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Anton P. Müller*

The Creditworthiness and International Payment Ability of Sovereign States

At the beginning of the 1990s debt accumulation has become persistent and the growth-cum-debt models which previously guided international lending offer no solution to the problem. The following article argues that major deficiencies in the methods used until now to assess the creditworthiness of debtor countries have exacerbated the debt problem and suggests an alternative approach.

At the beginning of the 1990s, we are still faced with two major international economic problems that emerged in the 1980s. One of the problems is the persistence of macroeconomic imbalances between the industrialized countries, the other is the international debt crisis. These two problems still threaten the stability of the international economic system. Both have to do with finance and trade and both can only be resolved within a global context.

This paper addresses the international debt problem. It approaches the analysis from the perspective of the determinants of creditworthiness. This offers a particular perspective because the actions and reactions of the borrower and lender come into play and the focus is directed towards the lender-borrower relationship and the policies they pursue.

This paper argues that the major deficiencies of the common approaches to the assessment of the international payment ability of sovereign states are that they concentrate on financial aspects and focus almost exclusively on the country under review. These approaches neglect, firstly, the interrelationship between lender and borrower, secondly, the interrelationship among the various lending institutions, and thirdly, the interrelationship between financial flows and the flow of goods and services. The common procedures analyze the creditworthiness of a country as if a credit were a unidirectional relationship, limited in its effects only to the borrowing country, and mainly a matter of financial transfers.

The alternative approach put forth in this paper points

out that a proper assessment of the creditworthiness of a sovereign state requires a sharp distinction between the periods when net financial transfer is positive, i.e. when a country is in the process of debt accumulation, and when it is negative, i.e. when the inflow of foreign credits has stopped and the debtor country has to reduce its outstanding debt. Each of these two periods of the debt cycle affects the international banking system and international trade in a distinctive way, and analytic methods which do not make a clear distinction between these two periods tend to drastically overestimate the creditworthiness of a country in the first stage and underestimate it in the second.

Basic Models and Conceptions

For debtor and lender alike, the decision to ask for and grant credit is based on a prognosis. In some cases it may be mere intuition, the "gut feeling" of the man of business or of the politician. In most cases the decision to grant or to refuse a credit is based on experience – and there are many ways to refine and model experiences. In international credit relations long-term records that include many debtors have been scarce. After the breakdown of international lending in the 1930s, it took over 40 years before international credit relations between private banks and developing countries reemerged on a substantial scale.¹ When there are not enough data available to allow the construction of a solid econometric prognostic model, we are forced to rely on theory, or even on mere hypotheses. Theory without empirical foundation and control, however, may offer misleading frameworks of

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¹ Rudiger Dornbusch: Dealing with debt in the 1980s, in: Third World Quarterly, Vol. 7, 1985, No. 3, pp. 532-551.

analysis and lead to wrong predictions. This was largely the case in the 1970s when "growth-cum-debt" models guided international lending and enticed bankers and governments alike to overlend and overborrow.

The basic models and conceptions that have guided international lending and borrowing since the 1970s, are the so-called "two-gap theory"² and the "growth-cum-debt" models.³ According to these models, a developing country is faced with two gaps: on the one hand, savings fall short of investment needs ($S < I$), and on the other hand, import needs exceed exports ($X < M$). The inflow of foreign capital serves to close two gaps at once: first, as a supplement to domestic savings it allows for the increase of investment and thus is supposed to trigger growth. As foreign exchange it allows for the import of foreign goods that the country needs. Provided that foreign debt is used for investment, the country will grow out of the savings and foreign exchange gap as income rises. This will reduce the need for imports, and the higher savings provide the funds to pay back external debt.

Assuming that such a "savings gap" exists, economic growth becomes the overriding factor in closing this gap, and capital imports will be instrumental in achieving this. In this view, capital imports produce economic growth which finally results in higher income, higher savings, and an export surplus. Thus, a developing country goes through development stages from a young debtor characterized by a passive current account to a mature debtor with an active current account. The status of a mature country allows the payment of the debts that had been accumulated in the earlier stages (cf. Table 1).

