

Holthus, Manfred

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Manfred Holthus\*

## On the Problem of Negative Net Financial Transfers to Developing Countries: A Reply

In his article in issue No. 2/1990 of *INTERECONOMICS*, Klaus Didszun dealt in considerable detail with the problem of the transfer of funds as it affects developing countries. In his introduction on the magnitude of the problem and its underlying reasons, he refers exclusively to the definitions and data used by the World Bank in its World Debt Tables. In the discussion of this concept which follows, he also gives extensive treatment to a critical remark I made in a paper on the indebtedness of developing countries in early 1987.<sup>1</sup>

Unfortunately, Didszun did not properly understand my critical remark, and hence also gave an incorrect rendering of it. This would be no great issue in itself, were it not for the fact that he sought to demonstrate the "absurdity" of my remarks with the help of macroeconomic equations which have not hitherto been seen in this "original" form. Yet Didszun claims that this concept – which he terms the "domestic concept" – actually forms the basis for the World Bank's definition of net transfers.<sup>2</sup> May I clarify this point at the outset: the national accounting equations used by the World Bank do not differ at all from those found in the usual textbooks.

So what are the facts? In its World Debt Tables, the World Bank applies the term "net transfers" to the difference between disbursements of new loans and debt servicing (repayments plus interest). This figure can easily become negative if the debt service relating to obligations which have been built up *over many years* is higher than the new disbursements in *that one year*. In the paper to which the article referred, I had illustrated this aspect with the help of a two-country example, and explained that a negative net transfer would not necessarily also lead to an actual outflow of funds. It was noted that it was still possible, as the example showed, for a negative net transfer to go hand in hand with a

deficit on the current account. By referring to some identities from national accounting which I had used in other contexts, I added that if a country should be in that position, it would still be possible for it to invest more than it was able to fund out of national savings.<sup>3</sup>

It is this latter point in particular which is discussed in Didszun's article. He reproduces the equations and definitions I had used as follows:

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

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

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.

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

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.

$$(4) \text{ restatement: } X - M - iD = (S - I) + (T - G - I_g)$$

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

where

(T - G) = government saving

(M - X + iD) = current account deficit."<sup>4</sup>

<sup>1</sup> Manfred Holthus: Die Auslandsverschuldung der Entwicklungsländer, Federal Ministry for Economic Cooperation, Materialien No. 76, Bonn 1987.

<sup>2</sup> Klaus Didszun: On the Problem of Negative Net Financial Transfers to Developing Countries, in: *INTERECONOMICS*, Vol. 25 (1990), No. 2, p. 58.

<sup>3</sup> Manfred Holthus, op. cit., p. 44.

<sup>4</sup> Klaus Didszun, op. cit., pp. 67 f. There is no need for current purposes to again cite the example he repeats in his article.

\* Hamburg Institute for Economic Research (HWWA), Hamburg, West Germany.

However, he then goes on to state: "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."<sup>5</sup>

Although not entirely correct, this is an interpretation it is still possible to accept, but a little further on Didszun adds: "... 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."<sup>6</sup>

As absurd as this outcome may appear to Didszun, it is nevertheless a true reflection of the situation in reality. When interest rates increased drastically in the early 1980s, this tended to increase the current account deficits of the highly indebted developing countries, as properly reflected in the current account definition I had used, namely  $M - X + iD$ . These deficits continued to be funded by means of importing capital, initially via voluntary loans and then via involuntary ones (i.e. by arrears on repayments), and in some cases also by allowing the depletion of foreign exchange reserves if this was possible. As long as inflows of capital were sufficient to balance out the current account deficit, the relation I had described could apply. However, in some countries capital inflows were not even enough to compensate for the increase in government consumption (the fall in government saving).

Perhaps things might not have appeared quite so absurd to Didszun if he had taken the second parenthesized expression on the right-hand side of equation (5) to signify the import of capital lying behind the current account deficit rather than the deficit itself, for investment is not, as he puts it, financed from savings and the current account deficit, but by savings together with capital imports equivalent to the current account deficit (less changes in foreign exchange reserves where appropriate).<sup>7</sup> Instead, he tries to draw a distinction between my concept and that used by the World Bank. My argument, he claims, is based on the "national concept".

