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FINANCIAL POLICIES
AND DEVELOPMENT

Jacques J. Polak

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Jacques J. Polak

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PREFACE

We are pleased to publish this paper by Jacques J. Polak as the eleventh in our series of Occasional Papers, which presents reflections by scholars and policy makers on development issues.

Dr. Polak analyzes the relationship between savings (both domestic and foreign) and investment, as well as the distinction between financial flows and financial policies and their importance for investment and economic growth. He examines these key topics in economic policy and relates them to international economic events of the past fifteen years, looking specifically at the external debt problem of developing countries. He concludes the paper by looking at the role of the IMF and the World Bank in the debt crisis and considers the conditions necessary to stimulate a resumption of growth. Dr. Polak's wide experience, as well as his lucid and systematic style, make this a valuable contribution to policy makers everywhere, with useful recommendations for both international and domestic financial policies.

During his distinguished career in international and development economics, Dr. Polak has made a number of important contributions to our understanding of development and the formulation of policy by developing countries and multilateral financial institutions. This paper presents a condensed version of a book published in early 1989 under the same title by the Development Center of the OECD.

Nicolás Ardito-Barletta
General Director

International Center for Economic Growth

Panama City, Panama
August 1990

ABOUT THE AUTHOR

Jacques J. Polak, a Dutch national, received his M.A. and Ph.D. in economics from the University of Amsterdam. He worked as an economist for the League of Nations from 1937 to 1943, for the Netherlands Embassy in Washington in 1943–44, and for the United Nations Relief and Rehabilitation Administration (UNRRA) from 1944 to 1946. In 1947 he joined the staff of the International Monetary Fund, where he was director of the Research Department from 1958 to 1980 and economic counselor from 1966 to 1980. From 1981 to 1986, he served as a member of the Fund's Executive Board. Since then, he has been a senior adviser to the Development Center of the Organization for Economic Cooperation and Development (OECD) and a consultant to the World Bank. He is president of the Per Jacobsson Foundation in Washington, D.C. In addition to *Financial Policies and Development*, his books include *The Dynamics of Business Cycles* (with Jan Tinbergen), *An International Economic System*, and *The New International Monetary System* (edited with Robert A. Mundell).

JACQUES J. POLAK

Financial Policies and Development

This monograph focuses on the role that financial policies play in the process of economic development. The term “financial policies” relates not only to the domestic financial structure of the economy but also to the external financial structure, such as the exchange rate and the institutions and rules that guide the flow of capital into and out of the country: the financial structure of the outside world, such as the international banking system, the World Bank and the International Monetary Fund (IMF), aid-giving agencies, multinational companies, and so forth. “Development” is defined narrowly as growth of gross national product.

Correct financial policy is important because it either adds to the supply of financial resources or encourages more efficient use of capital and other factors of production. The concepts of finance and financial policy can thus be seen as complementary. “Finance” is quantitative: it measures the supply of capital, expressed in units of currency, and can be translated, using the marginal productivity of that capital, into expected additions to output.

The effects of some forms of financial policy can also be expressed in terms of their impacts on the availability of capital. For example, if a given increase in interest rates is expected to raise domestic savings by x billion or reduce capital flight by y billion, there is

a direct translation from financial policy to finance. In other cases the link is less direct, as when higher interest rates or a more efficient stock exchange serve to channel the available supply of capital to more effective uses. But the yield of such policy actions can still be expressed, at least in principle, directly in terms of increased output.

Economic growth (development) is the yardstick by which financial flows and financial policies can be made commensurate. In this study, these parameters are seen as interrelated dimensions of the development process. Their integration into a two-dimensional approach should help avoid a one-sided development policy framework that puts undue emphasis on the supply of capital, particularly foreign capital, and pays insufficient attention to financial policies. This somewhat myopic viewpoint was common to the development theory of the 1950s and 1960s and still afflicts many analysts. A one-dimensional approach also has a natural appeal to many developing countries, as it can be used to focus attention on a single external cause for disappointing growth.

Yet, theory and rhetoric aside, policy will have to focus not only on raising the supply of capital, but equally on coaxing the maximum possible growth out of all factors of production.

Phases of Development since World War II

Between 1950 and 1975, the rate of growth in the industrial and the developing countries was without precedent; in the latter countries, the average GNP per capita increased by 3.4 percent per year. But the smooth expansion of the world economy was sharply changed by the first oil shock, which occurred in late 1973. The resulting income transfer from the many oil consumers to the far fewer oil producers brought about a noticeable increase in world saving, as well as a decline in investment demand in the industrial countries. Banks in the industrial countries were instrumental in recycling the savings of oil producers, mostly to the developing countries. The financial resources that became available permitted the oil-importing developing countries to raise their investment-to-GNP ratios while lowering their savings ratios and maintaining a reasonable growth rate.

The second oil shock (1979) put an end to this—at least on the surface—favorable economic climate. The oil-importing developing countries were hit not only by a doubling of the oil price, but by three interrelated adverse changes as well: the rise in interest rates that resulted from the anti-inflationary monetary policies adopted by the industrial countries, a recession-induced major decline in the terms of trade and an abrupt cessation of foreign credit as the earlier adverse developments undermined the debtors' creditworthiness. The resulting debt crisis hit many, but by no means all, oil-importing developing countries; some, including some heavy bank borrowers, managed to maintain respectable growth rates.

Why did some countries fall victim to the debt problem and others not? Comparative statistics on countries that developed debt-servicing problems in the mid-1980s and those that did not show striking differences between the two groups both before and after 1981. Thus, for example, the "problem" countries mostly used their sudden large access to foreign resources to raise consumption, the "nonproblem" countries to raise investment. In the years after 1981 the problem countries did much worse than the nonproblem countries (See Table 1). While growth and capital formation declined only modestly in the latter countries and average growth for this group was sustained in the 3 to 5 percent range, the problem countries had two years of negative average growth (1982 and 1983) and did not exceed 3 percent growth in any of the four following years. At the same time, they experienced a reduction in their investment ratio by 8 percentage points as against a mere 4 percentage point reduction for the nonproblem countries.

While these low investment figures can hardly be considered the cause of the low growth rates in recent years—output in the countries involved rose only a little beyond their end-1981 levels—they nevertheless raise some issues for future growth. In its 1987 World Economic Outlook, the IMF rightly called recent investment trends "disturbing." It noted that large capital inflows during the period of heavy borrowing did not lead to increases in investment ratios in the heavily indebted countries, but that, when external financing dried up, these ratios fell sharply while consumption tended to be safeguarded. Thus, by 1986, average per capita consumption in these countries was at the same level as in 1980, while investment was

TABLE 1 Economic Performance in Developing Countries
before and after the Debt Crisis

		Developing countries ^a	
	Period	Without recent debt-servicing problems	With recent debt-servicing problems
Developments up to 1981			
Current account deficit (% of exports of goods and services)	1969–1978	8	18
External debt (% of exports of goods and services)	1981	81	186
Growth rate of real GDP (% per year)	1968–1981	5.5	5.1
Gross capital formation (% of GDP)	1978–1981	28	26
Developments after 1981			
Growth rate of real GDP	1982–1986	4.1	1.2
Gross capital formation	1983–1986 ^b	24	18

a. Developing countries except Iran, Iraq, Kuwait, Libya, Oman, Qatar, Saudi Arabia, and the United Arab Emirates; China has also been excluded for reasons of continuity of the series.

b. The period selected starts in 1983, because although the gross capital formation ratio in the problem countries started to decline in 1982, it did not reach its new level of around 18 percent until 1983.

SOURCE: International Monetary Fund.

down by one-third. The sustained cuts in public-sector investment since 1982 weakened its contribution to future rises in living standards both directly and indirectly because of the complementarity of public and private investment. In this manner, both the policies that led up to the debt crisis and those that were pursued in response to it, while designed to benefit consumption in the short run, may well have set it back grievously over the longer run.

Looking at the experiences of three heavy borrowers in the 1970s—Brazil, Mexico, and South Korea—leads one to ask how it happened that Brazil and Mexico became deeply mired in the debt crisis in 1982 and proved unable to extricate themselves from it over the next six years, while South Korea escaped that crisis and by 1986 started reducing its foreign debt while continuing to enjoy rapid economic growth.

