.0
+ Private direct investment	16.3	12.2	9.0	11.5	6.5	9.8	9.8
+ Portfolio investment	1.4	0.4	0.2	0.3	1.2	1.0	1.0
+ IMF net purchases	5.9	6.0	11.4	5.1	0.3	-1.5	-4.2
+ Other private flows	3.6	3.0	2.8	3.6	5.5	5.6	5.0
Aggregate net transfers	74.2	51.6	43.1	28.1	9.2	5.6	4.8

^a Preliminary estimates. ¹ These figures differ from those given in Table 1 owing to differences in the price and exchange rate bases used. Source: Development Committee: The Adequacy of Resource Flows to Developing Countries, Washington D. C., 1988, p. 8.

Table 10
Highly Indebted Countries: Aggregate Net Transfers

	(in \$ bn)						
	1981	1982	1983	1984	1985	1986	1987 ^a
Net flows on long-term debt ¹	17.7	3.8	-7.4	-17.7	-26.1	-20.3	-13.8
+ Official grants	0.3	0.5	0.5	0.7	1.2	0.9	1.2
+ Private direct investment	4.7	3.0	0.2	2.0	-0.5	1.1	2.3
+ Portfolio investment	0.3	0.3	0.0	-0.1	-0.2	-0.4	n.a.
+ IMF net purchases	1.4	2.3	6.5	3.4	1.7	0.2	-1.1
+ Other private flows	0.0	0.0	0.0	0.0	0.0	0.0	n.a.
Aggregate net transfers	24.4	9.9	-0.2	-11.7	-23.9	-18.5	-11.4

^a Preliminary estimates. ¹ These figures differ from those given in Table 2 owing to differences in the price and exchange rate bases used. Source: Development Committee, op. cit., p. 24.

summary of transfers in accordance with this wider definition is given in a table drawn up by the Development Committee of the World Bank (see Table 9).

According to this calculation, the aggregate net financial transfer to *all developing countries* remained positive until 1987. However, here and in Table 10 net dividend payments have not been taken into account for lack of adequate statistics! This must be seen as a serious shortcoming, for the wider concept suggests that the coverage of payment flows is more comprehensive than it is in reality.¹⁵ If one considers the difference between inflows in 1981 and 1987, it will be seen that the reduction of \$69.4 billion broadly corresponds to the value shown in Table 1 for net financial transfers (\$73.4 billion).

Examination of the figures for *highly indebted countries* on the basis of the wider definition shows certain deviations by comparison with the figures in Table 2. In both tables, however, there is a negative net financial transfer of a similar magnitude, the relatively large difference in 1987 being due to the fact that the Development Committee had only a provisional estimate for the net financial transfer in that year.

Problems Masked by Statistics

Having now discussed these criticisms, the question arises as to the purpose of clarifying the definitions. The fact is that a sudden and radical reversal of financial flows to developing countries has occurred since 1982. Recognition that the heavy burden of interest payments places a severe brake on economic growth in developing countries led to the use of the *concept of net financial transfers*. It makes the changes very clear-cut, but it is controversial since the domestic concept on which it is based cannot be reconciled with the usual national accounting and balance-of-payments statistics.

The *concept of aggregate net transfers* gives a more faithful picture by covering a wider range of relevant payments, but the objections to the domestic concept also apply here. On the other hand, the *figures from the balance-of-payments statistics* fit with national accounting data, but have the disadvantage that they tend to mask the dramatic structural changes occurring

¹⁵ Page 10 of the 1989-90 edition of the World Debt Tables contains such figures for the first time. They also take account of dividend payments. The result is a negative net financial transfer of \$9.9 billion in 1987 and one of \$9.8 billion in 1988.

¹⁶ For this purpose Dornbusch invents the term "non-interest current account deficit" to describe the scale of the negative net financial transfer. See Rudiger Dornbusch: Debt Problems and the World Macroeconomy, in: Jeffrey D. Sachs, op. cit., p. 300.

in payment flows;¹⁶ in my view they call for further examination:

□ After the onset of the debt crisis the developing countries curbed imports severely by pursuing restrictive domestic economic policies and by devaluing their currencies in real terms. This was the main reason for the rise in the trade surpluses of the fifteen heavily indebted countries from \$4.4 billion in 1982 to \$43.5 billion in 1984. The contraction in imports was not an expression of reduced demand but the *necessary* reaction to the lack of new loans. If experience shows that economic growth in developing countries is limited by the level of imports,¹⁷ the detrimental effects of curbing imports are serious.