"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:

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

$$(7) \text{ GDP} = Y = C_p + S + T$$

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

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

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.<sup>8</sup>

The current account position, in this version, is denoted by  $(M - X) - iD$ . The quantity " $-iD$ ", so the text of the article tells us, is supposed to represent interest payments on foreign debt. Like exports, they carry a negative sign. Thus, in Didszun's world, an increase in the amount of interest payments ("... as a result of a general increase in interest rates, for example") has the same effect as an increase in exports and improves the current account position. Now that really is an absurd result. One can be sure that this is not the concept used by the World Bank.

The domestic concept and the national concept of national accounting differ in as far as the former deals with domestic production whereas the latter deals with the participation of nationals in production whether at home or abroad, for which the criterion is cross-border earned or unearned income (i.e. factor incomes). When it is expressed in income terms, the latter perspective defines GNP as all income accruing to nationals. They cannot be the recipients of interest earned on foreign loans, which flows to the foreign nationals who provided such loans. Yet that does not mean, as Didszun appears to believe, that in the national accounting concept I used these incomes do not need to be generated domestically. This is a point he would presumably realize if he were to adapt the formula for GNP expressed in income terms in equation (2) to read:

$$(2a) Y = C_p + S + T + iD$$

<sup>5</sup> Ibid., p. 68.

<sup>6</sup> Ibid., p. 68.

<sup>7</sup> Manfred Holthus, op. cit., p. 51, footnote 55, and also p. 21.

<sup>8</sup> Klaus Didszun, op. cit., p. 68.

This would then enable him to derive equation (5) without having to resort to the concept of the national product, and hence to the national concept.

If the assumption arising from the negative sign for interest payments in equation (2) that no other factor payments flow to or from other countries apart from interest payments is abandoned,<sup>9</sup> and the possibility of net interest receipts from abroad is permitted, equation (2) will then have to be expressed in the form

$$(2b) Y + iD = C_p + S + T$$

By substituting the right-hand side of (1) for Y in (2b) and rearranging the order somewhat, we obtain the equation

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

which is identical to equation (9). Without realizing it, then, Didszun has used his "domestic concept" to depict the situation in a country which receives more interest income from abroad than it has to pay to foreign creditors. Such a country is hardly likely to be found among the highly indebted developing countries.

There is no need to say any more on that point. Apart from that, the World Bank too now points out that developing countries have other means of obtaining external resources apart from those covered by the category of "debt-related flows and transfers". The broader concept of "aggregate net resource flows" which it now uses includes the other items belonging to the capital account of the balance of payments.<sup>10</sup> This is

a response to criticism which Didszun rightly took up again at a later stage in his article.<sup>11</sup> It should also be mentioned that in the passage criticised by Didszun I had pointed out that in my example the balance of trade is in surplus and that therefore for the investments financed by the continuing import of capital no further imports of real resources (e.g. machinery) could take place, but that capital goods produced domestically would have to be used.<sup>12</sup> In more general terms this would mean that the current account without factor payments and unrequited transfers is in surplus. The IMF has recently termed this balance the Net Resource Transfer.<sup>13</sup> In the balance of payments it forms – abstracting from changes in foreign exchange reserves – the contra item, with opposite sign, to the above-mentioned aggregate net resource transfers of the World Bank and other institutions. However, this is hardly likely to have put an end to the discussion surrounding the flow of resources to developing countries. The number of possible permutations and combinations of the various sub-balances of the balance of payments is still large enough to allow selection according to where one's interests lie.

<sup>9</sup> Manfred Holthus, *op. cit.*, p. 22.

<sup>10</sup> World Bank: *World Debt Tables 1989-90*, Vol. 1, Analysis and Summary Tables, Washington D.C. 1989, p. 10, box 2.

<sup>11</sup> Klaus Didszun, *op. cit.*, p. 69.

<sup>12</sup> Manfred Holthus, *op. cit.*, pp. 44 f.

<sup>13</sup> IMF: *World Economic Outlook*, Washington D.C., October 1989, p. 50 (box).

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