Comparison of Brazil, Mexico, and South Korea brings out some characteristic differences that proved relevant to these countries' expe-

rience in the 1980s, including differences in fiscal policies and the far greater outward orientation of the South Korean economy. In 1980 the ratio of exports of goods and services to GNP stood at 37 percent for South Korea, at 13 percent for Mexico and at 10 percent for Brazil. These different ratios reflected long-standing policy differences: a high degree of export orientation in South Korea, as against a far more inward-looking and protectionist stance in Latin America.

Moreover, the composition of exports was radically different: about 10 percent in the form of manufactures in Mexico, 30 percent in Brazil, and well over 80 percent in South Korea. Both the policy orientation and the composition of exports played a role in the differences in export growth in the 1970s: an average of 23 percent per year for South Korea, 13.4 percent for Mexico, and 7.5 percent for Brazil. The differences in the relative importance of trade to GNP lie behind the fact that in comparison to external earnings, the debt burden and the interest burden of South Korea were only about one-third of the corresponding burden for Brazil and Mexico.

A further important difference can be noted in the quality of the fiscal situation. Both Mexico and South Korea show a sharp increase in the overall public-sector deficit from 1979 to 1981–1982, and both reversed this increase in the next year (see Table 2; comparable figures for Brazil are not available). But at the start and the end of the period, South Korea's deficit was a modest 1.4 percent of GNP, while Mexico's was some six times as large. This large Mexican deficit began to play a dangerous role of its own as foreign loans became scarce, inflation worsened, and public finance became a major causative factor in the deepening of the debt crisis.

TABLE 2 Overall Public-Sector Deficits, Mexico and South Korea, 1979–1984

	1979	1980	1981	1982	1983	1984
Mexico (% of GDP)	7.4	7.9	14.7	17.5	8.9	9.0
South Korea (% of GNP)	1.4	3.2	4.6	4.3	1.6	1.4

One inference that can be drawn at this stage is that countries wanting to avoid future debt problems must constrain foreign borrowing even

when interest rates abroad are below the marginal productivity of capital at home. As a matter of policy, maintaining a spread between domestic and foreign interest rates has a number of implications for national policy on borrowing abroad. It implies, in the first place, that governments do not automatically borrow in the cheapest market, if that means borrowing abroad. It further implies that the government controls borrowing abroad by its subdivisions and state enterprises according to the same principle.

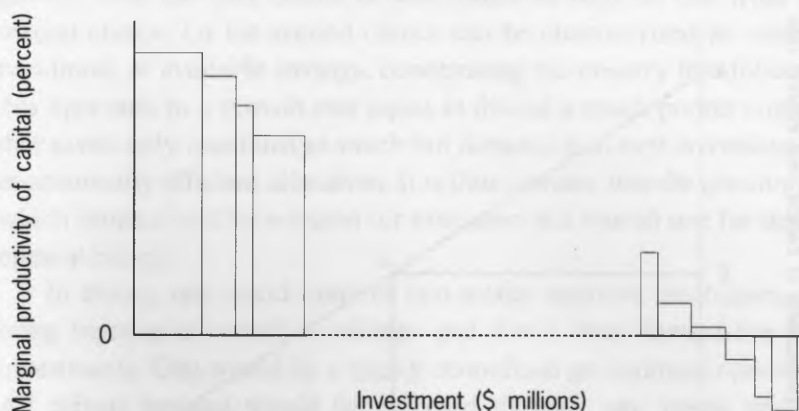
Saving and the Use of Savings

Economists may have learned too well Keynes's lesson that saving and investment in a closed economy are not just equal in amount—they are the same thing looked at from different angles. Saving is income not devoted to consumption and investment is output not absorbed in consumption. With income defined as the value of current output, saving must be identical to investment. But this identity can too easily lead to the erroneous inference that the amount of saving sets the contribution of investment to the economy. The essential point is that saving is different from investment in substance; or perhaps more accurately, the point is that savings do not yet have substance: they are undifferentiated purchasing power, while investment has a substance that determines its contribution to the process of production.

A country that saved \$100 million in one year must also have invested \$100 million; but while \$100 million saved or invested *can* make a large contribution to the growth of output, its contribution may also be small, zero, or negative, depending on the specific components of investment that together account for the \$100 million. The translation of savings into investment is crucial to the question of the contribution the identical twins, saving and investment, make to development.

Figure 1 brings together the results of an imaginary complete inventory of potential investment projects for a given country. The chart presents the queue of all such projects in that country. The width of each bar indicates the cost of the project; its height represents the marginal productivity of the project, measured as the ratio of the

FIGURE 1 Marginal Productivity of Capital and Investment

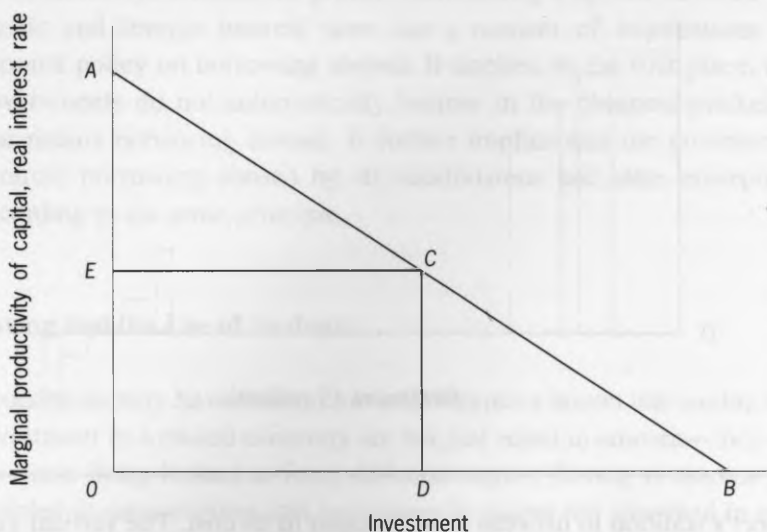


project's addition to national annual output to its cost. The vertical axis thus also indicates the highest rate of interest that the project could bear. The chart bears no numbers, because these would detract from the generality of the exposition. But suppose that project 1 (the most profitable project) had a marginal productivity of 50 percent and a cost of \$10 million. The area of the bar ($0.50 \times \$10 \text{ million} = \5 million) would then indicate the addition to GNP from this project. Project 2, with a marginal productivity of 48 percent and a cost of \$5 million, would add \$2.4 million to GNP, and so on. Once one specifies which projects are to receive finance for their execution, one can determine the aggregate additional output by summing the areas of the bars corresponding to the projects selected.

As we move along the queue we find projects that are less and less profitable; and at the far right of the chart we encounter projects with negative marginal productivity—those that, if executed, would reduce GNP by operating at a loss. If some of these projects are included among those chosen for execution, the negative values of the corresponding bars will enter into the figure for the addition to GNP.

Figure 2 is derived from Figure 1 by fitting a straight line to the tops of the successive bars. In this figure it is also assumed that the available supply of savings equals *one-half* of the total investment that would yield a positive return, that is, one-half of the distance *OB*

FIGURE 2 Marginal Productivity of Capital, Interest Rate, and Investment



measured along the horizontal axis. Thus, only half the profitable investment projects can be realized. We now compare two—admittedly rather extreme—methods of choosing among all competing investment projects with positive yields. If only half of *OB* is available for investment, optimum use of this amount would be the selection of all projects from *O* to *D*, leaving all those beyond *D* for possible execution in the future, when the supply of savings may be more generous or the competition from very good projects less intense. An alternative highly unsatisfactory selection would allow all projects starting from *B* to the left. This choice, which would still keep out any project with a negative yield (those to the right of *B*), would use up *DB* in investment, which also equals half of *OB*.