□ The increased resources for transfer abroad were raised mainly by cutting investment. This fact is not reflected in the balance-of-payments statistics at all. In the problem countries the investment ratio fell by a third from 25-28 % in the early eighties to 17-18 % in 1986-87 and the net investment ratio decreased *on average* from 16 to 7 %.¹⁸ It has therefore fallen to a level at which erosion of the capital stock must be expected in some countries and which limits their future debt servicing ability. The decline in investment corresponds more or less to the sum of negative net transfers. It is not realistic to expect that domestic savings will be sufficient to meet future debt servicing commitments and at the same time to finance investment on a scale that will boost real per capita income. Per capita income in the problem countries is now around one-seventh lower than at the beginning of the eighties; it has fallen every year since 1980.¹⁹

□ The trade surplus achieved by painfully reducing domestic consumption brings the debtor countries no benefit. The surplus serves solely to meet servicing obligations on foreign loans. Interest obligations in excess of the surplus increase the outstanding debt without increasing the scope for investment. By contrast, at the beginning of 1980 there was an inflow of resources that not only covered interest and

¹⁷ Martin Feldstein: International Debt Service and Economic Growth: Some simple analytics, NBER Working Paper No. 2076, Cambridge 1986, p. 8.

¹⁸ Development Committee (Joint Ministerial Committee of the Board of Governors of the World Bank and IMF): The Adequacy of Resource Flows to Developing Countries, Washington D.C., 1988, p. 25. In Argentina real private net investment in the last five years has been negative, in other words the existing capital stock is shrinking. Cf. Jeffrey D. Sachs: The Debt Crisis at a Turning Point, in: Challenge, Vol. 31, No. 3, New York 1988, p. 26.

¹⁹ World Bank: World Debt Tables 1988-89, p. xiii. In Bolivia per capita incomes declined by 40% over this period. Absolute poverty and malnutrition increased alarmingly. Cf. Jeffrey D. Sachs: The Debt Crisis at a Turning Point, op. cit., p. 25.

redemptions but also left funds over for increased domestic investment and consumption.

Whereas then the highly indebted countries had additional foreign resources available equivalent to around 2 % of GDP, according to the net transfer calculation they must now forgo consumption equivalent to around 3 % of GDP. The total debt servicing burden of this group of countries is expected to absorb 8 % of their GDP in the next few years.²⁰

This also has repercussions on the level of the budget deficit. In some of these countries the state's interest payments to foreign creditors have risen to 25 % of total budget expenditure, or 5 % of GNP.²¹ In times of weak economic growth with stagnating tax revenues, budgetary adjustments have led mainly to cuts in public investment and welfare programmes and to a continuation of financing through an expansion in the money supply.²² This in turn results in a reduction in domestic saving, whereas at the same time a growing proportion of the remaining saving is absorbed by the transfer of resources to foreign creditors. Domestic saving would have to increase by 5 % of GNP (around one-quarter) in order to offset this transfer.²³

After implementing adjustment programmes the developing countries have neither regained their creditworthiness (indeed, it has deteriorated further) nor do they have the prospect that forgoing consumption today will produce a higher standard of living tomorrow. If rigorous efforts to adjust do not bring them new loans,²⁴ the debtor countries are right to ask whether stringent austerity as part of adjustment programmes has any sense.²⁵ What is surprising is that the IMF, which is well known for its unyielding attitude towards adjustment measures, is also expressing similar thoughts.²⁶

Disadvantages of Adjustment

One can certainly agree with Holthus when he says that the analytical ambiguities in determining the position of the developing countries hardly help persuade the industrialised countries to increase the financing element further, for banks are reluctant to

provide new resources, given the high level of debt, the uncertainty whether new loans will be serviced in full and the high discounts on debt traded in the secondary market. Nevertheless, serious doubts must be expressed about his assumption, stated at the beginning of 1987, that only further adjustment efforts would create the conditions for restoring creditworthiness.

IMF staff now see one of the reasons for the problems facing debtor countries as the fact that "more emphasis has been placed on the extent of external adjustment than on the scale and quality of domestic investment and resource mobilisation."²⁷ For the Development Committee, the objective of an adequate resource transfer implies "some reduction in the onerous debt-servicing burden so that the surpluses generated can be diverted to the resumption of adequate growth in investment, output, and consumption."²⁸

At present some of the developing countries are clearly suffering from a *debt overhang*, a situation in which their obligations exceed their expected debt servicing capacity. In some countries a liquidity crisis has therefore become a solvency crisis.

This has several implications. *First*, a lack of political support for adjustment programmes that only produce greater welfare over the longer term, for "‘good behaviour’ (such as a higher investment rate) can actually reduce national welfare, by increasing the transfer of income from the debtor country to creditors".²⁹ *Secondly*, the repatriation of flight capital is hindered or further capital flight is provoked, since investors want to protect their assets against possible tax increases. The debt overhang then has the effect of a foreign tax on current and future domestic production. "In these circumstances it may prove difficult for governments to maintain political support for adjustment programs, and there may be pressure to retain the gains from such programs at home. In effect, an excessively heavy debt-service burden may be

²⁰ Development Committee, op. cit., p. 44.

