DISCUSSION PAPER

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DEVELOPING COUNTRY DEBT:
POLICIES AND PROSPECTS

Bela Balassa

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Development Research Department
Economics and Research Staff
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Developing Country Debt: Policies and Prospects

Bela Balassa

This paper examines recent changes in the external debt of the developing countries and the adjustment policies followed by these countries following the first oil shock, the second oil shock, and the debt crisis. The paper shows the advantages of output-increasing (expenditure-switching) policies over deflationary (expenditure-reducing) policies in coping with the debt problem. It is further suggested that these policies would need to be accompanied by measures aimed at reducing budget deficits and increasing private savings. The paper further considers various measures the industrial countries may take to ease the problems of adjustment in debtor countries.
DEVELOPING COUNTRY DEBT:
Policies and Prospects

Bela Balassa

* The author is a Professor of Political Economy at the Johns Hopkins University and Consultant to the World Bank. He presented this paper at the Conference "The International Debt Problems -- Lessons for the Future," held in Kiel on June 26-28, 1985 and at the Colloque "Endettement," held in Paris on July 3-4, 1985. Comments and suggestions received from Conference participants are gratefully acknowledged. The author is further indebted to Shigeru Akiyama for research assistance.

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DEVELOPING COUNTRY DEBT: POLICIES AND PROSPECTS

Bela Balassa

Introduction

This paper follows an earlier paper by the author on "The Problem of the Debt in Developing Countries" (1984). The present paper will consider recent developments in the debt situation of the developing countries, the policy implications of these developments, and prospects for the future.

Section I of the paper will examine recent changes in the external debt of the developing countries, with attention given to the changing relationship between the external debt and the exports of goods and services in these countries. Section II will analyse the adjustment policies followed by developing countries during the first period of external shocks, characterized by the quadrupling of oil prices of 1973-74 and the world recession of 1974-75, during the second period of external shocks, including the two-and-a-half fold increase in oil prices and the ensuing world recession, and during the period following the Mexican financial crisis. Section III of the paper will draw policy conclusions of the preceding analysis and consider future prospects for the debt of the developing countries.

I. Recent Changes in the External Debt of the Developing Countries

The optimism prevalent in the international community as regards external borrowing by the developing countries came to a sudden end, giving place to gloom, following the Mexican financial crisis of August 1982. Large commercial banks on the two sides of the Atlantic and well-regarded rating services suddenly revised their evaluation of the creditworthiness of major developing countries. Also, in an atmosphere reminiscent of the period
following the quadrupling of oil prices in 1973-74, dire predictions were made as to the prospective breakdown of the international financial system. Economic forecasters responded to the situation by putting forward estimates of their own as regards the prospects for developing country debt. The projections ranged widely. On the optimistic side, in the May 1983 World Economic Outlook of the International Monetary Fund, the view was expressed that the "non-oil developing countries as a group could improve their external positions substantially by 1986, provided that countries with serious imbalances implement comprehensive programs of adjustment" (1983, p.19). Also, Cline reached the conclusion that, under base case assumptions, "the severity of debt problem recedes substantially" (1983, p. 52). An intermediate position was adopted by the Morgan Guaranty Trust (1983) while the study by Adams, Sanchez, and Adams (1983) was representative of pessimistic predictions.

In fact, improvements in the debt situation of the developing countries in 1983 exceeded even the optimistic forecasts. This occurred largely because economic growth in the industrial countries and, in particular, in the United States much surpassed the projections. Thus, the gross domestic product of the industrial countries rose by 2.6 percent in 1983, compared with projections of 1.6 percent by the IMF, 1.5 percent by Cline and, under their crisis scenario, a decline of 1.7 percent by Adams, Sanchez, and Adams.

The projections made in early 1984 again showed considerable differences. On the optimistic side, the IMF (1984) predicted that the gross domestic product of the industrial countries would rise by 3.0 percent in 1984, accompanied by a 7 percent increase in the volume of the exports of
goods and services by the non-oil developing countries, resulting in a decline of their debt-export ratio. Less optimistic forecasts were made by Enders and Mattione (1984), pessimistic forecasts by Fishlow (1984) and, in particular, the Inter-American Development Bank (1984); these projections relate to Latin America alone.

In the event, the gross domestic product of the industrial countries increased by 4.9 percent in 1983, with the volume of the exports of goods and services by the non-oil developing countries rising by 10 percent. Correspondingly, although export prices in dollars did not change, the improvement in the debt-export ratio of the non-oil developing countries exceeded the IMF forecasts. Further gains were obtained as the countries in question experienced improvements in their terms of trade.

The cited results relate to the external debt of the non-oil developing countries, for which estimates were reported in the earlier paper by the author (Balassa, 1985a). The most recent IMF (1985) and World Bank (1985a) estimates pertain to the developing countries other than the Middle Eastern oil exporters.¹ This extension of the coverage is appropriate, given that several oil-exporting countries outside the Middle East have large foreign debts, and it will be used in the present paper. Table 1 provides

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¹ Under the IMF classification, the latter group includes Iraq, Iran, Kuwait, Libya, Oman, Quatar, Saudi Arabia, and the United Arab Emirates. The World Bank adds Bahrain and Brunei to the group while excluding Iraq and Iran.
data for the countries under consideration, to be denoted as developing countries

The table presents data on the medium- and long-term debt of the developing countries, their short-term debt, and IMF credits, the sum of which represents the total indebtedness of the countries in question. In adjusting for international reserves, the net indebtedness of these countries is obtained. All data are reported in current dollars.

It is apparent that the medium- and long-term debt of the developing countries continued to rise during the entire 1977-84 period. And while some slowdown occurred in recent years, the extent of the slowdown is much smaller if adjustment is made for changes in prices, irrespective of whether export or import price indices are used as deflators.

The short-term debt of the developing countries increased more rapidly than their medium- and long-term obligations until 1982; however, it fell in absolute terms in 1983 and, to a lesser extent, in 1984. The recent declines are explained in part by the reluctance of the commercial banks to renew short-term loans and in part by the transformation of some short-term loans into medium-term and long-term obligations.