In this perspective, no solvency crisis is conceivable. However, liquidity crises may occur due to unforeseen and

unfavourable circumstances. In this case, new capital is needed to bring the country back on its growth path and to guarantee that it will become a mature debtor or even an active creditor.

Balance of Payments Identities

In a simplified form the balance of payments can be divided into the current account, the capital account, and the reserves. Neglecting international aid and other forms of unilateral transfers, the current account reflects the trade of goods and services (including investment and debt service), while the capital account registers capital transactions (such as international credits and foreign investment). Imbalances between the current account (NX) and the capital account (CF) result in a change of the reserve position (ΔR).

The basic balance of payments equation is then

$$NX + CF = \Delta R$$

This shows that when reserves are depleted, an outflow of foreign capital ($-CF$) requires a trade surplus (NX), while an inflow of foreign capital (CF) allows trade deficits ($-NX$) or the accumulation of reserves (ΔR). These identities do not reveal causalities. The basic identity of the balance of payments can be read from both sides in terms of causalities. The question whether a current account deficit induces a capital inflow, or the chain of causality is the other way around and the capital inflow produces current account deficits, cannot be settled by the accounting framework as the balance of payments provides. However, these identities show that when reserves are depleted, any trade deficit necessitates a creditor and that the payment of principal and interest on external debt requires a surplus in the foreign trade or the non-debt related services. Three conclusions can be drawn here: the first is that there is a direct and fundamental connection between financial flows and trade, the second is that it is not necessarily foreign trade that induces financial flows but that financial flows as well are able to affect foreign trade,⁴ and the third is that the repayment of foreign credits requires trade surpluses of the debtor countries which in turn are only possible if there is at least one other country with a trade deficit. Assuming that the debtor countries have reached their credit limits and that the creditor countries – either by lack of demand or by design – will not allow trade deficits, the international debt crisis becomes insolvable.

The conventional view has largely ignored these

² Hollis B. Chenery and Alan M. Strout: Foreign Assistance and Economic Development, in: American Economic Review, Vol. LVI, No. 4, 1966, pp. 679-733.

³ Dragoslav Avramovic et. al.: Economic Growth and External Debt, Baltimore 1964.

Table 1
Development Stages, Debt Position and
Current Account

Development Stage	Debt Position	Current Account
young debtor	debtor	passive
adult debtor		balanced
mature debtor		active
young creditor	creditor	active
active creditor		balanced
mature creditor		passive

Source: Charles P. Kindleberger: International capital movements, Cambridge 1987, p. 35.

⁴ The implication of this is that "import needs" are not necessarily more urgent than a person may feel "consumption needs". In both cases it is the availability of credits that makes it possible for the country as well as for a person to realize the fulfilment of these "needs".

relationships. It stresses economic growth and the reduction of internal demand as the keys to a solution of the international debt crisis. The premise of this approach is the assumption that external debt accumulation is the consequence of current account deficits and these are the result of "import needs" which in turn result from the goal of achieving economic development. The origin of a payment crisis is then located in "over-consumption" or "unproductive investments" or particularly in "excessive government spending". The theoretical basis for this model is the "absorption approach" which states that if internal absorption – the combination of domestic consumption (C), investment (I) and government spending (G) – is higher than national production and income (Y), current account deficits (NX) and thus capital imports (CF) are induced.⁵ Whatever the particular components that have induced higher absorption, the growth of national income, or more specifically production in relation to demand, becomes the critical variable in this model.

