Barend A. de Vries

International Ramifications of the External Debt Situation

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International Ramifications of the External Debt Situation

Barend A. de Vries.
This latest Review Special Paper, written by Barend A. de Vries*, a Senior Adviser in The World Bank, takes a comprehensive view of the policies required to alleviate the present international debt predicament. The paper concludes that not only are urgent measures needed to improve the cash position of the debtor countries, but also a larger proportion of new finance must be made available on long and stable terms. Such finance should be provided for investment programs and projects agreed with official and private sources in a new growth-oriented effort.

The present situation is particularly difficult because debtor countries are in a severe depression and are not receiving any new finance for productive purposes.

Looking forward, the paper stresses that interest rates and export performance hold the key to the viability of the debtor countries. Essential export growth must be based on the debtor countries’ own efforts and supported by open trade policies in the creditor countries. Interest rates, although lower in nominal terms, are still high in real terms. Consideration should be given to compensation, on a selective basis, for high and fluctuating market interest rates.

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International Ramifications of the External Debt Situation

Barend A. de Vries

The scope and complexity of the external debt situation defy simple solutions. There has been extensive discussion of the situation as it evolved since the late summer of 1982. The interruption of debt servicing by Mexico, which for many years had been regarded as having top credit rating, came as a profound shock. The situation spread rapidly to other countries, and now extends to some 15 countries mostly in Latin America and eastern and southern Europe. The amounts involved are enormous—interruption in debt service affected more than half of total obligations of developing countries of $650-700 billion. There is widespread recognition of the importance of the major debtor countries such as Argentina, Brazil, Mexico and Yugoslavia, and the urgency of dealing with their cash problem in the interest of avoiding a collapse of the international credit and banking system.

Yet in the discussions so far it has been difficult to see the whole of the present situation. Indeed some aspects have been neglected or underestimated, especially the links between trade and finance, between domestic and international policies, and between short-term action and longer-term institutional and structural change. It is good to recall what H. L. Mencken said “For every complex problem there is a simple solution, but it is always wrong.”
To come to a more comprehensive understanding this article gives explicit attention to the following crucial aspects:

— The large magnitude of the financial resources needed to restore the liquidity of debtor countries. Without adequate liquidity, countries will find it more difficult to meet their present obligations or pursue the policies essential to their own recovery. Special action is called for, since the financing involved severely strains present institutional arrangements and policies;

— The paramount importance of reducing interest rates on outstanding debt and future borrowing, and the nature of international debt management or the special compensation arrangements realistically called for if market rates do not come down;

— The basic factors which led countries to borrow excessively and use at least part of the loan proceeds for consumption purposes or unwise investments; and the policies needed to avoid such unwise borrowing in the future;

— The social, human and economic consequences of programs now being pursued in the interest of meeting rescheduled debt obligations;

— At present most debtor countries receive little, if any, net external financial help. During 1983 and the next few critical years what they receive in external funds falls short of their interest payments and repayment of outstanding loans. This awkward situation can not persist for long unless debtor countries regain confidence and attain at least moderate growth;

— The longer term and fundamental structural changes that the debtor countries must bring about to place themselves in a sufficiently strong economic and financial position;

— In new international lending, a larger proportion must be provided on long and stable terms and linked to the investment process or to programs agreed with the International Monetary Fund, the World Bank and other multilateral institutions and the private financial community;

— The central role of increased growth of exports by debtor countries and the essential economic and trade policies that must be pursued by both creditor and debtor countries to make such growth possible.
The debt situation has been interpreted in different ways. At issue is not the actual repayment of debt outstanding, but the ability of countries to manage their present obligations and restore their creditworthiness sufficiently so that they can once again contract new debt to finance long-term growth.

At one end of the spectrum, one reads that debt problems are country-specific and must be resolved on a case-by-case basis; they are primarily a liquidity crisis—a classical cash squeeze caused by a recession-related drop in export earnings and a temporary but sharp increase in real interest rates. At the other end of the spectrum, one finds a concern with more deep-seated causes of a longer term nature.¹ In the wake of the first oil shock the LDCs received substantially larger international capital flows. At least a portion of these increased flows went for consumption purposes or investments with low economic justification.