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2 This is the expression used by the World Bank, whose data cover 104 debt reporting developing countries while the IMF employs the expression of "indebted developing countries." Unless otherwise noted, the data originates in IMF, 1985; this has been done in order to include the short-term debt of the developing countries that is not reported by the World Bank. At the same time, it should be understood, that data on the medium-term and long-term debt of the developing countries used by the IMF largely originate in World Bank statistics.

3 Deflating by the export price index will be appropriate if we are concerned with debt repayments while deflating by the import prices index will permit indicating changes in the purchasing power of the debt.
Credits granted by the IMF increased at a rapid rate after 1980, with a slowdown in 1984. Finally, after rapid increases, the international reserves of the developing countries reached a peak in 1980, followed by a precipitous decline in 1981, some further decreases in 1982 and 1983, and small rise in 1984.

In interpreting the figures, it should be noted that, in Table 1, international reserves are estimated by valuing gold at its London price. Correspondingly, the earlier increase, and the subsequent decline, in gold prices have affected the results to a considerable extent. This is not the case with figures reported in the IMF World Economic Outlook, where gold is valued at SDR 35 per ounce.

Table 1 further shows changes in the various ratios customarily used in studies of the debt problem of the developing countries; they are discussed in some detail in Balassa, 1985a. In the following, reliance will be based on the debt-export ratio in preference to the debt-GNP and the debt service ratios.

The debt-GNP ratio does not appear to be an appropriate indicator for gauging recent changes in the debt situation of the developing countries. This is because, in recent years, the rise in the value of the U.S. dollar has reduced the dollar equivalent of non-traded goods produced in the developing countries. At the same time, non-traded goods cannot be utilized directly to service the debt.

In turn, debt-service ratios, calculated by relating interest payments and amortization to the exports of goods and services, is affected by the rescheduling of the debt. This explains that, after rising uninterruptedly between 1977 and 1982, amortization (principal repayments)
Table 1

Outstanding External Debt, Capital Flows and Debt Service of Developing Countries