Lenders and the borrowing countries as well as the two major debt initiatives by Baker and Brady⁶ have stressed the growth dimension. The International Monetary Fund (IMF), when dealing with countries that are having payment difficulties, has concentrated on demand reduction, particularly government expenditures and consumption.⁷ The growth-cum-debt theoretic approach necessitates a long-term perspective and the readiness to overcome short-term liquidity crises with "fresh money". The IMF works within the same paradigm but stresses the short-run perspective. As an increase in the rate of economic growth cannot be produced in the short run, overcoming a balance of payments crisis requires a reduction of demand. Both strategies can be characterized as endeavours to "make the model work".

But the growth oriented approach will only work if the assumption is valid that higher income increases exports and reduces imports; and the demand oriented approach, as it is applied by the IMF, depends on the effectiveness of economic policy in reducing demand without hampering investment. Both approaches suffer from the possible violation of their assumptions by reality. Quite often, import demand increases faster than exports for a considerable period of time with economic growth. When creditors do not apply the long-term perspective that would be

necessary, a developing country may reach its credit limits before sufficient export growth takes place. In the IMF concept, overall savings, particularly by the governmental sector, must be increased in order to achieve the export surplus. But here, too, quite often the result of the application of IMF policies is a significant drop of investment and the resulting weakness of economic growth.

Lending Criteria

The most frequently used indicators of creditworthiness are the debt ratio, i.e. overall debt in relation to national income

$$DR = D/Y$$

and the debt service ratio, i.e. principal (P) and interest payments (Int) in relation to exports (X).

$$DSR = (P + Int)/X$$

The Group of Thirty's survey of eleven country risk analysis systems in international banks⁸ found that the fundamental economic indicators used by banks were:

- ☐ the debt service ratio (debt service costs in per cent of export earnings)
- ☐ the balance of payments position
- ☐ the export growth trend
- ☐ the level of internal economic growth.

If the debt ratio and the debt service ratio are the criteria of creditworthiness, it becomes the rule that the growth rate of income and that of exports must exceed interest rates in order for the country to remain creditworthy.⁹

The applications of these concepts and criteria have not been very successful for either guiding the expansion of international lending or – after 1982 – for formulating strategies of how to deal with the international debt crisis. Despite an immense capital inflow to the developing countries, growth rates have been stagnating since the early 1980s, living standards have drastically fallen and international banks have had to write-off substantial amounts of their outstanding claims on developing countries. We are confronted with the problem: why did the

⁵ Sidney S. Alexander: Effect of a devaluation on a trade balance, IMF Staff Papers, No. 2, 1952, pp. 263-78.

⁶ Anne O. Krueger: Developing Countries' Debt. Problems and Efforts at Policy Reform, in: Contemporary Policy Issues, Vol. VIII, 1990, No. 1, pp. 1-37, here p. 12.

⁷ John Spraos: IMF Conditionality: Ineffectual, Inefficient, Mistargeted, Princeton 1986.

⁸ Group of Thirty: Risks in International Bank Lending. First Report of the International Banking Study Group of the Group of Thirty, New York 1982, p. 37.

⁹ Mario Henrique Simonsen: The Developing-Country Debt Problem, in: Gordon W. Smith and John T. Cuddington (eds.): International Debt and the Developing Countries. A World Bank Symposium, Washington 1985, pp. 101-126; World Bank: World Development Report, Washington D.C. 1985.

model not work, what went wrong and is there a more adequate model to analyze the debt problem?

Deficiencies of the Current Approach

The two-gap and growth-cum-debt models expose three major weaknesses. First, they assume that financial and physical capital shortages are the most predominant bottleneck of economic growth; second, they apply a theory of the balance of payments according to which there is an *ex ante* given need for imports, and that these needs diminish with growth of income. Third, it neglects the role of credit rationing or the existence of credit limits. It is the last point that seems to be the most important and most neglected.

There is no borrower with unlimited access to credit. Credit is not the same as apples which anybody can buy who pays the market price (which would be the equivalent of interest).¹⁰ The major implication of credit limits, which need to be set by the lender and are subject to error, is that when dealing with credit relations we are confronted with two strikingly different sets of patterns, depending on whether there is a positive or negative net financial transfer. A net inflow of foreign capital may take place as long as the borrower has not yet reached its credit limits. A negative net financial transfer is the result of reaching this credit limit or of a lowering of credit limits by the lender. The difference between the process of net debt accumulation and net debt payment is not as striking in lending to private companies, but it becomes central for sovereign debts.