The actual outturn might well lie somewhere between the best and the near-worst methods of selecting projects indicated. But it is instructive to calculate the difference to the growth in output made by following one or the other of these two approaches. The chart itself answers the question. The contribution of an investment from *O* to *D* would be *OACD*, while the contribution from *D* to *B* would be *DCB*. Since *ACB* is a straight line and *OD = DB*, the two triangles *AEC* and *CDB* are the

same, and the rectangle $OECD = 2CDB$. Thus the contribution to growth from the first choice is three times as large as that from the second choice. Or the second choice can be characterized as wasting two-thirds of available savings, condemning the country that followed this approach to a growth rate equal to that of a much poorer country that saved only one-third as much but directed it to best advantage by economically efficient allocation. It is thus obvious that the question of which projects will be selected for execution is a crucial one for development policy.

In theory, one could think of two totally opposite mechanisms to bring together a country's savings and direct them toward the best investments. One would be a highly centralized government operation. All private savings would be garnered through, say, postal savings banks and the social security system, and business profits would be creamed off by high tax rates. Foreign savings too would flow into the central government. All investment projects would be submitted to the government, and the government would decide, on the basis of cost-benefit analysis and without political influence or preference for government corporations over private businesses, where the available investment funds would flow.

The second model would be a fully decentralized market system. The system would consist of multiple banks, both general and specialized, security markets, investment banks, and so forth, all of which would compete for the available funds through interest rates and dividends, among other ways. This market would establish a general cost of capital, with premia for each enterprise set on the basis of the market's best judgment of relative risk. Since no lender would want to make losses, projects that could not pay the market cost of capital would be screened out of the market. Self-investment projects that promised less than the prevailing market yield would not be undertaken, since the saver would have the alternative opportunity of earning the market yield by using any one of the available channels for intermediation.

Of these two theoretical models, there is no evidence that the first one operates anywhere, even as a remote form of approximation, as an efficient mechanism for the selection of investment projects. The centrally planned economies may succeed in centralizing a very large

proportion of all savings, but if nothing else, their lack of proper costing of capital goods and of recognition for the proper function of the interest rate would prevent them from using these savings in an efficient manner. By contrast, the second model functions, in an approximate manner, in the advanced industrial countries, thanks to many types of banks, capital markets, and other intermediary instruments. Financial deregulation in recent years has moved the system closer to the model. The availability of a great deal of information on individual firms makes it possible for savers and those to whom savers have entrusted their savings to come to reasonable judgments about the risk-adjusted yield of alternative assets. These judgments are inevitably subject to some degree of error; even very good markets do not avoid mistakes. But these mistakes, which can be corrected over time, are probably not the most important flaw in the system of allocation. Systematic weaknesses in the system are, rather, related to various aspects of the taxation system, such as its almost universal discrimination in favor of debt financing over equity financing.

Whatever the shortcomings of the system of financial intermediation in the industrial countries, it is clear that the same intermediation function is performed with far less efficiency in the great majority of developing countries. Fragmented capital markets—often linked to equally fragmented labor and goods markets—are one frequent cause of this inefficiency. In many developing countries that fragmentation is geographic, historically based on poor communications systems between regional and cultural groups. In others, it is vertical, as various unofficial markets of money lenders exist in parallel with a more formal official market structure. In many countries, both forms of fragmentation exist. As a result, the national pool of capital is broken into smaller markets too insular to clear regional surpluses and channel them efficiently to areas of capital shortage, much less link them into world markets.

But the fragmentation of the capital market in developing countries is by no means an entirely natural phenomenon that only time, improved communications, and growth itself will cure. It is also brought about by two causes for which the responsibility clearly rests with governments: inflation and the imposition of artificially low interest rates.

Whether they had moderate, high, or explosive rates of inflation, developing countries have, with few exceptions, exercised controls on interest rates that banks were allowed to pay depositors and charge to borrowers, thus keeping these rates artificially low and indeed often below inflation rates. Governments have advanced a wide range of arguments in favor of their low interest rate policies, stretching from the religious to the protection of the poor. Probably the most plausible economic reason given for such policies was, and continues to be, that low interest rates promote investment and thus the adoption of new technology. It is surprising that so obvious a fallacy could prove so persistent. True, at lower interest rates more investment projects meet the test of economic feasibility, but the total amount of investment demand that can be met is in any event constrained by the supply of domestic plus foreign savings. That total supply is certainly not increased by bringing interest rates down. On the contrary, though there may be some doubt about the effect of the level of interest rates on domestic saving (as seen in the next section), there can be absolutely no question that lower interest rates reduce the total supply of savings, and must therefore reduce investment. But their effect is worse than that: by admitting to the savings queue projects that would automatically be disqualified on the basis of an equilibrium interest rate, controls on interest rates inevitably cause the use of part of the available scarce savings for the execution of suboptimal investment projects and the concomitant exclusion of a larger amount of more deserving projects—a larger, not an equal, amount, because the reduction in interest rates also reduces the total supply of saving.

It should be stressed that the distortion of investment caused by uneconomically low interest rates paid by the banks is not limited to the amount of investment that the banks intermediate. It also applies to the savings that the banks do not receive, either because would-be savers are turned off by the low yields and consume rather than save, or because savers decide to invest in their own households or enterprises. Faced with highly negative real interest rates in the banks or on government paper, and in the absence of other attractive forms of financial investment, savers may opt to put their money into any available inflation hedge. The social and private yield of such investments

may be zero or negative, but the saver might still select them as long as the yields were less negative than those available on monetary assets.

At lending rates so low in real terms, it is obvious that the demand for credit far exceeds the available supply and that the banks must ration credit. A specified part of the credit often has to go to preferential borrowers at especially low rates; for the remainder, the banks are free in their choice of customers. The obvious interest of the banks is to lend to completely safe borrowers whose reputation is known or whose collateral is relatively riskless, or to borrowers with whom the bank has special connections. There is no mechanism to ensure that this process will channel savings to the economically most deserving projects. Indeed, if the banks regularly concentrate their lending on a few chosen customers and give them all the credit they can justify, the marginal productivity of the projects of these borrowers may be almost as low as the interest rate charged by the banks.

Cross-country correlations for forty developing countries from 1965 to 1984 explain differences in growth rates in terms of real interest rates and a number of other variables—the ratio of investment to GDP and the growth rate of the purchasing power of exports—and confirm these theoretical findings (see Table 3). These calculations indicate that keeping the real interest rate 5 percent too low might cost a country about 1 percent in its annual growth rate and that it would require a rise in the investment ratio by some 5 percentage points (for example, from 20 to 25 percent of GNP) to compensate for the low interest rate. It would follow that international organizations that supply additional resources to developing countries should insist on these countries' pursuing interest-rate policies that economize on the use of capital; in the past neither the World Bank nor the IMF has put sufficient emphasis on this matter.

It is clear from the preceding analysis that the cost to a country of distorted capital markets can be very high. The admittedly tentative figures just cited suggest that, for many a developing country, cost, measured as that part of the investment ratio necessary to compensate for distorted capital markets, might well be of the same order of magnitude as the amount of foreign capital that the country receives from abroad in the form of loans, grants, and direct investment. These find-

TABLE 3 Explanation of Differences in National Growth Rates, 1965-1984

Equation	Explanatory variable			\bar{R}^2
	RRI	INV	X	
(1)	.27 (.06)			.32
(2)	.23 (.06)	.092 (.045)		.37
(3)	.19 (.06)		.19 (.05)	.49
(4)	.18 (.06)	.044 (.043)	.17 (.05)	.49

RRI = Real interest rate.

INV = Ratio of investment to GDP.

X = Growth rate of the value of exports deflated by a country-specific import price index.

ings call for a maximum effort by policy makers in developing countries to rationalize their capital markets.

This effort should include the removal of unduly low, below-equilibrium interest rates. It does not call for high interest rates, brought about by whatever cause. The experience of recent years indicates two classes of situations in which high, indeed extremely high, real interest rates occurred, accompanied by an unfavorable investment climate.