<table>
<thead>
<tr>
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<td>Outst. Debt</td>
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<tr>
<td>End of year ($ billion)</td>
<td>269.2</td>
<td>326.5</td>
<td>389.1</td>
<td>451.7</td>
<td>524.3</td>
<td>592.4</td>
<td>653.4</td>
<td>701.3</td>
<td>760.3</td>
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<td>(1) Medium-Term and Long-Term Debt</td>
<td>63.2</td>
<td>71.9</td>
<td>81.8</td>
<td>113.3</td>
<td>136.2</td>
<td>154.6</td>
<td>173.7</td>
<td>125.3</td>
<td>104.9</td>
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<td>(2) Short-Term Debt</td>
<td>8.0</td>
<td>8.0</td>
<td>8.3</td>
<td>9.5</td>
<td>14.9</td>
<td>21.2</td>
<td>31.3</td>
<td>34.2</td>
<td>36.0</td>
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<td>(3) IMF Credit</td>
<td>340.4</td>
<td>406.4</td>
<td>479.2</td>
<td>574.5</td>
<td>675.4</td>
<td>768.2</td>
<td>822.0</td>
<td>861.8</td>
<td>901.2</td>
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<td>(4) Total Indebtedness (1)+(2)+(3)</td>
<td>97.1</td>
<td>117.8</td>
<td>173.7</td>
<td>195.6</td>
<td>169.1</td>
<td>153.3</td>
<td>147.8</td>
<td>150.4</td>
<td>136.4</td>
</tr>
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<td>(5) International Reserves</td>
<td>243.3</td>
<td>288.6</td>
<td>305.5</td>
<td>378.9</td>
<td>516.2</td>
<td>615.9</td>
<td>674.1</td>
<td>711.3</td>
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<td>(6) Net Indebtedness (4)-(5)</td>
<td>20.2</td>
<td>21.0</td>
<td>21.0</td>
<td>20.6</td>
<td>22.9</td>
<td>25.1</td>
<td>29.8</td>
<td>32.2</td>
<td>28.6</td>
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<tr>
<td>Ratio to GNP (percent)</td>
<td>25.5</td>
<td>26.1</td>
<td>25.8</td>
<td>26.1</td>
<td>29.4</td>
<td>33.8</td>
<td>37.0</td>
<td>37.8</td>
<td>38.2</td>
</tr>
<tr>
<td>(7) Medium-Term and Long-Term Debt</td>
<td>18.2</td>
<td>18.5</td>
<td>18.3</td>
<td>17.2</td>
<td>22.5</td>
<td>27.1</td>
<td>30.3</td>
<td>31.2</td>
<td>n.a.</td>
</tr>
<tr>
<td>(8) Total Indebtedness</td>
<td>102.6</td>
<td>108.5</td>
<td>98.6</td>
<td>88.2</td>
<td>97.9</td>
<td>117.4</td>
<td>130.5</td>
<td>128.2</td>
<td>130.5</td>
</tr>
<tr>
<td>(9) Net Indebtedness</td>
<td>129.7</td>
<td>135.1</td>
<td>121.5</td>
<td>112.2</td>
<td>126.1</td>
<td>152.2</td>
<td>164.2</td>
<td>157.6</td>
<td>154.6</td>
</tr>
<tr>
<td>Ratio to Exports of Goods and Services (percent)</td>
<td>92.7</td>
<td>95.9</td>
<td>77.4</td>
<td>76.0</td>
<td>96.4</td>
<td>122.1</td>
<td>134.6</td>
<td>130.1</td>
<td>n.a.</td>
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<tr>
<td>(10) Medium-Term and Long-Term Debt</td>
<td>27.3</td>
<td>51.1</td>
<td>60.9</td>
<td>63.4</td>
<td>88.0</td>
<td>65.1</td>
<td>65.7</td>
<td>35.0</td>
<td>59.8</td>
</tr>
<tr>
<td>(11) Short-Term Debt</td>
<td>14.7</td>
<td>9.8</td>
<td>9.6</td>
<td>30.4</td>
<td>32.8</td>
<td>13.4</td>
<td>-17.3</td>
<td>-10.9</td>
<td>-21.4</td>
</tr>
<tr>
<td>(12) IMF Credit</td>
<td>-0.2</td>
<td>-0.4</td>
<td>0.2</td>
<td>1.5</td>
<td>6.0</td>
<td>7.0</td>
<td>11.0</td>
<td>3.3</td>
<td>-1.8</td>
</tr>
<tr>
<td>(13) Total (11)+(12)+(13)</td>
<td>41.8</td>
<td>60.5</td>
<td>70.7</td>
<td>95.3</td>
<td>126.8</td>
<td>85.3</td>
<td>59.6</td>
<td>48.4</td>
<td>40.2</td>
</tr>
<tr>
<td>Ratio to Exports of Goods and Services (percent)</td>
<td>102.6</td>
<td>108.5</td>
<td>98.6</td>
<td>88.2</td>
<td>97.9</td>
<td>117.4</td>
<td>130.5</td>
<td>128.2</td>
<td>130.5</td>
</tr>
<tr>
<td>(14) Medium-Term and Long-Term Debt</td>
<td>25.5</td>
<td>26.1</td>
<td>25.8</td>
<td>26.1</td>
<td>29.4</td>
<td>33.8</td>
<td>37.0</td>
<td>37.8</td>
<td>38.2</td>
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<tr>
<td>(15) Total Indebtedness</td>
<td>129.7</td>
<td>135.1</td>
<td>121.5</td>
<td>112.2</td>
<td>126.1</td>
<td>152.2</td>
<td>164.2</td>
<td>157.6</td>
<td>154.6</td>
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<tr>
<td>(16) Net Indebtedness</td>
<td>92.7</td>
<td>95.9</td>
<td>77.4</td>
<td>76.0</td>
<td>96.4</td>
<td>122.1</td>
<td>134.6</td>
<td>130.1</td>
<td>n.a.</td>
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<tr>
<td>Net Borrowings annual ($ billion)</td>
<td>27.3</td>
<td>51.1</td>
<td>60.9</td>
<td>63.4</td>
<td>88.0</td>
<td>65.1</td>
<td>65.7</td>
<td>35.0</td>
<td>59.8</td>
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<tr>
<td>(17) Disbursements (13)+(18)</td>
<td>51.5</td>
<td>85.9</td>
<td>103.4</td>
<td>106.2</td>
<td>136.1</td>
<td>116.8</td>
<td>109.4</td>
<td>106.1</td>
<td>120.3</td>
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<tr>
<td>(18) Principal Repayments (Amortization)</td>
<td>24.2</td>
<td>34.8</td>
<td>42.5</td>
<td>42.8</td>
<td>48.1</td>
<td>51.7</td>
<td>43.7</td>
<td>52.1</td>
<td>60.5</td>
</tr>
<tr>
<td>(19) Interest Payments</td>
<td>15.3</td>
<td>21.6</td>
<td>32.2</td>
<td>45.7</td>
<td>63.8</td>
<td>72.3</td>
<td>67.4</td>
<td>71.0</td>
<td>74.0</td>
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<tr>
<td>(20) Debt Service (19)+(19)</td>
<td>39.5</td>
<td>56.4</td>
<td>74.7</td>
<td>88.5</td>
<td>111.9</td>
<td>123.9</td>
<td>121.1</td>
<td>123.1</td>
<td>134.5</td>
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<td>(21) Net Transfers (16)-(20)</td>
<td>26.8</td>
<td>38.9</td>
<td>38.5</td>
<td>49.6</td>
<td>63.0</td>
<td>13.2</td>
<td>-8.0</td>
<td>-22.6</td>
<td>-33.8</td>
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<td>(22) Official Transfers</td>
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<td>8.3</td>
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<td>12.5</td>
<td>13.5</td>
<td>13.0</td>
<td>12.9</td>
<td>13.1</td>
<td>14.8</td>
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<tr>
<td>(23) Net Transfers (22)+(22)</td>
<td>34.8</td>
<td>47.2</td>
<td>50.2</td>
<td>62.1</td>
<td>76.5</td>
<td>26.2</td>
<td>4.9</td>
<td>-9.5</td>
<td>-19.0</td>
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<tr>
<td>Ratio to Exports of Goods and Services (percent)</td>
<td>15.1</td>
<td>18.7</td>
<td>18.9</td>
<td>17.3</td>
<td>20.9</td>
<td>24.6</td>
<td>22.2</td>
<td>22.5</td>
<td>23.1</td>
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<tr>
<td>(24) Debt Service</td>
<td>13.7</td>
<td>4.2</td>
<td>22.2</td>
<td>23.2</td>
<td>-0.8</td>
<td>-5.9</td>
<td>-4.4</td>
<td>0.0</td>
<td>0.4</td>
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<tr>
<td>Changes in Outstanding External Debt ($ billion)</td>
<td>15.1</td>
<td>18.7</td>
<td>18.9</td>
<td>17.3</td>
<td>20.9</td>
<td>24.6</td>
<td>22.2</td>
<td>22.5</td>
<td>23.1</td>
</tr>
<tr>
<td>(25) Medium-Term and Long-Term Debt</td>
<td>n.a.</td>
<td>57.3</td>
<td>62.6</td>
<td>62.6</td>
<td>72.6</td>
<td>68.1</td>
<td>61.0</td>
<td>47.9</td>
<td>59.0</td>
</tr>
<tr>
<td>(26) Short-Term Debt</td>
<td>n.a.</td>
<td>8.7</td>
<td>9.9</td>
<td>31.5</td>
<td>22.9</td>
<td>18.4</td>
<td>-17.3</td>
<td>-11.0</td>
<td>-21.4</td>
</tr>
<tr>
<td>(27) IMF Credit</td>
<td>0.0</td>
<td>0.0</td>
<td>0.3</td>
<td>1.2</td>
<td>5.4</td>
<td>6.3</td>
<td>10.1</td>
<td>2.9</td>
<td>1.8</td>
</tr>
<tr>
<td>(28) Total (25)+(26)+(27)</td>
<td>66.0</td>
<td>72.8</td>
<td>95.3</td>
<td>95.3</td>
<td>52.8</td>
<td>32.8</td>
<td>39.8</td>
<td>39.8</td>
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<td>Memorandum Items</td>
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<td>18.9</td>
<td>17.3</td>
<td>20.9</td>
<td>24.6</td>
<td>22.2</td>
<td>22.5</td>
<td>23.1</td>
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<tr>
<td>(29) Annual Percent Change in Export Unit Values</td>
<td>13.7</td>
<td>4.2</td>
<td>22.2</td>
<td>23.2</td>
<td>-0.8</td>
<td>-5.9</td>
<td>-4.4</td>
<td>0.0</td>
<td>0.4</td>
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<tr>
<td>(30) Annual Percent Change in Import Unit Values</td>
<td>7.6</td>
<td>10.1</td>
<td>17.6</td>
<td>19.3</td>
<td>2.3</td>
<td>-3.3</td>
<td>-4.5</td>
<td>-0.7</td>
<td>1.0</td>
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<td>(31) Imports of Goods and Services ($ billion)</td>
<td>262.4</td>
<td>300.8</td>
<td>394.5</td>
<td>511.9</td>
<td>535.6</td>
<td>504.6</td>
<td>500.7</td>
<td>546.9</td>
<td>582.4</td>
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<td>(32) Gross Domestic Product ($ billion)</td>
<td>1334.9</td>
<td>1555.9</td>
<td>1853.9</td>
<td>2198.4</td>
<td>2293.4</td>
<td>2270.3</td>
<td>2221.1</td>
<td>2280.2</td>
<td>2357.8</td>
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</table>