As a rule, sovereign debts are neither backed by collectible collateral nor are they based on a reliable procedure for assessing the creditworthiness of the country. In contrast to borrowing by private entities, country borrowing involves macroeconomics, both at the domestic and the international level. Credit limits for countries are unstable, highly volatile and the underlying rationale for their changes often uncertain and unpredictable. Because of the lack of collateral, the lender's position is more risky, credit contraction may more easily occur and spread over to other country borrowers.

An Alternative Approach

Lending to sovereign states is characterized by a high degree of reflexivity. This term is to describe the interrelationship between lender and borrower. When a credit is extended, it is not unidirectional but reflexive, i.e. it affects the indicators that the credit decision was based on

in the first place and even extends beyond the two-sided relationship of creditor and debtor to other lenders and borrowers.

Because of the characteristics of international lending, extreme swings of credit expansion and contraction on international markets may occur. International credit has shown waves of expansion and contraction which create a pattern of boom and bust.¹¹ In the first phase of a cycle, when banks initiate sovereign lending, the flow of funds leads to a confirmation of the perception of creditworthiness. In addition, one bank's new credit serves as an indicator for the creditworthiness of the borrowing country at other banks because additional funds increase payment ability. Irrespective of the use of the credits, the first stage in the process of debt accumulation when the credit limits are not yet reached is generally characterized by economic growth and increased international liquidity in the borrowing country. Banks which base their assessment on such factors as growth and liquidity are induced to overextend themselves and countries tend to overborrow. Busts occur when credit limits are reduced, when liquidity on international financial markets contracts or when it finally appears that the borrowing country's ability to pay may not be sustained. The rationing of credits works as a self-fulfilling prophecy and speeds up this process. The perception of a declining creditworthiness will be confirmed in reality by the squeeze in the flow of funds.

Such a process happened in 1982, and after more than seven years we are confronted with the problem of "re-establishing" the international payment ability of a large number of developing countries. For this we have to develop a conceptual framework that helps us to formulate a strategy of how to deal with the situation.

Conditions for Negative Net Financial Transfers

A perspective different from the growth-cum-debt and two-gap theories to address these issues was provided by the analysis of the German reparation problem of the 1920s as it was addressed by Salin, Machlup, Haberler, Roepke, and Eucken.¹² The payment of reparations poses a number of the same problems as in the case of indebted countries that are more or less abruptly faced with the need to generate net negative financial transfers. The German analysis, in contrast to the Anglo-Saxon debate between

¹⁰ As Weizsäcker pointed out, this perception does not hold because it would allow all kinds of Ponzi schemes as one could always service old debts with new debts. Cf. Carl Christian von Weizsäcker: Das eherne Zinsgesetz, in: *Kyklos*, Vol. 32, 1979, No. 1/2, pp. 270-282.

¹¹ Charles P. Kindleberger: Debt Situation of the Developing Countries in Historical Perspective, in: Stephen H. Goodman (ed.): *Financing and Risk in Developing Countries*, New York et al. 1978, pp. 3-11.

¹² Edgar Salin (ed.): *Das Reparationsproblem. Teil I. Verhandlungen und Gutachten der Konferenz von Pyrmont, Berlin 1929*; Edgar Salin (ed.): *Das Reparationsproblem. Teil II. Verhandlungen und Gutachten der Konferenz von Berlin, Berlin 1929*.

Keynes, Ohlin and Rueff,¹³ used a different approach and pointed out that the transfer problem is much more difficult to solve than simple balance of payments models suggest.¹⁴

In order to achieve negative financial transfers, an indebted country has to solve three interrelated problems:

- ☐ the budget problem
- ☐ the foreign exchange problem
- ☐ the economic transformation problem.