The first is in the immediate aftermath of stabilization from hyperinflation. At that stage, the actual increase in prices may have been brought down to a very moderate rate of inflation through a combination of policies such as price freezes, fiscal measures, and tight money; but inflationary expectations, which dominate interest rates, have not yet been turned around. In such situations the difference between expected and realized rates of price increases keeps ex post real interest rates high. This was the experience in Argentina and Israel in the first months of their 1985 stabilization plans—as it was the general experience in the stabilization plans in Europe in the 1920s. Ex post real interest rates of 3 or 4 percent per month proved necessary for a number of months in both countries to prevent undue expansion of credit and to protect newly stabilized exchange rates. Such high real rates are detrimental to investment activity and to economic activity in general, but they are, at least for a short period, an inevitable cost to a country that needs to shake off hyperinflation. That cost can only be minimized by making the design and the execution of the policy package as convincing as possible, with a view to bringing down, as rapidly as possible, the expectation of future inflation. Lowering the interest rate and raising the supply of money before the reversal of inflationary

expectations has increased the real demand for money would be counterproductive and might prove disastrous if it reignited inflation.

The second situation producing extremely high interest rates, which may, but need not, coincide with the first, relates to deregulating the banking system without ensuring proper financial supervision. In Chile in 1981 and 1982, real interest rates (in a period of low inflation) exceeded 3 percent per month as banks granted and rolled over masses of bad loans. Similar symptoms of banking systems in disarray were encountered around that time in Argentina and Turkey. The remedy against those cases of high interest rates was the institution or reinstitution of essential prudential supervision over the banking system, which, in Turkey at least, included regulation of interest rates.

The Supply of Savings for Investment

Determinants of the domestic savings rate. With few exceptions, domestic saving is the dominant determinant of domestic investment. For the developing countries as a group, the association of investment and saving is so high that domestic savings financed about 90 percent of their investment from 1960 to 1983. Only in the countries in which foreign aid played a large role in the provision of resources could countries achieve and maintain an investment rate far in excess of the savings rate. Thus the low-income countries in Africa have been able to afford an excess of investment over savings of some 10 percent of GNP throughout the 1980s, after excesses of only about 3 percent in preceding decades.

A wide range of factors influence the domestic savings rate. Simple development models tend to assume that the savings rate is a positive function of per capita income, but China and India have among the highest savings rates, and in Latin America some countries with the highest incomes have the lowest savings rates.

A review of the savings literature suggests a weak positive influence of interest rates. Against this finding based on cross-country correlation exercises one should also give attention to individual cases where the introduction of positive real interest rates has been associ-

ated with sharp increases in the personal savings rate. In Korea, the increase of the real return on one-year time deposits—from slightly negative in the early 1960s to positive figures on the order of 10 to 20 percent between 1965 and 1971—brought about a rise in personal savings from about zero to 8 percent of GNP. Taiwan, where high positive real rates were introduced earlier, has, since their introduction, consistently enjoyed a high personal savings rate and, as a result, has had to rely much less than Korea on foreign capital to finance a high level of investment. It seems justified to conclude that, to an individual country considering the transition to pronounced positive real interest rates, both the general experience and that of the few highly successful countries would be relevant.

Moreover, the general findings of a weak response of total private savings to interest rates are fully compatible with the evidence that *financial* savings in developing countries are strongly responsive to the real deposit rate; increases in the proportion of savings channeled through financial institutions brought about by higher interest rates have an economic benefit of their own in that they would tend to encourage a more rational use of these savings.

Not all private domestic savings are available for domestic investment if either (1) the government is a net dissaver, as has been the case in many of the heavily indebted countries, or (2) resources move abroad as capital flight. These two issues are discussed next.

Government finance and the debt problem. From the narrow point of view, the problem that many developing countries have experienced for six years or more—the service of their foreign debt—can appear as simply a balance-of-payments problem. The balance-of-payments statistics showed that credit items in the current account, such as exports and remittances by emigrants, did not provide enough foreign exchange to pay for necessary imports and to pay in full the interest on the foreign debt, let alone any repayment of the principal. Thus it appeared that the debt problem would be relieved, and perhaps become manageable, to the extent that growth in the industrial countries became more buoyant, export prices improved, and import prices (of energy, for example) came down. It was acknowledged, of course, that these external

factors would need the support of sound domestic policies and realistic exchange rates in the debtor countries themselves, but the emphasis remained nevertheless on external variables.

Such a view of the debt problem, however, particularly when it persists over a long period, is inadequate because it does not look beyond the immediate effects of higher exports or cheaper imports on the balance of payments. It ignores the fact that these favorable effects on the current account are accompanied by an equal increase in domestic real income, which in turn, and with some lag, will lead through a multiplier process to a stream of additional imports. With assumptions that seem plausible for developing countries, the resulting stream of additional imports will absorb a large proportion of the initial positive change in the balance of payments. Accordingly, the search for a *lasting* positive change in the balance of payments will have to go beyond exogenous current-account improvements.

Government deficits (whether on current or capital accounts) have played a major causative role in the balance-of-payments deficits of many heavily indebted countries in recent years. With the easy availability of foreign credits in the late 1970s, many Latin American countries allowed a deterioration of public-sector finance on the order of 8 to 10 percent of GNP to take place.

Perhaps because the deficit had become so enormous in so short a time the need for a large fiscal adjustment was promptly recognized and—if one bases one's judgment on the pace of fiscal adjustment in industrial countries—was acted on forcefully and with considerable speed in some countries. Argentina, Bolivia, Mexico, and Venezuela all managed fiscal corrections of 8 to 10 percent or more of GNP two years after reaching their peak deficits. And, not surprisingly, just as fiscal deterioration had its counterpart in a worsening of the current account of the balance of payments, fiscal adjustment tended in most cases to be accompanied by notable improvements in the current account. But in the countries mentioned, as in other heavily indebted countries, the fiscal improvements frequently did not stick.

In some countries, the nature of the expenditure cuts was such that they could not be sustained over the long run—essential capital spending, maintenance costs, social services, or real government salaries were reduced below levels that were economically or socially accept-

able. Some of the adjustment measures taken to raise revenues also proved to be unsustainable. In some countries, political pressures, understandable after a string of years of declining real per capita consumption, overcame the best intentions of the authorities to restore fiscal order. Finally, and perhaps most disconcertingly, there are indications that, in some countries, the adjustment process itself has started to have a negative effect on government finance. Thus, a very necessary real depreciation of the currency could raise the real interest cost of the foreign debt, and the inability of the government to contain inflation could reduce the real yield of existing taxes.

A country's first step toward meeting its payments obligation abroad is to mobilize the necessary domestic resources through the budget. Without this step it is unlikely that the country will attain the balance-of-payments position that would make the transfer possible. Even if it did, as a result of some fortuitous development in the net foreign transactions of the private sector, the attempt by the government to acquire these resources by borrowing from the Central Bank would be likely to undo the favorable payments position in a short time.

In appraising the success of a country in restoring its fiscal balance, the definition of the fiscal deficit has become an important issue. It is suggested that the correct starting point for this purpose is the "operational deficit," which excludes the component of interest payments in a highly inflationary situation that serves to compensate creditors for the decline in the real values of their claims. In some recent years, the difference of this deficit from the conventional deficit has been of the order of 10 to 15 percent of GNP for Mexico or Brazil.

• **Domestic and foreign savings.** In the context of the desirability of enhancing the supply of capital available to developing countries, attention naturally focuses on the stream of capital toward these countries and on measures to enlarge that stream. But in a highly integrated world economy it cannot be assumed that capital moves along a one-way street. Official capital movements—from donor countries and international lending institutions—can be expected to move initially from developed to developing countries, but at a later stage loan repayments may become quite important and may indeed ultimately exceed new

loans as the receiving country “graduates” from its status as an international borrower.

In addition, official capital exports from developing countries occur as these countries acquire needed reserves of foreign exchange. For movements of private business capital, such as direct investment and commercial bank credit, the natural direction would also be expected to be overwhelmingly into, rather than out of, the developing countries. The large multinational corporations are typically located in the industrial countries, and while most of their foreign assets are also in industrial countries, they have also contributed, and are still contributing, large amounts of capital to the developing countries. Commercial banks in the industrial countries gave huge credits to the developing world in the 1970s and early 1980s, based in part on the deposits these banks were accepting from the oil surplus countries; again the reverse flow of outward banking money from developing countries is likely to be small.