Sources: IMF, World Economic Outlook, 1985, except for IMF credit and international reserves that originate in IMF, International Financial Statistics.

Notes:

1/ Derived as the sum of medium term and long term net borrowings and principal repayment.

2/ Changes in year end position of external debt between two consecutive years.
declined by 28 percent between 1982 and 1983. And while the decline was more than undone in 1984, when some of the rescheduled debt was repaid, these fluctuations limit the usefulness of the ratio for indicating short-term changes in the debt situation of the developing countries unless adjustment is made for the rescheduling of the debt; this has not been attempted in the present paper.

At the same time, as is apparent from the preceding discussion, the debt-export ratio is affected by changes in export prices. An alternative would be to relate the debt to changes in debt-servicing capacity, defined as the value of exports adjusted for changes in import prices. In 1983 and in 1984, the use of this indicator would not affect the results, although it would modify the estimates for earlier years.⁴

The data show that, after earlier increases, the ratio of the medium- and long-term debt of the developing countries to their exports of goods and services declined in 1979 and in 1980, when export prices rose rapidly. The ratio increased in subsequent years as export prices fell, but it declined again in 1984 when the stability of export prices was accompanied by substantial increases in export volume.

The ratio of total indebtedness to exports exhibits a similar pattern up to 1982. However, the ratio shows a smaller increase in 1983 and a much larger decline in 1984 as the fall in the short-term debt of the developing countries was not offset by the rise in IMF lending to them. At the same time, in view of the transformation of some of the short-term debt into longer

⁴ The information necessary for making this calculation is contained in Table 1.
term obligations, this ratio provides a more appropriate gauge of changes in the debt situation of the developing countries than the previous one.

Increases in the international reserves of the developing countries in 1979 and in 1980 limited the decline in the ratio of their net indebtedness to the exports of goods and services in those years. In fact, subsequent decreases in reserves reduced the rise of the ratio between 1980 and 1983, with a slight reversal occurring in 1984.

Valuing gold at SDR 35 per ounce shows a different picture, with the international reserves of the developing countries increasing from $107.4 billion in 1982 to $115.9 billion in 1983 and to $131.6 billion in 1984. The changes largely reflect increases in the foreign exchange holdings of the developing countries, from $85.8 billion in 1982 to $91.6 billion in 1983 and to $105.2 billion in 1984. These figures are relevant from the short-term point of view as developing countries vary their foreign exchange holdings but rarely their gold reserves. Nonetheless, from the long-term point of view, changes in the value of total international reserves are of importance.

The recent improvement in the net debt-export ratio of the developing countries will thus be greater if gold is valued at SDR 35 per ounce rather than at its London price. This result reflects the fact that the developing countries were able to increase their exports to an extent greater than their external debt while adding to foreign exchange reserves.

The observed favorable changes reflect a configuration of circumstances. For one thing, rapid economic expansion in the industrial countries provided growing markets for the exports of the developing countries. For another thing, as discussed in Section II, changes in the policies of highly indebted developing countries encouraged exports.
The engine of world expansion was the American economy, with its gross domestic product rising by 6.8 percent in 1984, compared to average increases of 3.5 percent in the other industrial countries. U.S. economic growth, in turn, was beneficial to the developing countries directly, by creating demand for their export products, and indirectly, by contributing to economic expansion in the other industrial countries that, in turn, increased their purchases from the developing countries. In fact, the dollar value of total U.S. imports rose by 26 percent between 1983 and 1984 while imports from the non-oil developing countries increased by 21 percent in the United States and by 9 percent in the other industrial countries.

It has been argued, however, that U.S. policies have adversely affected the developing countries through higher interest rates. While it is difficult to determine the extent to which the government budget deficit in the United States has contributed to worldwide increases in interest rates, the U.S. economic expansion of 1983 and 1984 has not been accompanied by higher interest rates.

London Eurodollar rates for six-month deposits fell from 16.6 percent in 1981 to 13.5 percent in 1982 and to 9.8 percent in 1983. Adjusting for changes in the import prices of the developing countries, the corresponding real rates were 13.7 percent, 17.3 percent, and 14.6 percent. And although nominal interest rates rose to an average of 11.2 percent in 1984, real rates declined to 12.0 percent. Nominal rates fell again to 9.2 percent, in the first quarter of 1985, with real rates declining even more as inflation picked up slightly.