Each of the problems calls for the construction of indicators and criteria of analysis on which we can base our assessment of creditworthiness and formulate business and policy strategies.

The Budget Problem

The international payment ability of a country where the government is the debtor requires a system of public finance that is instrumental in generating sufficient revenue. Before external transfer can take place, the internal transfer from the economy to the public sector needs to be accomplished either by an increase in taxes and/or reduction of spending. In order to achieve this, economic growth in itself is not enough when this growth is debt-driven or when the taxation system is inadequate. One of the first criteria for international payment ability is provided by a government's finances: indicators are the budgetary balance and, as an in-depth analysis, the details of a country's revenue and expenditure system. The reduction of private consumption has to be brought about without reducing investment. The capacity of the government to reduce expenditures and to increase revenue without a negative effect on growth becomes the central criteria.

The government budget provides indications about the ability of the country to reduce consumption by fiscal measures. In addition to that, the inflation rate provides an indicator for a country's inclination to resort to money creation as seignorage. In the phase of debt accumulation, the budgetary balance and the inflation rate become the foremost indicators of creditworthiness. Drastic increases

in budget deficits and rising inflation rates signify deteriorating creditworthiness and can be used as early warning indicators.¹⁵

The growth-cum-debt approaches have paid little attention to the role of public finance in servicing international debt. Rather, they envisioned an automatic process in which growth by itself generates the revenues internally, and public finance may remain in a passive role. This perspective has led to the neglect of the political process in the analysis of international debt. The IMF takes the economics of public finance into consideration but it does not draw a clear distinction between the period of debt accumulation and the phase when the debt ceilings have been reached. Applying a medicine as a preventive means when the patient is still fairly healthy may kill him if it is applied after the illness has broken out.

The Foreign Exchange Problem

The foreign exchange problem encompasses the transformation of internal resources into foreign exchange. This implies that the country must increase its exports and/or decrease its imports. Besides growth, this aspect is central to current approaches used by many international banks and the IMF. But quite often it is ignored that an export surplus is not solely dependent on the indebted country but requires that some other country take over the surplus. The major aspects for the assessment of an indebted country's ability to solve its foreign exchange problem is the country's competitive position in the world economy, and the growth of the world economy and of international trade, particularly of the major trading partners of the indebted country. The solution to the foreign exchange problem becomes more difficult with the number of indebted countries involved. When these countries export the same or substitutable goods, which in addition may also face inelastic demand (e.g. oil, agricultural and other raw materials), the foreign exchange problem can become unsolvable because higher output will result in lower prices and in a reduction of foreign exchange revenues despite an increase in the quantity supplied. The IMF favours the "case-by-case" approach to the "solution" of the international debt crisis, and thereby systematically neglects this interrelationship.

The budget and the foreign exchange problems cannot be resolved without a transformation of the economy. They are closely linked to the economic transformation

¹³ The Anglo-Saxon discussion of the German transfer problem took place in the *Economic Journal*: J.M. Keynes: *The German Transfer Problem*, in: *The Economic Journal*, March 1929, pp. 1-7; J.M. Keynes: *A Rejoinder*, in: *The Economic Journal*, June 1929, pp. 179-182; Bertil Ohlin: *Transfer Difficulties: Real and Imagined*, in: *The Economic Journal*, June 1929, pp. 172-178; Bertil Ohlin: *A Rejoinder from Professor Ohlin*, in: *The Economic Journal*, September 1929, pp. 400-404; Jacques Rueff: *Mr. Keynes' Views on the Transfer Problem*, in: *The Economic Journal*, September 1929, pp. 388-399. It concentrated on "the principle of the preservice of purchasing power" and with the exception of the difficulties predicted by Keynes, no major transfer problem was envisioned.

¹⁴ As history then proved, they were right – unfortunately however.