²¹ At the onset of the debt crisis the governments of some debtor countries such as Argentina, Chile and Yugoslavia took over large amounts of private debt on the assumption that this would help safeguard their relations with commercial banks (World Bank: World Development Report 1989, p. 24). Felix, on the other hand, speaks of the state being forced by the banks to take over the debt *ex post*. See David Felix and John Casky: Baker to Brady to Chance? Tinkering with the Latin American Debt Crisis, in: Werner Baer (ed.), forthcoming volume on the debt crisis.

²² World Bank: World Debt Tables 1988-89, p. xxv.

²³ World Bank: World Development Report 1989, p. 22.

²⁴ Between 1986 and 1988 the commercial banks granted none of the highly indebted countries more net resources than they received in interest payments. Cf. Ishrat Husain: Recent Experience with the Debt Strategy, in: Finance & Development, No. 3, 1989, p. 13.

²⁵ Jeffrey D. Sachs: Conditionality, Debt Relief, and the Developing Country Debt Crisis, op. cit., p. 257.

²⁶ IMF: World Economic Outlook, April 1989, p. 53.

²⁷ Michael Doolley and C. Maxwell Watson: Reinvigorating the Debt Strategy, in: Finance & Development, No. 3, 1989, p. 8.

²⁸ Development Committee, op. cit., p. 5.

²⁹ Jeffrey D. Sachs: Conditionality, Debt Relief, and the Developing Country Debt Crisis, op. cit., p. 258.

viewed as a tax on adjustment efforts which could impede the implementation of better policies."³⁰ *Thirdly*, the willingness of the private sector in these countries to hold domestic securities decreases, in other words domestic saving declines. *Fourthly*, foreign lenders will not be willing to grant new loans as long as they see that

the debtor is not even capable of meeting its existing obligations.

In this situation, as shown by a Laffer debt curve, debt servicing reductions or a renunciation of claims would increase the probability that the governments of debtor countries would fulfil the conditions imposed by the IMF and the World Bank. An increase in the scope for additional investment could help enable a country to service its remaining debt in full by increasing its debt servicing capacity. The market value of developing country debt could recover, thus giving them access to the credit markets.³¹

It is therefore a question of breaking the vicious circle whereby the burden of rising debt stunts growth, which in turn further reduces the country's creditworthiness. If the damaging financial gap is not closed, it is to be feared that the debt problems will be further exacerbated.

³⁰ IMF: World Economic Outlook, April 1989, p. 53.

³¹ For the counter-theory that debtors are instead cut off from the international capital market if their debt is reduced, see Peter N u n n e n k a m p: Capital Drain, Debt Relief and Creditworthiness of Developing Countries, Kieler Arbeitspapiere No. 379, Kiel 1989. In principle, the question is whether the low investment ratio in problem countries was caused by the debt overhang acting as an additional tax on investment or by the drying-up of new lending, in other words, a scarcity of capital. Neither the balance-of-payments statistics nor the net transfer concept reveal anything about the determinants of investment behaviour. It should be borne in mind, however, that in view of high debt service/export ratios the direction of the net transfer could reverse abruptly if there were a further inflow of resources, but that this would further increase future obligations. For this reason debt relief appears to be indispensable. See also Karl Ste i n i n g e r: Der Nettotransfer als Umschuldungsindikator, in: Quartalshefte der Girozentrale, Vol. 25, No. 2, 1989, p. 67.

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The Counter-effects of Market Regulation

Regulation can have counter-effects that work against the interests of those who advocate it, in both centrally-planned and market economies. Little research on these effects has been carried out so far, with the result that they have been ignored by policymakers.

Free market solutions are being increasingly accepted by institutions that had previously tended to reject them; this is as true of the debate about a new, market-oriented international trade order as it is of the moves towards market-oriented reforms in the countries of Eastern Europe. On the other hand, it is also evident that countries are trying increasingly to ensure that market forces are constrained by tighter regulation. Examples of this range from neo-protectionism within the context of "free world trade" to the efforts of the "reform-minded" Eastern bloc countries to retain political control of markets by preserving a significant centrally-planned sector. In practice this leads to

systems in which markets are subject to a greater or lesser degree of regulation.

Economic analysis takes only partial account of the impact of such regulation on the real economy, however, so that it remains largely ignored in the political discussion about the controllability of markets. In order to draw attention to the substantial real economic effects of regulation, the following article analyses two systems for the world economy, both entailing a high level of regulation.

The first is the system for regulating world trade, which has been discussed recently primarily in terms of "neo-protectionism"; here quantitative trade restrictions lead to an upgrading of product quality. The other system of interest relates to efforts to carry out market-

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