A further question concerns the relative effects of the acceleration of economic growth and increases in interest rates. Cline has estimated this
trade-off by reference to the impact of higher interest rates on the interest-sensitive external debt of the developing countries. He has found that each percentage point rise in the GDP growth of the industrial countries compensates for a 4.8 percentage points rise in interest rates after one year. However, the ratio is less favorable for highly-indebted countries; it is e.g. 2.0 for Brazil (1984, p. 182).

It would thus appear that, on balance, the policies applied in the United States since the Mexican financial crisis of August 1982 have been strongly favorable for the developing countries. The question remains if the cost to the developing countries of servicing their external debt has been excessive. This cost is said to be associated with the transfer of financial resources from the developing countries to the industrial countries. Thus, according to Feinberg

The most serious [problem] is that many third world nations have become net exporters of capital to the international credit markets. In 1983, non-oil exporting countries were obliged to pay an estimated $50 billion in interest to private creditors, while receiving only about $20 billion in loans. The resulting 'financial flow gap' of $30 billion exceeded by some $5 billion the net transfer by the World Bank and the IMF to the third world (1984, p. A27).

The figures cited by Feinberg exclude public capital flows other than those channeled through international institutions. Including these flows, a net transfer of $4 billion is shown from the developed to the non-oil developing countries in 1983. At the same time, a reverse transfer of $11 billion is observed in 1984; the comparable figure is $10 billion according to Table 1, the data of which include the oil-exporting developing countries outside the Middle East.
However, from the economic point of view, interest payments should be set against other items of the current account rather than against the inflow of capital. For one thing, if the proceeds of medium- and long-term borrowing are appropriately invested, they will generate output increments that permit increasing exports or replacing imports. For another thing, short-term credits are linked to foreign trade and would appropriately be financed through increases in exports.\(^5\)

Correspondingly, changes in the availability of external funds to the developing countries may be indicated by the sum of net borrowings\(^6\) and official transfer rather than by the net transfer figure. Net borrowings and official transfers to the developing countries reached a peak of $101.5 billion in 1981 and declined subsequently to $72.1 billion in 1984. Nonetheless, this amount nearly equaled one-fifth of the value of merchandise imports of the developing countries.

II. Adjustment Policies in Developing Countries

In analyzing the adjustment policies applied by the developing countries since 1973, three periods need to be distinguished. The first period was characterized by the quadrupling of oil prices of 1973-74 and the world recession of 1974-75; the second included the two-and-a-half fold

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\(^5\) It should be recognized, however, that in recent years unexpected increases in interest rates have added to the debt burden of the developing countries. Also, as Henri Bourguinat noted in commenting on my analysis, the use of the concept of net 'transfer' has a long history in the economic literature.

\(^6\) Net borrowings may differ from changes in total indebtedness because of changes in the inclusion of the debt due to exchange rate changes.
increase of oil prices of 1979-80 and the ensuing world recession; while the third has begun with the August 1982 Mexican financial crisis.

Table 2 provides data on the balance-of-payment effects of external shocks and of policy responses to these shocks in the first two periods for newly-industrializing and for less developed countries, classified according providing similar incentives to exports and to import substitution were classified as outward-oriented, and countries discriminating in favor of import substitution and against exports as inward-oriented, economies.

Among newly-industrializing economies, Kenya, Singapore, and Taiwan adopted an outward-oriented development strategy in the early 1960s and continued with this strategy after 1973. They were joined by Chile and Uruguay, which had previously applied an inward-oriented strategy, but turned outward following the external shocks of 1974-75. Conversely, after earlier efforts to reduce the bias of the system of incentives against exports, Brazil, Israel, Portugal, and Yugoslavia again increased the degree of inward orientation while Argentina, Mexico, and Turkey maintained their inward-oriented stance. In turn, among less developed countries, Kenya, Mauritius, Thailand, and Tunisia were classified as having followed outward-oriented and Jamaica, Peru, Morocco, Phillipines, Zambia, Egypt, Tanzania, and India as having pursued inward-oriented, policies.

For the sake of comparability, this classification scheme has been retained for all three periods, although in several countries policy changes occurred in later years. Thus, Turkey undertook a far-reaching policy reform in January 1980 whereas Chile and Uruguay introduced considerable distortions in the system of incentives by failing to adjust their exchange rates in accordance with domestic inflation between mid-79 and mid-82.
<table>
<thead>
<tr>
<th></th>
<th>Terms of Trade</th>
<th>Export Volume Effects</th>
<th>External Shock</th>
<th>Interest Rate</th>
<th>Together Total Effect</th>
<th>Additional Net External Financing</th>
<th>Export Promotion</th>
<th>Import Substitution</th>
<th>Effects of Lower GDP Growth</th>
<th>As a Percentage of GNP</th>
<th>As a Percentage of External Shock</th>
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<td></td>
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<td>3.8</td>
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External shocks have been defined to include terms-of-trade effects, associated in large part with increases in oil prices, export volume effects, resulting from the recession-induced slowdown in world trade and, during second period of external shocks, interest rate effects, due to the rise of interest rates in world financial markets. In turn, policy responses to external shocks have included additional net external financing, represented by increased borrowing compared to past trends, export promotion, reflected by increases in export market shares, import substitution, expressed by decreases in the income elasticity of import demand, and deflationary macroeconomic policy measures, resulting in declines in economic growth rates.

1974-76

Due to their greater exposure to foreign trade, outward-oriented developing economies suffered considerably larger external shocks than their inward-oriented counterparts during the first period. Nevertheless, after a temporary slowdown, these countries surpassed their earlier rates of economic growth and increased the growth rate differential vis-a-vis inward-oriented economies (Table 3). In fact, the differential came to exceed differences in the size of external shocks between the two groups of countries several times.