¹⁵ Anton P. Müller: *On the Utility of the Price Index and the Government Budget as Country Risk Indicators*, in: J. Rogers (ed.): *Global Risk Assessments. Issues, Concepts and Applications*, Riverside, California 1986.

problem. In contrast to the growth-cum-debt models which assume that the inflow of foreign capital prepares the country for the future debt service, there is rather a tendency that as long as the process of debt accumulation continues, the economy of a debtor country receives incentives that move it towards dependence on imports and government expenditures. At the outbreak of the debt crisis hardly any of the countries involved was "ready" for net negative financial flows, irrespective of the level of past growth rates and export performance.

To some extent, the transformation will be brought about by taxation of consumption and an increase in the real exchange rate, i.e. devaluation. But as with the budget problem, it may be too late to solve the transformation problem when the inflow of foreign credits has petered out. Countries as South Korea, Taiwan and others demonstrated that the government must be active in initiating export orientation at the onset of the debt accumulation process.¹⁶ However, the transfer process may fail nevertheless if the major importing countries reduce demand or adopt unfavourable trade policies. In particular, neither the reduction of purchasing power nor exchange rate devaluations will be sufficient if the debtor country is faced with competitors that supply an identical or substitutable pattern of goods, and if competitive devaluations occur.

The growth-cum-debt models assume that external credit serves as an addition to internal saving and is transformed into investment. But this did not occur during the 1970s with the developing countries.¹⁷ In most of the debtor countries the accumulation of foreign debt was accompanied by a growth of internal debt, by declining investment and savings rates and by an increase of real wages as well as current account and budget deficits. Foreign credits have tended to trigger consumption-led growth and undermine export-oriented growth.

Some Preliminary Conclusions and Criteria

From this perspective, the following conclusions can be drawn:

1. With the beginning of the process of debt accumulation the groundwork for the ability to pay must be laid by the implementation of appropriate economic policies that reduce internal consumption and strengthen international competitiveness. This requires the improvement of the effectiveness of the fiscal apparatus, monetary stability to induce saving, and improvements in

the quality of human capital that provide the basis for an increase in international economic competitiveness.

2. The payment ability of a country depends not only on the economic policy of the indebted country but on its position in the world economy. The relationship of the indebted country to its competitors and the reactions of its major importing countries have to be taken into consideration. The direction of trade is as important as the kind of products that are exported or can be developed for the world markets. In order to assess creditworthiness, the analysis of macroeconomic factors has to be supplemented by assessments of the performance and abilities of the major domestic companies that offer tradable goods.

3. The IMF policy which addresses each debtor country individually is inadequate. The international debt crisis is a global problem and needs a global solution. Active involvement of the creditor countries and the international organizations is essential in order to integrate the indebted countries into the world economy.

4. The transfer-theoretic approach to the analysis of international debt allows for the construction of several stages and the establishment of criteria to assess economic policy action. There is no automatic mechanism for guaranteeing that a country will be able to achieve a negative net transfer. If the flow of international credits stops, the country will have to undergo a complex transformation process, which is most difficult to accomplish. The success of the transformation process depends on a number of internal and external factors and involves politics to no less a degree than it does economics. The following criteria must be fulfilled in order to accomplish net foreign financial transfers:¹⁸

- ☐ in the debtor country a reduction of internal demand;
- ☐ in the creditor country an increase of internal demand;
- ☐ production in the debtor country be shifted from the domestic market to the foreign markets;
- ☐ in the creditor nations and in other countries that are affected, an adaptation to the above criteria;
- ☐ the debtor nation must achieve an export surplus high enough to finance the foreign exchange transfer abroad;
- ☐ the creditor nation (or some other countries which will pay with convertible currency) must accept a trade deficit.

¹⁶ Yung Whee Rhee et al.: Korea's Competitive Edge. Managing the Entry into World Markets, Baltimore and London 1984.

¹⁷ Nor did it happen in the United States in the 1980s during the massive capital inflow, or in Germany during the 1920s.