There is, however, one category of private capital movements for which the balance of inflows and outflows could be expected to be out of the developing countries. These are the movements of *private non-business* capital. Wealthy individuals in developing countries may have a variety of strong reasons to move their assets—which may not be sharply distinguishable from the assets of business firms under their control—to other countries: to diversify their portfolios, to hedge against expected devaluations of national currencies, to get better yields, to avoid taxes or confiscation, to seek anonymity, and so on. Some movement of funds from developing to developed countries has probably gone on for many years. It appears to have intensified in the 1980s, partly because the incentives for such movements became greater and partly because the facilities for these outward movements of capital were enhanced by the active solicitation of these funds by banks in the industrial countries. It is essentially these private funds that constitute the flight capital from the developing world. For countries in which capital and foreign exchange are scarce, the outflow of capital on a large scale is without a doubt a most serious matter. It can be assumed that most of it constitutes a diversion of resources from domestic real investment to foreign financial investments—although if the alternative would have been larger consumption expenditure

abroad, the cost to the country would have been even greater. Even if the yield of this financial investment is repatriated at some time, the country loses the additional benefits that would have been brought about if the money had been productively invested at home: entrepreneurial income, additional workers' earnings, and taxes.

There may be many structural reasons, such as taxation or the diversity of investment choices, why residents of low-income countries prefer to hold part of their assets abroad; but experience shows that countries can in general prevent important outflows of domestic capital by keeping the rate of interest and the exchange rate competitive.

The ability of residents to buy, on a net basis, foreign exchange from the authorities presupposes that the latter are willing to sell foreign exchange at an exchange rate that the capital exporters still consider favorable. Whenever the demand for foreign assets is large, this can only happen on a protracted basis if the authorities replenish their foreign reserves by borrowing abroad. A country that is unwilling to reduce its reserves, or to borrow to accommodate the demand for foreign exchange of would-be capital exporters, will allow the exchange rate to depreciate in a free market. In that event, the attempt of some to acquire foreign exchange would depreciate the exchange rate of the country's currency to the point where others see an advantage in bringing an equal amount of foreign exchange into the country.

Whenever currencies are overvalued or interest rates are kept well below equilibrium levels, mobile capital will try to take advantage of the situation and seek investment abroad. Exchange controls on capital movements can make capital flight more difficult, but they are unlikely to succeed for any length of time in preventing flight where the exchange-rate and interest-rate incentives are strong. And there have been a sufficient number of instances of a return flow of capital when exchange rates and interest rates were brought into line to confirm the significance of these two variables in the struggle to keep capital at home. Admittedly, return flows have, so far, been small compared with the estimated stock of assets held abroad, part of which may indeed have become permanently uprooted from its home soil. But the pursuit of correct policies from now on can, as a minimum, ensure that capital flight does not further sap the stock of savings available for investment in the country of its origin.

The Search for Foreign Savings

The debt problem has left many countries short of inflows of foreign capital; hence the search for new, or the revival of old, techniques for the transfer of capital to developing countries. This search is proceeding against the background of a radical change in the system, where the United States has become a massive absorber of the savings of the rest of the world.

The resumption of a broad flow of capital to the developing world will require that the United States bring its balance-of-payments situation under control. Action to this end by the United States will need to be complemented by action on the part of the other industrial countries, particularly by the countries with large current-account surpluses. One possible form of such action would consist of expansionary fiscal, monetary, and other measures aimed at reducing the national rate of saving with a view to raising these countries' absorption of resources relative to GNP.

But this is not the only, nor from a world point of view the optimal, method of adjustment. There is no indication that aggregate saving in the world is unduly high: rather, the prevailing, unusually high real interest rates signal an insufficiency of world saving (in which the low savings rate in the United States is, of course, a major element). Most evidently there is a large unmet need for savings in the developing world, both in the low-income countries where this is a chronic phenomenon and in the middle-income highly indebted countries as an aftermath of the debt crisis.

From a world welfare point of view, therefore, the high-saving industrial countries, as well as the high-saving NICs in East Asia, should not be encouraged merely to consume more. It may well be in their own interest to raise consumption levels, for example, by allowing their wage earners to enjoy more of these nations' increased productivity and by raising national housing standards. But the adjustment process would be served as well, and the plight of the developing countries would be served much better, if the surplus countries continued to save in the form of current-account surpluses but directed these resources as capital flows to the developing countries, rather than to

the purchase of government paper, real estate, or corporate stock in the United States.

Assuming that the global supply situation in the world's capital markets will gradually be returned to balance by the necessary action on the part of the United States and its major trading partners, will there be enough capital available to meet the needs of the developing countries? And if so, in what form, by what capital instruments, will these needs then be met?

It is not useful to look for a single number measuring the supply of capital from abroad available to, or needed by, the developing countries. The creditworthy countries, mostly in Asia, are on the whole not suffering from a lack of foreign capital. Any new initiatives would provide them, but not the other developing countries, with either more capital or less costly capital. The low-income countries depend almost entirely on the supply of aid money; developments with respect to other foreign sources of capital are almost entirely irrelevant to them. In between, the middle-income, highly indebted countries are likely to be subject to a long period of capital scarcity even if the world supply of capital is plentiful. Against this general background, three categories of capital flows deserve particular attention:

- Direct investment flows have shown no increase in real terms in the 1970s and 1980s. During these two decades, major companies in the industrial countries increasingly developed techniques to control their involvement in production in other countries through "new forms of international investment" that did not necessarily involve important movements of capital. For a time, this approach of "unbundling" direct investment also suited the investee countries as they could attract capital through bank loans. It is questionable whether this process can now be reversed. Like other flows of capital, the resumption of direct investment flows is likely to require the prior reestablishment of creditworthiness.
- In principle, there are wide opportunities for capital flows to developing countries through other forms of equity investment:

in emerging stock markets, through venture capital, and leasing, among others. In practice, the growth of these various forms of investment has been slow, in spite of efforts by the Organization for Economic Cooperation and Development and the International Finance Corporation.

- Official export-credit agencies of the main industrial countries had played a major role in financing the export of capital goods until the early 1980s. In the next few years, as arrears developed, the agencies typically ceased to provide cover. More recently, they have been willing to resume cover as borrowing countries agreed to stabilization programs with the IMF. This has not led to a strong resumption of export credits, as these credits have traditionally been used to insure large public-sector investment projects, which debtor countries have cut back on.

Financial Flows and Financial Policies:

The IMF and the World Bank

In the postwar period, the International Monetary Fund and the International Bank for Reconstruction and Development (the World Bank) have been the two major official institutions concerned with both the financial flows to the developing countries and the financial policies of these countries.

After finishing its reconstruction task, the World Bank concentrated its financial activities entirely on the provision of loans to promote—and in recent years also to maintain the momentum of—the economic growth of developing countries.

The Fund's field of activities, both regulatory and financial, covers its whole membership, with no formal distinction between developed and developing countries. As a matter of practice, however, the Fund's financial policies have been increasingly directed toward the needs of the developing countries. These policies included the creation of the Compensatory Financing Facility (CFF, 1963), the Extended Fund Facility (EFF, 1974), the Structural Adjustment Facility (SAF, 1986), and

the Enhanced Structural Adjustment Facility (ESAF, 1988), all of which were designed to assist the nonindustrial members of the Fund.

No industrial country has made use of the Fund's financial resources in the past ten years. The reason for this is not that the industrial countries have avoided balance-of-payments difficulties, but that they have found convenient sources of finance elsewhere: in the Euro-dollar markets, in the credit mechanisms of the European Community, and, as far as the United States is concerned, in large-scale purchases of dollars in the exchange markets, mostly by other industrial countries anxious to mitigate the appreciation of their own currencies.

One of the Fund's principles is that the revolving character of its resources must be safeguarded. This means, in the first place, that each credit granted by the Fund must be reimbursed over a specified period, which may be either three to five years or five to ten years, depending on the lending facility under which the country has borrowed. As a matter of principle, the Fund does not renegotiate or extend the terms of credits previously granted. But where the conditions justify new credits as earlier credits are repaid, countries can remain in debt to the Fund for long stretches of time. In fact, among the smaller developing countries, prolonged use has been the rule rather than the exception. By the end of 1987, eighteen African countries had been uninterruptedly in debt to the Fund for more than ten years, including three for over twenty years. Eight countries in the western hemisphere, eleven in Asia, and four in southern Europe were also in the over-ten-years group. Thus, if one looks at the pattern of total outstanding Fund credit to developing countries over the years, the trend is strongly upward—from about SDR 1 billion in the mid-1960s to about SDR 30 billion in 1987, after declining from the 1984–1985 peak of over SDR 37 billion—a thirtyfold increase over a period during which these countries' imports increased roughly tenfold and their quotas about fivefold.