The results obtained reflect differences in the policies applied by the two groups of countries after the quadrupling of oil prices and the ensuing world recession. In order to limit increases in their external debt, outward-oriented economies did not step up their foreign borrowing in response to external shocks. Rather, after initially taking deflationary measures, they relied on output-increasing policies of export promotion and import substitution. These policies, in turn, led to the subsequent acceleration of their economic growth.
Inward-oriented developing economies attempted to avoid a slowdown of economic growth through foreign borrowing. They were not successful in attaining this goal, however. For one thing, the borrowed funds were not utilized efficiently, due in part to distortions in the system of incentives and in part to often misdirected public investments. For another thing, the countries in question failed to apply output-increasing policies of export promotion and import substitution.

In interpreting these results, emphasis should be given to the interdependence of the policies applied. In limiting reliance on foreign borrowing, outward-oriented economies had recourse to devaluations for ensuring balance-of-payment equilibrium. In turn, as the adoption of realistic exchange rates contributed to export expansion and import substitution, the need for foreign borrowing in these countries decreased.7

By contrast, the external financing of the balance-of-payment deficits resulting from external shocks made it possible for inward-oriented economies to forego exchange rate adjustments. In the absence of such adjustments, however, these countries lost export market shares and experienced little import substitution, so that their foreign borrowing requirements failed to decline.

The effects of the policies applied by outward- and inward-oriented economies are apparent in changes in their external debt. While the gross debt-export ratio increased only from 47 percent in 1983 to 55 percent in 1978

7 In fact, calculations made by the IMF show that the real effective exchange rate appreciated to a considerable extent in developing countries that subsequently rescheduled their debt while little change occurred in developing countries that did not require debt rescheduling.
in outward-oriented economies, this ratio rose from 95 to 197 percent in inward-oriented countries. Also, in the latter year, the net debt-export ratio, calculated by adjusting for international reserve holdings, was 31 percent in this first group and 161 percent in the second.

1979-81

Given their low level of indebtedness, outward-oriented economies were able to increase their foreign borrowing after 1978. Nevertheless, they continued to limit reliance on external financing and utilized largely domestic adjustment policies. As in the first period of external shocks, output-increasing policies of export promotion and import substitution were the dominant form of policy response. As a result, although deflationary economic policies were used in the years of the oil price increase, outward-oriented economies maintained higher GDP growth rates than their inward-oriented counterparts.

The second oil shock found inward-oriented economies with a large indebtedness. While, with the major exception of Turkey, these countries continued to enjoy a favorable credit rating, they did not consider it opportune to increase their foreign debt at earlier rates. Correspondingly, although the countries in question continued to rely on additional oil external financing, they did so to a lesser extent than beforehand. At the same time, in the absence of output-increasing policies,⁸ use was made of

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⁸ The positive export promotion effects shown in Table 2 are explained by the exportation of newly-discovered petroleum by Mexico and Peru and by efforts towards outward orientation in Turkey discussed below. Making adjustments for these exports, transforms the figure from positive to negative.
deflationary measures in response to the external shocks of the 1979-81 period.

Part of the external financing of the adverse balance-of-payment effects of external shocks took the form of drawing down foreign exchange reserves in inward-oriented economies. Thus, their net debt-export ratio continued to increase after 1978, although gross debt-export ratios underwent little change (Balassa, 1985a).

The described pattern of adjustment in outward-oriented and inward-oriented economies applied, on the whole, to the newly-industrializing countries (NICs) and the the less developed countries (LDCs) as well. The results need to be qualified, however, by reference to the fact that official transfers made it possible for the inward-oriented LDCs to place greater reliance on additional net external financing than the inward-oriented NICs and thus to attain higher rates of economic growth. Also, among inward-oriented LDCs, India limited reliance on foreign borrowing.

1982-84

The August 1982 Mexican financial crisis further accentuated differences in the situation of outward-oriented and inward-oriented economies. With the exception of Chile and Uruguay, their relatively low indebtedness permitted outward-oriented economies to accelerate their economic growth in response to the output-increasing policies applied. In contrast, with the major exception of India, inward-oriented countries had to adopt measures to reduce their large outward debt. They did so by deflating their economies in 1983, so as to lower imports.

The contrast is especially apparent among newly-industrializing economies. While outward-oriented NICs averaged GDP growth rates of 6.0
percent in 1983, the gross domestic product of the inward-oriented newly-industrializing countries declined by 1.4 percent, on the average. Within the latter group, GDP fell by 3.2 percent in Brazil and by 4.7 percent in Mexico, which had the highest debt-export ratios among inward-oriented NICs. In turn, Argentina and Israel postponed the adjustment whereas Turkey enjoyed the benefits of the shift towards outward orientation undertaken in 1980-81.

Within the outward-oriented group, Chile and Uruguay were exceptions as they both relied to a considerable extent on foreign borrowing to finance their trade deficits, which were largely the result of overvalued exchange rates. Correspondingly, the two countries had to apply deflationary measures in 1983, leading to declines of 2.0 percent and 4.8 percent in their gross domestic products, respectively, in 1983.

In 1984, outward-oriented newly-industrialized countries further accelerated their economic expansion, with average GDP growth rates of 7.8 percent. The three Far Eastern economies were now joined by Chile and Uruguay, which again resumed their economic growth.

At the same time, a change occurred in the policies applied by several major inward-oriented NICs. Helped by economic expansion in the industrial countries, these countries increasingly shifted from reliance on reducing imports to promoting exports. Thus, while the dollar value of their exports to the industrial countries rose by 7 percent in 1983, an increase of 16 percent was attained in 1984. In the latter year, Brazil led with an

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9 In interpreting these figures it should be noted, however, that in the non-oil developing countries export prices declined by 2.9 percent in 1983 and by only 0.1 percent in 1984.
export growth of 26 percent whereas poor markets for oil limited increases in Mexico to 9 percent.

Export expansion, in turn, contributed to economic growth in the inward-oriented NICs, with their GDP growth rates averaging 2.8 percent in 1984. But, the highest growth rate (5.7 percent) was again attained by Turkey, where further measures towards outward orientation were taken. In turn, the application of deflationary policies led to a fall in the gross domestic product in Israel and Portugal.