Given the enormity of the problems of adjustment some politicians in debtor nations have called for unilaterally stopping debt payments, a position widely regarded as against the interest of both debtors and creditors as well as the international system of finance. But there are also more responsible calls for a restructuring of the debt of many developing nations including a consolidation of the short-term debts. Some observers, like Felix Rohaytn and Professor Kenen, have offered ideas for the refinancing of a major portion of the debt outstanding. Richard Weinert proposed that the World Bank refinance and assume part of the LDC debts on long and subsidized terms in return for World Bank bonds to be held by commercial banks.² However, proposals of this kind have not been considered in detail, and indeed they could adversely affect new bank lending and there is widespread doubt that they could work.

For the time being, responsible officials, both national and international, are of the view that the situation in individual countries can be managed, assuming sustained recovery of the world economy and given the forthright short-term assistance provided by both national and international institutions, especially the IMF, and including the US authorities (the Federal Reserve and the Treasury), other central banks, and the BIS.

¹See, for example, Jan Tumlir: "The World Economy Today: Crisis or a New Beginning?", National Westminster Bank Quarterly Review, August 1983.
²Richard S. Weinert "Banks and Bankruptcy", Foreign Policy, Number 50, Spring 1983.
all working in tandem with the large commercial banks which have assumed a constructive attitude.

It is possible that the next few years will bring significant improvements. Indeed, much is expected of the effects of lower interest rates and the recovery in the US and in other OECD countries. Recovery would make possible new export growth which would strengthen LDCs' ability to service outstanding debt and hence their creditworthiness for new debt. However, there are doubts about whether or not current trends are sufficient. The doubts stem from the continuation of relatively high long-term interest rates, the pace and persistence of the recovery in the industrial countries, and the extent to which new LDC export growth may be hampered by protection. A US study in April 1983 projected a 4.2% near-term OECD growth, based on long-term growth trends, as a sufficient base for LDC debt management, but this figure is higher than the 3-3.5% OECD growth projection for the next 3-4 years presented in 1983 OECD and the IMF-IBRD Development Committee meetings. If only minimal growth is to be maintained over a reasonable period and if exports do not grow and interest rates do not come down to a sufficient extent, the debt service on outstanding debt may be excessive in many countries. In that case, the difficult question remains: How to deal with the excessive burden of existing debt? Will debtor countries be able to depress their economies further to meet existing obligations? Will creditor countries accept the consequences of such further cuts? Or will they be prepared to mobilize the necessary funds to keep the debtor countries afloat and start on a new path to their recovery, so essential for growth worldwide?

Dynamism of the World Economy

The deterioration in the external debt situation is a critical aspect of dynamic change in the world economy. Since 1982 it has profoundly affected the flow of funds to developing countries and the relations between industrial and debtor countries. Lasting improvement in the debt situation and the working of international financial and trade relations are closely intertwined.

The financial and economic integration of the world economy had numerous benefits, but has also contributed to the present predicament of the debtor countries. The 'seventies witnessed a quantum jump in international finance and a continued deepening and widening of trade. During the decade the value
of world trade grew almost sixfold to exceed $1700 billion in 1980. With the exception of the recession year of 1975, the real value of world trade—i.e. after allowing for inflation—increased each year by 7 to 8%. Manufactured exports of the developing countries increased by 25 percent per annum in current dollars. The flow of international finance increased even more rapidly than world trade. Thus the Euro-dollar market, the channel for a great portion of international lending, expanded eleven times to reach $730 billion in 1980. Likewise international liquidity expanded rapidly in the early 'seventies—the dollar value of world foreign exchange reserves rose by some 15-43% per annum in 1970-76 as against only 1.2-6.2% in 1961-69.

The expansion of international markets grew to some extent beyond the control of national authorities and tended to defy attempts at keeping prices at fixed or steady levels. Witness the abandoning of fixed exchange rates after 1971, the weakening of the OPEC controlled price structure after 1981, and the deepest post-World War II decline in primary commodities in 1980-82. The rapid developments in the world economy made it difficult for national governments to adjust and adapt their domestic economies. Economic measures in some of the larger countries had profound implications for the functioning of the international economy even though they were taken primarily with domestic objectives in view. Situations in developing countries now have direct effects on industrial countries. The debt troubles caused hundreds of thousands of American workers to be laid off and the Mexican situation helped depress the economy of Texas.3

The trade and finance policies and practices which helped support the expansion of the world economy underwent significant and often abrupt change in the 'seventies. For example, one can cite the following: the breakdown of the Bretton Woods system of fixed parities, the change in energy pricing initiated with the OPEC action in 1973, the explosive growth of financial markets and their role in financing development, and the increasing strain on free trade associated with the export success of Japan and the newly industrializing countries (NICs) and the recessions of 1973-75 and 1980-82. In the recession of 1980-82, the rapid increase in international

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3Albert Bressand discusses the need for broad, new thinking about measures to cope with interdependence. See "Mastering the 'World Economy,'" Foreign Affairs, Spring 1983.
financial flows contrasted with the deterioration in the trade environment which was evidenced by the slower increase in exports, especially of manufactured goods, from major debtor nations like Brazil and Mexico. The disparity between the growth rates of financial flows and exports is one of the basic causes of the present debt situation.