Through its conditions for lending, as well as by means of its consultations, the Fund has attempted to influence the financial policies of its developing member countries in directions conducive to economic growth. Over the years, supply policies have acquired an established place in Fund programs, side by side with policies to contain demand within the limits of available resources (with the latter

enlarged by the supply of Fund resources on a temporary basis). For the lowest-income countries the Fund now actively collaborates with the World Bank in drawing up joint policy papers to guide the financing activities of both institutions.

Allocations by the Fund of SDRs, introduced into the system in 1970, have fallen out of favor with most of the major industrial countries. Their resumption would lighten the burden for developing countries of maintaining adequate reserves and would, at the same time, make the international monetary system less dependent on borrowed reserves. The contentious question whether SDR allocations should be used to provide development finance appears to have been buried; the potential benefits of this approach had in any event been greatly reduced by the introduction of a market interest rate for the SDR.

In its early years, the World Bank's loans were overwhelmingly for individual projects, mostly for infrastructure. In recognition of the crucial importance to the development process of correct macro- and microeconomic policies the Bank, since about 1980, has moved increasingly toward "policy loans"; such loans are now about one-fourth of its total annual lending. Borrowers are attracted to these because they provide quick finance for general imports, thus relieving the foreign-exchange constraint on growth. These policy-based loans, which are normally granted in the context of an arrangement between the borrower and the Fund, have enhanced the policy dialogue between the Bank and many of its members.

When the debt crisis broke in the summer of 1982 the IMF, and in particular its managing director, Jacques de Larosière, assumed a crucial role in the highly confused and potentially explosive situation. The Fund became the traffic policeman at a multiple intersection: negotiating with debtor countries on adjustment programs, without which no financial arrangements were possible; promising to lend its own resources on a large scale if agreement on programs could be reached; working with the Bank for International Settlements and central banks on bridge financing pending the elaboration of a program and its formal acceptance by the Fund; persuading governments to provide credit on a bilateral basis through export financing agencies or otherwise; and bringing heavy pressure to bear on the commercial banks to restructure loans falling due, to lend large sums in "new money" in proportion to

their existing exposure, and to maintain interbank lines of credit to foreign branches of international banks located in indebted countries.

In this first phase of the management of the debt crisis, from late 1982 to late 1985, the Fund was the organizer of both the policy packages and the quid pro quo financial packages. In these latter packages, World Bank credit typically constituted only a small proportion, far larger amounts being lent by the Fund and the commercial banks.

In late 1985 the so-called Baker initiative—named for its initiator, James Baker III, who was then the U.S. secretary of the treasury—envisaged a more modest lending role for the Fund and increased lending by the World Bank. This materialized in the form of a succession of large sector loans. By 1987 all the heavily indebted countries, with the exception of Venezuela, had become adjustment borrowers from the Bank, with more than 60 percent of the sectoral adjustment loans having gone to these countries.

In greatly enlarging their credits to the highly indebted countries, the Fund and the Bank responded to the risks to which the system was exposed, and in light of the unique contributions that only they could make.

- International institutions can contribute an essential ingredient to successful discussions between creditors and debtor: the seal of approval for a policy program by the debtor country that enhances the likelihood that the creditors' claims will be serviced. In their normal course of business, the institutions' seal of approval is implied in the willingness of the institution to grant credit. The standby arrangements concluded with the Fund traditionally performed this function.
- International institutions can play a major mediating role by proposing a particular bargain in the light of their expertise, and they, as well as national governments, can twist the necessary arms to bring about "voluntary" agreement along the lines of the proposed bargain.
- The institutions and national governments carry a responsibility for the international monetary system and for domestic monetary systems in the major countries; both systems

were seriously at risk in the first phase of the debt problem, and the best place to defend them appeared to be on the defense perimeter, namely, by shoring up the banks' claims on developing countries.

- The injection of new credit by the international institutions, and in some cases by governments, served to reduce the scope of the conflict of interest between the negotiating parties: official money reduced the combined effort that these parties would otherwise have been obliged to make—in terms of immediate adjustment by the debtors and “new money” from the creditors—to reach a credible package for the period ahead.

For many years the Fund's approach has been to avoid activating its own financial component of an arrangement negotiated with a member country until it had sufficient assurance that the country's balance-of-payments gap would be covered, taking into account the financing contributions of all participants in a particular arrangement. By not disbursing its own resources until the entire financing package was in place, the Fund was able to play its leadership role in the debt crisis most effectively. More recently, however, the Fund's negotiating approach has lost some of its effectiveness, as is evident from the increased time between the conclusion of the Fund's negotiations with a member country and that country's agreement with its banking creditors. At the same time, the approach is increasingly exposing the Fund to the criticism that it puts the debtor under undue pressure in its negotiation with the banks.

In these circumstances, less linkage between Fund credit and the renegotiation of commercial bank credits would be a healthy development. The debtor countries and the banks are jointly responsible for the loans made in the late 1970s and early 1980s. These loans may or may not have been sound at the time, when real interest rates were negative, and the proceeds may have been used more or less well, all depending on the individual loans and the individual countries. As in any relationship between debtor and creditor that has gone sour, it should be primarily up to the parties concerned to find their way out of the relationship into which they had entered. While international organizations and national governments have a role to play in these difficult

negotiations (as discussed above), the Fund would want to avoid tilting the scales in favor of the banks and against the debtor countries. Market pressures on these countries to come to terms with the banks are strong in any event. The countries do not have the simple option of letting interest arrears accumulate and just waiting until those arrears force out compensating "new money"; as the standoff between the country and the banks drags on, the country is likely to find that trade credits and other credits dry up or become more expensive.

The declining willingness of the commercial banks to respond to Fund and Bank initiatives for balanced adjustment-cum-financing solutions point to the need for caution on the part of both institutions in the commitment of resources in connection with the continuing effects of the debt crisis. As has already been noted, the arguments that strongly favored the institutions' activism in the past have lost some of their weight. At the same time, failure of the banks to carry a fair share of the financing burden creates a risk of putting pressure on the Fund and Bank to fill a larger proportion of the need for financing. But the question is not only one of the size of the contribution to be made by these institutions; that question can be handled by the adoption of certain conservative rules of thumb. The most difficult task is to recognize those cases where the degree of adjustment that can effectively be achieved and maintained holds no promise of a return to creditworthiness. Experience shows that in such cases the institutions' major members will not necessarily hold them back from accepting too much risk. These members may prefer to risk "the Fund's money" or "the Bank's money" (which is their own money only in event of liquidation of the institution) rather than face the alternatives: providing fresh money of their own or contemplating the financial and political implications of default. Surrounded by such pressures, the international institutions have only one compass to sail by, namely, their own independent, objective judgment on the quality of a country's adjustment program.

The Debt Crisis and the Resumption of Growth

There is wide agreement that a close connection exists between the resumption of satisfactory growth in the heavily indebted countries and

the resolution of these countries' debt problems. The linkages run in both directions. If economies grow, a given amount of debt will become a declining proportion of GNP or exports, and its service will thus become more bearable to the debtor countries and, at the same time, will appear more probable to be met in the eyes of the creditors.

At the same time, finding solutions to the debt problem is essential to the promotion of growth. For the countries that have been strongly affected by the debt crisis, a high debt service holds back growth in a number of ways. First and most directly, the payments to be made to creditors reduce the amount of foreign exchange available to finance essential imports; in the short run, at least, this can keep down both the rate of current output and the installation of new capacity. Second, the expectation that for a long period in the future an important part of current output will have to be paid to foreign creditors may dampen the profit outlook, and hence the entrepreneurial spirit in the country. Third, the need for the government to devote a greatly enlarged part of its revenue to debt service is likely to signal the risk that, if government domestic expenditure is inflexible downward, the tax burden is likely to rise in one form or another, thus putting a further damper on enterprise.