Nevertheless, inward-oriented NICs continued to fall behind outward-oriented NICs, whose exports to the industrial countries increased by 14 percent in 1983 and by 23 percent in 1984. In fact, taking 1981 as the benchmark, the actual exports of the outward-oriented NICs were 9 percent higher than their hypothetical exports, calculated on the assumption of unchanged export shares in industrial country markets, whereas inward-oriented NICs experienced a loss of 1 percent.\(^\text{10}\) Within the latter group, the major exception was Turkey that, following a turn towards outward orientation, achieved a gain of 24 percent.

Less developed countries rely to a greater extent on primary exports where market possibilities are less favorable. At the same time, outward-oriented LDCs again experienced better export performance than their inward-oriented LDCs. Thus, the shortfall of actual, compared with hypothetical, exports was 10 percent in the first case and 13 percent in the second.

\(^{10}\) The calculations have been made with respect to the combined exports of the twenty-four newly-industrializing and less developed economies under study to individual industrial countries.
Outward-oriented less developed countries also attained higher GDP growth rates, averaging 5.2 percent between 1982 and 1984, compared with an average rate of growth of 4.0 percent in inward-oriented LDCs. Within the latter group, India provides an exception as it reached relatively high economic growth rates by limiting its foreign borrowing in the previous period and liberalizing its economy after 1980.

III. Policy Conclusions and Perspectives for the Future

The preceding analysis leads to certain policy conclusions. To begin with, it is apparent that outward orientation has considerable advantages over inward orientation in responding to external shocks. This conclusion has been reconfirmed by an econometric study of 45 developing countries. The study has also shown that, among alternative policy responses to external shocks, export promotion is superior to both import substitution and additional external financing in its effects on economic growth (Balassa, 1985b).

At the same time, the external financing of the balance-of-payments effects of external shocks leads to the accumulation of the foreign debt that imposes costs on the national economy in subsequent periods. Furthermore, countries will encounter debt servicing difficulties unless the proceeds of foreign borrowing are used to generate increases in tradeable output that exceed interest charges on foreign loans. Such does not appear to have been the case in inward-oriented economies.

In turn, the policies that may be used to cope with debt servicing difficulties include deflationary macroeconomic policies and output-increasing policies of export promotion and import substitution. In view of the limitations of continued import substitution in the domestic markets of the
developing countries, and its rising cost over time, output-increasing policies would have to rely largely on export promotion.

The described alternatives, commonly denoted as expenditure-reducing and expenditure-switching policies, lead to diametrically opposed results as far as economic growth is concerned. While under the former alternative the reduction in domestic absorption will generally entail a decline in output, the latter will raise output levels.

Turkey provides an example of the success of output-increasing policies in easing the burden of the external debt. Having failed to make domestic adjustments in response to external shocks after 1973, Turkey was practically bankrupt at the end of 1979. In January 1980, a policy package was adopted, containing stabilization as well as adjustment measures, which entailed a shift towards outward orientation. In particular, a large devaluation was undertaken, export incentives were provided, import protection was reduced, and prices were liberalized.

These measures had favorable effects once political stability was established in September 1980. As noted above, Turkey substantially increased its share in industrial country markets. It achieved even larger gains in the Middle East and North Africa, bringing the total increase in the dollar value of its merchandise exports between 1980 and 1984 to 120 percent. During the same period, world exports other than oil rose by about 5 percent.

The rapid expansion of exports permitted Turkey to attain rapid rates of economic growth. Between 1980 and 1984, its gross domestic product rose at an average annual rate of 4.7 percent, with an acceleration shown towards the end of the period. Parallel with the expansion of output and exports, Turkey
reduced its current account deficit to a considerable extent, restoring its creditworthiness in international financial markets in the process.

The favorable experience of Turkey conflicts with the views of those who contend that domestic adjustments aimed at easing the burden of the debt impose a great, and even unacceptable, burden on developing country. This conclusion is reinforced if we consider that the shift from the expenditure-reducing policies of 1983 to the expenditure-switching policies of 1984 permitted a resumption of economic growth in the major borrowing countries.

Looking in the future, however, Makin put forward the view that the debt crisis of the developing countries could not find a solution if present conditions continue; rather, the situation "carries with it a significant risk of total collapse" (1984, p. 253). In particular, he suggested that, with real interest rates on their external debt exceeding the rate of economic growth in the developing countries by 5 to 6 percentage points, the minimum conditions for stabilizing the ratio of the debt burden to ability to pay -- that the real rate of interest does not exceed the sum of the rate of growth of output and that of the tax rate -- is not fulfilled (Ibid).

Makin's analysis puts emphasis on the ability of developing country governments to service the public external debt. He does so, however, by implicitly assuming that the ratio of government expenditures to the gross national product will remain unchanged. Yet, with large government budget deficits importantly contributing to the emergence of the debt problem in the
developing countries, the first priority in IMF-supported stabilization programs has been to reduce this deficit by lowering government expenditures. At the same time, with marginal tax rates exceeding average rates, economic growth will bring with it an increase in the average ratio of tax receipts to GNP.

Thus, while Makin correctly points to the need for appropriate fiscal measures to finance interest charges on the public external debt, the problem is far from being intractable. In fact, although these interest charges equalled 2 percent of the gross national product of the developing countries in 1984, major debtor countries have reduced the ratio of their budget deficit to GNP by more than two percentage points.

At the same time, the external debt of the developing countries may increase over time without endangering their creditworthiness, provided that the rate of growth of exports exceeds the rate of interest. If this condition is fulfilled, the debt-export ratio of the developing countries will decline over time.

Reference has been made above to the importance the rate of economic growth in the industrial countries has for the external debt situation of the developing countries. According to Cline, a 2.5 percent GNP growth rate in the industrial countries is needed to ensure that the debt problem of the developing countries will improve in the coming years (1984, p. 52). In turn, the IMF projects industrial country GNP to rise at an average annual rate of 3.1 percent between 1984 and 1990. Assuming further a decline in the real

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11This conclusion is supported by a cross-section analysis of 35 developing countries in the 1973-78 and 1978-82 periods (Balassa, 1985a, Table 4).
interest rate by 1.7 percentage points in 1985 and by another 1.1 percentage points in 1987, the ratio of the external debt of the developing countries to their exports of goods and services would decrease from 151 percent in 1984 to 149 percent in 1985, 142 percent in 1986, and 108 percent in 1990.12

These results are based on the "best estimates" of likely policies followed by the industrial and the developing countries, with alternative projections made under the assumption of "better" and "worse" policies by the two groups. Particular interest attaches to the worse policy scenario in the industrial countries that would entail a GNP growth rate of 2 percent and no further reduction in the real interest rate after 1986 as well as a deterioration in the terms of trade of non-oil primary commodities by 3 percent.