Overall, integration with a dynamic world economy has had major benefits for the semi-industrial developing countries. Until the onset of the 1981-82 recession, export growth, especially in manufactured products, and capital inflows substantially added to resources for investment and domestic growth. However, increased integration also carried a cost—not the least being the widened dependence on foreign finance and the associated required discipline in financial and economic policies. Also, fluctuations in the price of capital and foreign exchange and in export volume and prices are now felt more intensely. The more open system of trade and capital flows reduces countries' freedom of maneuver. Thus, there are quick and severe penalties for not keeping the exchange rate in line with relative inflation, and this may run contrary to social and political objectives. In an environment of inflation—often much higher than in industrial countries—a lag in exchange rate adjustment damages export performance and distorts protection incentives for manufacturing. It also stimulates expectation of further devaluation which, as occurred in several Latin American countries, pushes domestic interest rates far above international levels.

Short- and Long-Term Aspects: Liquidity and Restructuring

The present debt problem can be regarded as one of lack of liquidity and not of solvency. True, it is often difficult to distinguish between short-term cash problems and long-term difficulties in servicing debt. In countries which enjoy rapid growth, a cash problem can be overcome by new borrowing. On the other hand, in countries which suffer from low or negative growth for several years, new borrowing may not overcome the cash shortage but merely add to an already excessive debt.

While the debtor nations suffer from a cash squeeze in facing their present obligations, their productive capacity has been substantially expanded over the past decade. Most of these countries are in the middle income range and have built up impressive production facilities, in contrast with many of the poorest countries especially in Africa. Thus most of the major
debtor countries can meet their obligations over the longer term once liquidity has been improved and growth has been resumed. Completion of large ongoing investments already covered by external financing arrangements will further enhance these countries' ability to produce and export.

Measures to restore the liquidity, i.e. the cash position, of the debtor countries are urgent at present. They must go hand in hand with policies to bring about longer term growth. Indeed they lay the basis for longer-term financial action.

The international liquidity of debtor countries has been drained by the run-up in interest rates, the collapse of export commodity prices and the impact of the recession in industrial countries and of their own spending policies. Various steps are needed to restore liquidity to adequate levels:

— Rebuild the foreign exchange reserves of the debtor countries and take measures to cope with future fluctuations in commodity prices;

— If market interest rates do not come down, provide some form of compensation for high interest rates on outstanding debt;

— Adjust short term credit lines to levels compatible with the needs of expanding trade.

Even if external conditions are favored by strong and lasting recovery, these measures are not simple, and they will require time to put in place. Indeed they are bound to strain the capacity of present arrangements and call for institutional reform and special action.

The proposed increase in the resources of the IMF is a crucial first step in measures to assist in re-establishing the liquidity position of developing countries. But additional resources are needed to keep liquidity abreast of the requirements of global production and trade. Several observers have called for new issues of SDRs. In comparison with schemes designed to cope with specific debt problems (such as a rediscounting of certain claims on LDCs or their conversion into equity), the SDR route is more suitable because it uses an existing institutional framework, and it directly addresses the liquidity shortage.

Measures to restore liquidity must be accompanied by more

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4See e.g. H. Johannes Witteveen, “Developing A New International Monetary System: A Long-term View” Lecture before the Per Jacobsson Foundation; Washington D.C., September 1983.
External Debt

Structural measures which may take several years to be fully effective and which could raise difficult national and international issues. Two key measures are improvements in the term structure of present and prospective debt and the restructuring of the developing economies in response to changes in the international economy.