Finally, and perhaps most important, the absence of a resolution to the debt problem keeps interest rates in the debtor countries at exorbitant levels and thus depresses investment. The key consideration in this linkage is that the capital markets in the middle-income highly indebted countries are closely connected with the markets in the industrial countries. As a consequence, the impairment of a country's creditworthiness means far more than the interruption of voluntary lending to it by the commercial banks in the main money centers. It means that claims on the indebted countries trade in secondary markets at implied rates of interest that compare unfavorably to interest rates on junk bonds. If a twenty-year claim at a nominal interest rate of, say, 8 percent is quoted at fifty cents on the dollar, this implies an interest rate of nearly 16 percent. If a country's obligations yield that much on foreign markets, arbitrage will keep interest rates for dollar claims in the internal market at a similar level; if rates were significantly lower, capital flight would be encouraged. Rates in local currency would, in addition, carry a premium reflecting the expected depreciation of that

currency against the dollar. Such high interest rates will make only few investments profitable; low levels of investment-to-GNP ratios in all highly indebted countries confirm the working of this mechanism.

These mutual influences of debt and growth can produce a vicious circle scenario in which insufficient growth mires a country in an apparently endless debt struggle, and continuous debt problems keep growth forever below the critical value that would allow the country to break out of the circle.

But the risks of a vicious circle should not deflect attention from two other sets of factors that have a major impact on growth in developing countries. The first of these is the result of the policy choices made by the industrial countries in the management of their economies: their growth rates, the containment of protectionism, and the world interest rate. Without minimizing the impact of these variables, which are beyond the control of the developing countries, attention should be equally focused on the policy choices that each of these countries makes itself, which can still make a large difference to the growth outcome that it will be able to achieve.

In the recent attention given to "policies for growth," three distinct causal strands can be observed: growth can be raised by greater efficiency, by additions from abroad to the supply of saving, and by reducing the constraint on imports.

The growth rate in exports is seen as a crucial variable for the attainable growth rate of the economy as a whole, with allowance for changes in the terms of trade, world interest rates, and available flows of capital imports. If the resulting growth rate is not considered acceptable, further adjustment will be required, probably including depreciation of the real exchange rate to enhance the export growth rate.

Even after a country has adopted policies designed to produce an acceptable rate of growth for the medium term, its calculations may be upset by short-run fluctuations in exports or in the two other variables mentioned in connection with exports: the terms of trade and world interest rates. Moreover, although these last six years have been extraordinarily difficult for the highly indebted countries, it is noteworthy that growth in the industrial world has consistently been in the positive range; since 1980–1981, there has been no general recession in the industrial world. It would not be a surprise if one did arrive on the

scene before the countries struggling with the aftereffects of the debt crisis had regained a position of creditworthiness. The need for the IMF to assist countries financially if one or more of these unfavorable events occurred should be fully recognized and provided for. A substantial increase in Fund quotas under the Ninth Review of Quotas, now under consideration, should provide the resources to meet the extra needs that might arise from such eventualities.

But, in addition, and as a further encouragement for countries to enter into stabilization programs and accept the political cost that these programs usually entail, these countries should have the Fund's assurance that they will be eligible for specific help if their programs are buffeted by exogenous factors. In 1988 the Fund responded to this need by introducing a contingency facility, under which a member country that experiences unfavorable exogenous shocks in the course of an arrangement it has with the Fund can borrow additional resources to absorb part of these shocks. The facility is still very new and experience will have to show its ability to meet two critical tests: that it will encourage countries in payments difficulties to come to the Fund at an early stage of their problems; and that it will in fact assist countries to deal quickly and smoothly with such contingencies as may arise, and do so in a manner that keeps their adjustment programs intact without sacrificing their growth momentum.

The Debt Crisis and Beyond

From the beginning of the debt crisis some have insisted that the approach being followed to deal with the problem would not restore creditworthiness to the highly indebted countries and would, moreover, retard the expansion of world trade: the larger the interest payments the debtors have to make to the banks in creditor countries, the less money they would have left to buy exports from the factories and farms in the same countries.

Thus there originated a long series of proposals—from Kenen and Rohatyn in 1983 to Senator Bradley in 1986 and Robinson of Amexco in 1988. Most of these envisaged that some international agency, endowed with enough capital or guarantees by the industrial countries,

would buy, at a discount, the claims on the middle-income highly indebted countries held by commercial banks and then lower the debt service that the debtor countries would have to pay on their liabilities—for example, by bringing the interest rate to a level substantially below prevailing market rates and extending maturities. It has always seemed highly unlikely that governments would find it politically or financially feasible to “bail out the banks” or even, if the banks absorbed the losses that had already taken place, to take over from them the risk of future losses. The fundamental flaws in these proposals have become more obvious as the discount on the banks’ claims on these countries has tended to increase even where policies appeared to improve.

The first flaw is that any generalized arrangement to relieve the banks of their claims on these countries would remove whatever incentive the banks, acting collectively, still have to raise the debtors’ foreign exchange availability by “defensive lending.” It is true that, particularly in the past few years, banks have been extremely hesitant to engage in defensive lending; yet such lending may well be the only means available to the banks to improve the quality of their loans to the problem countries and to minimize the likely size of their losses.

Second, transferring the problem of negotiation with the debtor countries from the banks to an international governmental body would make it inevitable that the important distinctions among debtor countries would be subordinated to the principal task for which the new agency was created, or with which an existing institution had been specifically charged, namely, “solving the debt problem.” The possibilities for many of the major debtors to ease their debt problems through a combination of growth, adjustment, and financing would be jeopardized by the application of what would in essence amount to a bankruptcy procedure.

Much has been made of the proposition that any form of *ex post* debt relief, especially if it is “market-based,” involves a degree of moral hazard. If a country is more likely to receive debt relief the less able it appears to service its debt, there can be an incentive to follow weak policies that will strengthen the statistical case for relief. The introduction of such moral hazard in international creditor–debtor relationships implies a weakening of the system, which could long outlast

the current debt crisis. But it is doubtful whether moral hazard is the central issue. No government that approached its economic policy choices in a rational manner—whether its rationality was of the economic or the political variety—would opt for disorganized government finance, lax monetary policy, or an overvalued exchange rate for the purpose of building up its qualifications for debt relief. The domestic cost of such self-inflicted wounds would far outweigh what the country could extract from its creditors in debt relief.

While a deep discount on a country's foreign obligations may appear as a convenient argument in favor of debt relief, it is not without domestic costs to the debtor country. The discount translates, of course, to an effective interest rate far in excess of the nominal interest rate. Such an interest rate on one category of the country's liabilities will tend to spill over to all negotiable claims on that country, both those held abroad and those held within the country, and to claims expressed in domestic currency as well as those expressed in dollars. At the same time, the low supply of capital from abroad, as well as the low savings ratio that has characterized the most heavily indebted countries, will tend to raise interest rates from the inside.

Through various connections—including the possibility of residents' moving money in or out of the country, and the scope for arbitrage exercised by multinational corporations operating in the country—the internal and external markets will (subject, of course, to important market imperfections) gravitate toward a single interest rate that reflects all the forces bearing on the supply and demand of capital for this country. In foreign capital markets, questions about the country's creditworthiness will manifest themselves in a large discount in secondary markets. Within the country, real interest rates will be extremely high; figures on the order of 2 or 2½ percent a month can be found in many of the countries discussed here.

As noted earlier, the scarcity of capital and the high interest rates will act to retard growth and may in effect constitute the most telling costs of a country's lack of creditworthiness.

In the early phase of the debt crisis, there was a good case for minimizing the significance of any secondary market in banks' claims. This approach, which held up the value of developing countries' debt through collective action by the banks, debtor countries, creditor coun-

tries, and international organizations, was only viable if it could lead to an equilibrium situation over a moderately short time span. It required not only light at the end of the tunnel, but a short tunnel as well. When it became apparent that the tunnel was a long one in the best of circumstances, the approach could no longer be maintained; banks began to give recognition to the reduced value of their claims on the highly indebted countries, and some were willing to sell their claims at market prices.