¹⁸ Wilhelm Roepke: Welchen Hemmungen kann eine für die Reparationsübertragung etwa erforderliche Umstellung in den Handelsbeziehungen begegnen? Wie würden diese Hemmungen auf den Transfer einwirken?, in: Edgar Salin (ed.): Das Reparationsproblem, op. cit., p. 334.

5. Whether the transformation will succeed depends on three major conditions:

- ☐ the demand on the world market for the product of the debtor country
- ☐ trade policies of the creditor countries and major importing countries
- ☐ trade policy of the debtor country.

The assessment of these factors requires an analysis of

- ☐ size and structure of import reduction
- ☐ size of export increases
 - in particular areas of production
 - elasticity of demand and supply
 - degree of competition
 - degree of import dependence on the export industry
- ☐ direction of trade
- ☐ trade policy of target countries.

A New Perspective

From the 1930s up to the 1970s, the problem of massive structural economic change as a result of conditions on the international financial markets had not reached an acute stage because there was no prolonged period of continuous extreme debt accumulation by individual countries. In the early seventies many countries began to increase foreign debts, and continued to do so for more than a decade. During the same period the number of creditor countries shrank. At the beginning of the 1990s very few creditors face more than a hundred debtor countries. Debt accumulation has become persistent because with the increase in debt, the import dependency of an economy grows. The inflow of capital triggers economic growth but the indebted country develops a structure that is counterproductive to the servicing of foreign debt. An active role by the government is required to counteract this tendency. While it is obvious that foreign debt accumulation is the mirror image of trade imbalance, one must also take into consideration that long-term trade imbalances and the accompanying debt accumulation induce structural changes in the economies involved. Specifically, the process of de-industrialization that countries have experienced in the process of debt accumulation finds its counterpart in the over-industrialization of major creditor countries. To some degree, these shifts have occurred independent of international credit flows.

In the past two decades, however, the conditions set by the international financial markets have become a more important factor. Prevailing trends on financial markets as to the assessment of the degree of creditworthiness of

individual countries or groups of countries produce shifts in economic structures, and as the experience of the indebted developing countries shows, correction of these misallocations involves substantial private and social costs. If, for example, financial markets determine that a debtor country has reached its credit capacity, the trade deficit and trade surplus countries alike will be confronted with the problem of adaptation to this situation. In order to service its international debts in the absence of either new credit or aid inflow, the debtor country must generate a net financial outflow which necessitates an increase in exports and/or reduction of imports. The economy of the debtor country must shift towards the production of tradable goods and reduce its production for domestic demand. In the trade surplus country, the economy must reduce its production of tradable goods and increase its imports. This shift affects not only aggregate production and consumption but also the structures of the economies involved.

This synchronization problem between the adaptation processes of the debtor and the surplus countries is likely to be exacerbated by a mismatch between financial markets and the real economy, and over a prolonged period of time, discrepancies may persist because financial markets are able to adapt rapidly to new conditions and perceptions while a correction of industrial structures is much harder to accomplish and proceeds more slowly. There is self-interest at work which may prevent an over-reaction by financial markets. But this may be no more than wishful thinking when we consider financial history.

Towards a Solution of the Debt Crisis

Solving the international debt crisis means solving the three transfer problems. This cannot be done by the debtor countries alone or in isolation. Solving the budget problem and achieving monetary stability are necessary but not sufficient conditions for the solution of the transfer problem. Beyond domestic finance and money, international trade comes into play and this requires an active role by the creditor countries and creditor banks. What should they do?

Neither new credit nor IMF policies will work if the countries in debt cannot find an outlet for their products. New credits do not provide a solution; they may save time but this policy is wasteful if the time cannot be used to move towards a solution. Without an increase in exports by the indebted countries and intensified foreign trade relations, the mere reduction of internal absorption may even be counterproductive if it hampers the integration of the debtor countries into the world economy.