The changes in the term structure of the external debt in the last 10 years must be seen against the background of the greatly expanded role of the commercial banks in financing development. They made possible a substantial increase in external resources for the middle income developing countries. At the same time, however, external finance became less related to adjustment policies and the investment process, and the maturity structure of debt tended to deteriorate. For 13 large debtor countries, private sources accounted for 71.9% of total debt (including private non-guaranteed debt) in 1981, compared with 66.8% in 1978 and only 27.6% in 1971. There was a corresponding decline in the share of credits from official institutions. Among these countries, there are wide and significant variations in the relative importance of private and official creditors. In Brazil and Mexico, credit from private sources accounts for 89% and 87% respectively of the total debt outstanding in 1981. In Korea and the Philippines these shares are a lower 63% and 68%. The maturity of total medium and long term debt of the major debtor countries shortened from 17.4 years in 1972 to 12.7 years in 1981, with the average 1981 maturity for Brazil still shorter at 9.7 years and Mexico at 7.7 years.

The sharp run-up in short-term debt, especially after 1979, further worsened the debt structure. Action is required to reduce these short-term credits to more normal levels consistent with individual country requirements of financing trade — the excess could be $50-70 billion out of an estimated $135-150 billion total short-term credits outstanding. Such action could take considerable time and pose difficult questions of policy and procedure for both private and

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5 Cf The World Bank: World Debt Tables 1982-83 Edition. It defines major debtor countries as those with disbursed and outstanding debt estimated at more than $12 billion in 1981; they are: Algeria, Argentina, Brazil, Chile, Egypt, India, Indonesia, Israel, Korea, Mexico, Turkey, Venezuela and Yugoslavia.

6 The World Bank estimates total 1982 debt at about $665-680 billion, of which $135-150 billion is short term. These figures exclude some $100 billion debt of Eastern European Countries. For 21 major LDC borrowers, Morgan Guaranty Trust Co. estimates short-term debt at $132.5 billion, of which $87.4 billion is in excess of 3-month imports. (World Financial Markets, June 1983)
official creditors. In some countries part of the short-term debt may have to be consolidated into longer term obligations. International agreement on the role of interbank transactions, under study for some time, would also affect future movements in short-term debt.

Countries' ability to manage debt hinges critically on the level of interest rates, as many discovered in 1981-82. The in-depth analysis of the process of growth and debt which the World Bank undertook twenty years ago drew attention to what was called the critical interest rate which varies for different countries roughly in line with the rate of increase in output and exports they can sustain over a period of years. If the interest rate actually paid by a country exceeds its critical level for long, the debt situation will explode in the sense that debts will accumulate out of all economic proportions and normal servicing must eventually break down. Looking at the situation of the developing countries, at one extreme are many of the semi-industrial countries whose dynamic growth and export performance have been the basis of their creditworthiness for loans on market terms. At the other extreme are low-income countries with poor growth records and low creditworthiness for loans on market terms. These countries must rely predominantly on loans with low interest rates and need continued concessionary assistance if they are to avoid an explosive growth of debt service in relation to their payment capacity; examples are Bangladesh or several sub-Saharan countries. This consideration is fundamental to the economic case for continued operations of the International Development Association, the concessionary arm of the World Bank.

In addition to the interest rate, the maturity of external borrowing is of importance. In a macro-economic sense what matters is the net inflow of capital i.e. the funds actually disbursed minus the payments on outstanding obligations — the net inflow can result from the disbursement of either shorter or longer term loans. However, in practice loans with longer maturities have two advantages over loans with shorter maturities. First, as the maturity — the time to repay — of existing debt shortens, amortization (actual repayment) rises rapidly and so does the gross flow needed to generate a given net inflow. In fact the annual gross capital needs rise geometrically, and as a result the negotiation of the annual roll-over becomes much harder to manage and runs a much greater danger of breaking down in the

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wake of political or economic upsets. Second, loans with longer maturities can more easily be integrated into the investment process of developing countries. They are more suitable for major investments with longer gestation—such as capital intensive manufacturing plants or hydroelectric and other infrastructure projects. At present many projects are in trouble because they borrowed on relatively short terms while their revenue stream has been reduced or delayed. Bridging loans can give relief, but the economics of some projects, especially large infrastructure and industry projects, may be in doubt as they face slower demand in the post-recession world.

Longer-term lending is also critical to the success of restructuring by the developing countries. Restructuring is a long-term proposition, a crucial aspect of greatly increased international integration. The increased financial flows often facilitated the process of balance of payments adjustment or domestic adjustment to high energy costs in the 'seventies. However, in some countries, they also permitted a delay in adjustment in critical sectors, and steps must now be taken to correct this situation.