With lower GNP growth rates in the industrial countries, the rate of growth of the export volume of the developing countries would be 2.5 percentage points lower than under the baseline scenario, thus reducing their 1990 exports by approximately 10 percent. This export shortfall would, in turn, raise the debt-export ratio of the developing countries to 119 percent compared to its most likely value of 108 percent. Other influences, including higher interest rates, the deterioration of the terms of trade, and lower official development assistance, would raise this ratio further to 127 percent.

Thus, even under unfavorable assumptions as regards industrial country policies, the debt-export ratio of the developing countries would

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12 The figures for 1984 to 1986 are lower than those shown in Table 1 because the latter also includes credit by the IMF.
improve to a considerable extent. At the same time, the assumption made about
the key variable, the rate of economic growth in the industrial countries, is
unreasonably low.

This optimistic appraisal needs to be qualified, however, by
considering the possibility that the developing countries would limit debt
repayments if their export earnings were to rise at a lower rate. This
assumption is made by the World Bank (1985a) that posits considerably higher
GDP growth rates for the developing countries (4.1 percent), with consequent
needs for foreign borrowing, than the IMF, in the event of lower economic
growth rates in the industrial countries. Further consideration needs to be
given to differences in the debt situation among developing countries and
short-term fluctuations in interest rates that may ensue.

Among the major debtors, Brazil and Mexico successfully carried out
adjustment while Argentina continues to experience debt servicing
difficulties. These difficulties are explained by the lack of appropriate
policies; in particular, Argentina has failed to sufficiently reduce its
budget deficit and has continued to lose export market shares in the
industrial countries. Among middle-size countries, Peru and the Phillipines
have made insufficient adjustments while in Chile the deterioration of
external conditions has led to an increase in the debt-export ratio. Finally,
among oil-exporting countries, Nigeria has suffered the consequences of a
decline in the oil price and a reduction in the volume of oil exports.

In countries with continuing debt problems, measures would need to be
taken to reduce government budget deficits, to increase private savings and to
ensure increases in foreign exchange earnings. Such measures would include
lowering government expenditures, adopting realistic exchange rates and
interest rates, and reducing the bias in the system of incentives against
exports. Apart from contributing to domestic adjustment, the application of
these measures would increase confidence on the part of the international
financial community and permit the reversal of the capital flight that assumed
considerable importance in recent years in several developing countries.

In the industrial countries, the maintenance of adequate levels of
economic growth is the first priority. This, in turn, necessitates reducing
the budget deficit in the United States, lessening structural rigidities in
Western Europe, and increasing public and private expenditures in Japan.

There is also need for the industrial countries to liberalize their
trade, in particular to remove discriminatory barriers against developing
country exports. Furthermore, the adjustment efforts of the developing
countries should be supported by financial flows. Finally, in the case of the
poor countries of Sub-Saharan Africa, whose adjustment possibilities are more
limited, additional increases in aid levels would be desirable.

A number of proposals have been made for improving the processes of
commercial bank lending to developing countries (Bergsten, Cline, and
Williamson, 1985; Bourguinat, 1985). It is not the purpose of this paper to
review the proposals in question. At the same time, one may welcome the
recent long-term rescheduling of the debts of Mexico and Venezuela, with
reductions in margins above LIBOR, and suggest taking similar action in the
case of countries where a serious adjustment effort has been made.

Also, one may reiterate the proposal made for the establishment of an
Interest Equalization Scheme in the IMF. As suggested in the earlier paper by
the author, "the new facility would provide loans to compensate for a
substantial part, say two-thirds, of the excess burden of interest payments on
loans subject to variable rates, whenever LIBOR rises above a pre-determined benchmark" (1985a, p. 85). The proposed scheme would be modelled on the IMF Compensatory Financing Scheme that provides financing in the event of export shortfalls.

The additional burden of higher interest rates should be estimated by allowing for interest earnings on international reserves13. Also, the benchmark interest rate should be calculated in real terms, preferably by reference to changes in the export price index of the industrial countries. Following suggestions made in the volume by Bergsten, Cline and Williamson, one may further allow for increases in foreign exchange earnings as rapid expansion in the industrial nations tends to contribute simultaneously to higher interest rates and to higher imports from the developing countries (1985, pp. 44-45). But, these countries will encounter debt servicing difficulties if interest rates rise without the expansion of exports as it occurred in 1982.

At the same time, in contradistinction to the Bergsten-Cline-Williamson proposal, the scheme should be made automatic for developing countries that carry out a policy program accepted by the IMF. This is because of the need to reduce uncertainty in international financial markets that adversely affects borrowers as well as lenders, thereby discouraging adjustment efforts and limiting the flow of international finance.

13 This point was made by Jean Baneth who also raised the issue of private financial assets, observing that they in part or in whole compensate for periods of external liabilities.
The extension of secondary markets for developing country debt would also be desirable. This would permit the banks to adjust their portfolio through swap transactions or through outright sales, allow developing countries to repurchase their debt at a discount, and enable multinational corporations to purchase debt obligations for use in direct investment.

In fact, the burden of debt servicing in countries that encounter particular difficulties may be eased by transforming some of the debt into equity.\textsuperscript{14} More generally, it would be desirable to encourage foreign direct investment in the developing countries, which will reduce the need for external borrowing. In this connection, participation by the developing countries in the proposed Multilateral Investment Guarantee Agency under World Bank auspices would be useful.

\textsuperscript{14} Such a proposal has reportedly been made in Mexico (\textit{The Wall Street Journal}, February 8, 1985).
REFERENCES