The criteria established above such as fiscal and monetary restraint and an active policy of enhancing the competitive edge of export industries refer to the assessment of the creditworthiness of a country that has not yet reached its credit limits. When a country has to generate a net negative financial transfer, the emphasis must shift towards generating foreign exchange via exports. When lender countries and creditor banks strive towards a solution of the debt crisis, they must help to establish a link between negative net financial flows and net exports. A mechanism must be found by which positive net exports are achieved and then are linked to negative financial transfers. In order to do this, a group of countries or at least one country must be available with high internal demand and the ability to pay for it. The United States can no longer fulfil this role. The United States itself has become a debtor nation. In addition, it is near full capacity utilization and, in order to lower its trade deficit, must reduce its imports. Japan, on the other hand, is a very unlikely candidate for becoming a high absorber. This leaves us with Europe.

The OECD countries are in the process of establishing a "Bank for Reconstruction and Development of Eastern Europe". Western governments have decided to provide new loans to the countries in Eastern Europe. This is a political decision. Its financial implication is that the Western governments as creditors have decided to raise the credit ceilings for the countries in Eastern Europe. The economic implication of this political decision is that it will allow the countries in Eastern Europe to increase their imports and postpone export surpluses which would be needed to generate a net outflow of resources for debt service. Taking into consideration the existing high level of debt in a number of these countries, particularly Poland and Hungary, and the long period of time that it will take for them to become competitive, the plan to set up a development bank for Eastern Europe amounts to a kind of debt-forgiveness scheme. Politically it may be the right thing to do, but the plan leaves out the developing countries. In addition, it involves the risk that Western governments and private banks may further restrict their foreign aid and credits to developing countries in Latin America and Africa, and the international debt crisis will worsen. In order to prevent this, inclusion of the developing countries is needed.

The first step towards this would be to establish a linkage system by funding the development bank for Eastern Europe to some extent with the claims of private international banks on the debtor countries of the third world. The Bank for Reconstruction and Development of Eastern Europe could use these claims in the form of credits to the governments of Eastern Europe, which, in

turn, would use them for imports from the indebted developing countries. The establishment of a direct link between trade and finance between Eastern Europe and the indebted countries of the third world under the authority of the new development bank for Eastern Europe provides an incentive to increase trade between these areas. Demand and supply between Eastern Europe and a number of the countries of the third world match in many respects, whether they concern products of a medium technological level, footwear, textiles, or tropical fruits and other agricultural products. By intensifying trade relations between Eastern Europe and the developing countries both can increase their degree of specialization and become more deeply integrated into the world economy. This linkage system would offer an alternative to the IMF approach, provide economic opportunities for the countries of the third world and reduce the exposure of the private creditor banks.

Conclusion

In contrast to the concepts based on growth-cum-debt models, the transfer-theoretic approach acknowledges the difficulties and riskiness of international credit relations—for both the lender and the borrower. There is no automatic mechanism at work that makes a country "grow out of its debts". No country possesses unlimited creditworthiness, and in international banking, where criteria for creditworthiness are unstable, a reduction of credit limits may occur abruptly. In this situation, an indebted country is faced with the problem of generating foreign exchange by export surpluses in order to produce net negative financial transfers. The performance of indicators such as the growth rates of national income and of exports can lead to wrong assessments. Economic growth may be the result of the inflow of foreign capital and of government expenditure, and export growth may come to a standstill when a number of countries are simultaneously confronted with the problem of credit restrictions.

Criteria for international payment ability that are based on the transfer-theoretic approach emphasize budgetary and monetary policy and observe indicators such as the growth of government revenue and expenditures and the inflation rate. In addition, export promotion and trade policies have to be analyzed in order to assess a country's international economic competitiveness. A solution to the international debt crisis requires—besides the appropriate economic policy of the debtor country—an active role by the creditor countries and the creditor banks. One step in this direction would be the funding of the Bank for Reconstruction and Development of Eastern Europe at least in part with private banks' claims on the indebted countries of the third world.