This constellation of circumstances made the emergence of a recognized secondary market inevitable—a market, however imperfect, in which participating banks could sell to stop the losses incurred on existing sovereign claims and, at the same time, to protect themselves against pressure to share in future concerted lending to the same debtors.

The disposal by banks of claims at discount prices for use in a variegated “menu” of options does not automatically involve debt relief for the debtor country. Typically, claims that have been acquired by buyers at a discount are converted by the central bank of the debtor country into local currency at the prevailing exchange rate against the dollar. Although in some instances the debtor country may apply a “conversion fee” or use an auction technique to capture part of the discount, much of the benefit arising from the original discount accrues to the user of the claim and to intermediaries.

Although the menu approach serves the interests of certain banks in improving their asset structures, its benefits to the debtor country are far less obvious. It will bring about some reduction in outstanding debt as the country gives up tradables, or assets in its economy, to redeem a portion of the debt. The character of the debt service is changed, as the country owes a smaller amount of interest-bearing debt and a larger amount of investment claims, on which dividends will have to be remitted as the investment yields profits (subject to such time constraints on remittances as may have been imposed as conditions for the conversion). On the balance sheet of the government of the debtor country, the change is merely a substitution of internal for external indebtedness, either directly, if the foreign investor is paid in government bonds (as is the practice of the Central Bank of Chile), or indirectly, if the government sells debt at home to obtain the domestic

currency needed for this purpose. If it issued the domestic currency without withdrawing the same amount by domestic borrowing, the effect of the swap would be inflationary—a consequence that debtor countries have, with good reason, been anxious to avoid.

While the menu approach has been referred to as “market-based,” it still contains many nonmarket elements. The buyer of a claim from a bank cannot trade this claim in a market for the currency of the debtor country; the currency can only be obtained from the central bank, provided that it is to be used for approved asset purchases. Moreover, the currency can only be obtained at a price in units of local currency per dollar set by the central bank (or sometimes determined in an auction process) by categories of investment and subject to regulations on the remittance of profits and the invested capital. The difficulty of bringing together sellers and potential users of claims explains both the thinness of the market and the very substantial commissions made by middlemen. These market imperfections suggest that there should be room for other techniques. Such techniques should recognize the interests of debtor countries in reducing the discount on their indebtedness while, at the same time, channeling to debtors, rather than to the buyers of claims or to middlemen, the benefits from such discounts as sellers of claims are willing to accept to reduce their exposure.

Countries could achieve this market (no longer “market-based”) solution by adopting a double policy of (1) strengthening as much as possible their balance of payments and (2) using any balance-of-payment surpluses to buy back their international debt as long as it trades at a discount from what the debtor country considers its fair value. The debtor country can get the maximum benefit from a buy-back program by determining from time to time the amount of money that it can use for this purpose and inviting competitive offers of its outstanding debt.

The question may be asked as to how much of a dent any highly indebted country can make in its outstanding debt by applying from time to time some excess reserves to buy-back auctions. That question is, however, essentially misconceived. The underlying assumption of a program by any debtor country to repurchase debt whenever it can do so advantageously is that the country envisages itself as on the road to creditworthiness. That attitude, rather than the amounts applied, is the

most important contribution that the country can make toward becoming creditworthy. Given that attitude as a determinant of policy—and given reasonably favorable external conditions, a point never to be overlooked—the country's road to viable debt ratios lies predominantly in raising its GNP and export levels, not in reducing the absolute amount of its debt.

Whether this favorable result will materialize depends on three things: (1) the perseverance of the debtor country in the necessary adjustment policies, (2) satisfactory world economic conditions, and (3) supporting action by the banks themselves. Only at their peril can the banks ignore the last of these three conditions and base their policies on a combination of hope that the first two conditions will be met and the building of reserves against the eventuality that this hope will prove false. A rational approach by the banks includes measures they can take that will both raise the probability of a satisfactory debt work-out (even though they cannot guarantee that outcome) and encourage the debtors in their pursuit of adjustment policies.

There remains, then, one approach that is well within the range of normal bank practice and does not involve disproportionate risks. That approach would be an expressed willingness by the banks to make annual "new money" loans (or to capitalize interest, at the bank's choice) up to, say, half the interest due, on condition that the debtor country continued to pursue a satisfactory adjustment program. The banks might find it legally difficult to come to a binding judgment whether this condition is being fulfilled; instead, they might prefer to derive this judgment from the country's relation with the Fund or the Bank. If preannounced for a considerable span of time, say five to seven years, this approach should dramatically raise the probability that the debt crisis would be nearing an end for the countries that qualified for this assistance and showed every intention of continuing to do so.

The thrust of the preceding was that the debt problem of many of the highly indebted middle-income countries may be open to resolution through a process of work-out based on sufficient policy readjustment by these countries, a collaborative attitude on the part of the commercial banks, and the maintenance of lending by national and international official creditors. There is no certainty about

this outcome, and much will depend on the strength of external circumstances. But the scenario described carries sufficient probability to make it reasonable for all the major players to accept it as the basis for their policy planning.

By no stretch of the imagination could a comparable scenario be accepted for the poorest countries, most of which are found in sub-Saharan Africa. This least developed part of the world has been in a state of stagnation and retrogression since about 1974. Per capita incomes, which were among the lowest in the world, have been on a downward trend and earlier progress on health and education has been reversed. The role played in these tragic developments by inadequate economic and financial policies has been extensively documented in recent years, most particularly by the World Bank, and the need for policy adjustment is now widely accepted by the governments in Africa. At the same time, external conditions have been harshly unfavorable. Four factors stand out as direct external causes of the deteriorating situation: drought and resulting food shortages over a large part of the continent in 1984 and 1985; a sharp deterioration in the terms of trade in the 1980s; a more than two-fold increase in interest payments on foreign debt as a percentage of exports over the same period; and a drying up of private capital flows since 1982. Partially offsetting these negative factors, net aid disbursements increased by about 7 percent per year in real terms.

In recognition of the fact that the debtors' difficulties are not temporary, a long term approach to the African debt problem is necessary. Such an approach is also possible without the risks of encouraging policy laxity on the part of the debtors. In the case of the African countries the presence of creditor-imposed conditionality is unlikely to be a passing condition. Not only are these countries likely to need Fund and Bank programs for many years to come; they will be dependent for decades to come on foreign aid from donor countries. Donors—essentially the same countries as the Paris Club creditors—could far more sensibly insist on policy conditions as a quid pro quo for continued bilateral aid, where the donors make a substantive contribution to the country, rather than for debt relief, where their only choice is between accepting rescheduling or accepting arrears. For the highly indebted African countries, therefore, a bold generalized ap-

proach to debt relief will be required, such as that proposed by the African Development Bank, under which a sharply curtailed debt service replaces the current annual Paris Club rescheduling rounds.

Concluding observations. In the past, too, many countries have suffered the costly aftereffects of excessive foreign indebtedness. In one way or another these debt problems of the past were resolved. Some highly indebted countries maintained debt service in full, or resumed it after interruption and regained creditworthiness in that way. Some negotiated concessions from their creditors. Some defaulted, in whole or in part, in name or *de facto*; they too, ultimately, came to be considered as attractive clients for capital exports.

There can be little doubt but that the debt crisis of the 1980s will pass into history in much the same way. What seems certain is that nowadays no country will, for long, perform debt service beyond the limits of what it considers compatible with its best chances for growth in the long run.

But the choices countries face are often far from clear, and the same applies to the choices creditors have to make. Many complex considerations enter into the calculations that debtor countries, creditor banks, and creditor governments have to make. The evidence of recent years strongly suggests that actors in each of these three groups need time and experience to arrive at correct appraisals of where their best interests lie. That is why the process of decision making and negotiation has already taken an inordinate number of years. The glaring inefficiency of this process has entailed large costs to the indebted countries—unnecessary costs that are superimposed on the unavoidable costs of adjustment. Public policy requires that every effort be made to speed up the process and bring it to an early and satisfactory solution.

In the preceding pages, a number of suggestions have been presented toward resolving the debt crisis for the two main groupings of debtor countries. These suggestions are not blueprints of preferred solutions; instead, they aim at laying out the analytical guidelines within which any solutions will have to be found. The sooner they are found, the better.

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