Restructuring contributes to stronger longer-term creditworthiness in several ways. It aims at greater efficiency in resource allocation. Thus, it places developing countries in a stronger position to complement the industrial restructuring now underway in the developed countries. It focuses attention on export development and on an increased role of export industries in industrialization strategy. In this strategy, a key role is necessarily played by medium-sized manufacturing enterprises, largely in the private sector. At the same time, the large often capital intensive state enterprises need to be put on a more autonomous financial and managerial footing and made to rely to a lesser extent on budget assistance, price subsidies and controls. Such a change in policy should enhance their productiveness. It also reduces the public sector deficit which, many debtor countries, must be brought down often from a high 10-15% of GDP to a more manageable 5% or less—a painful process which cannot be accomplished overnight.8

A lower public sector deficit is also an essential ingredient of policies to increase savings and bring about a recovery of domestic financial markets, so necessary for the revival of business investment and confidence. In many countries, e.g.

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Turkey, Brazil, and other South American countries, domestic private industry presently must borrow at *real* interest rates of 50% or more. At such rates, the liquidity of many productive enterprises is being drained, and they are near bankruptcy. The banking system is merely keeping enterprises afloat by financing the flow of interest payments, but there is little scope for new investment. Clearly a restoration of domestic financial markets has high priority in these countries.

The debtor countries are now making structural and other policy improvements in a difficult environment of greatly reduced growth. No one can tell with certainty how far they can go in reducing growth, output and employment. Some of them may already be close to the social limits of adjustment—if one considers that the consequences of unemployment and further cuts in output will be a spreading of unrest, poverty, and distress. At present, debtor governments are understandably fully occupied with crisis management. Most debtor countries at present and for the next 2 or 3 years are actually transferring resources abroad—in the sense that what they currently receive in new loans and official finance falls short of what they must pay to the creditor institutions in interest and debt repayments. This is an extremely difficult position to manage and maintain when it is combined with high unemployment and severely reduced growth or a decline in output and incomes. Financial stability will be threatened if present programs cannot be combined with a resumption of growth and confidence—not tomorrow but today. Indeed, the time has come for the debtor countries to start planning for a resumption of growth and to meet the challenge of their rapidly increasing labor force, lest the gains of the past decade will be washed away. Over the longer term, improved creditworthiness must be based on growth in output and more efficient resource use, not on reduction of economic activity.

*Trade and Industry Policies*

Policy changes in individual debtor countries, even if they cut deep into the economic and social fabric, will not suffice to place these countries in a sufficiently strong position to resume normal debt service. National policies must find support in the international system: in international trade policies, in positive restructuring in the developed countries, and in vigorous financial system able to supply *long-term* resources. Thus close coordination is needed between financial and trade policies—a requirement which has recently been stressed in several quarters.
In the same vein close cooperation among industrial countries and a more stable structure of interest rates and exchange rates is in the interest of more effective international debt management.

It is widely recognized that a resumption of vigorous growth in export earnings is basic to a solution of the debt problem. Export growth is of special interest at the present because it injects a positive element in a situation dominated by negatives: cuts in investment, imports and output. The arithmetics of demonstrating the key role of exports are simple, but the domestic and international policies needed to bring about the necessary growth are often difficult. Many of the debtor countries themselves must introduce fundamental reform in their export policies. While several countries have already initiated new export programs, few have pursued export development with the same thoroughness and consistency that marked the policies which produced such spectacular results in South Korea and other countries on the Pacific Rim. Fundamentally, a reorientation of export policies must be linked with a reordering of domestic industrial priorities. This is a tall order, especially in those countries, like Brazil, Mexico and Yugoslavia, where industry has had a predominantly domestic orientation.

Recovery, combined with open trade policies in the OECD countries, is a basic underpinning of adequate export growth in the developing countries, but the pace and nature of recovery remain uncertain. In the next few difficult years, growth in the industrial countries could easily fall short of the recovery pace achieved in 1976-78 and world trade is expected to grow slower than in most of the ‘seventies. Furthermore, while industrial countries are officially committed to open trade and restructuring, the nature of any new measures and their specific significance for the prospects of many debtor countries remain to be defined. In the past decade much of the efforts of the industrial countries and a substantial amount of government assistance have been spent on breathing new life into old industries, like textiles and steel, where the semi-industrial countries are equally or more efficient producers.

The export outlook for debtor countries depends on performance in markets for both primary and manufactured products. Exports or primary products are still the more important component in many of these countries. Unfortunately, non-fuel commodity exports have shown little volume growth
over the past 10-15 years. They have also continued to be subject to severe fluctuations in price despite considerable international consultation about measures to compensate for sharp downturns in export earnings. Fortunately, most non-fuel primary prices are now projected to recover somewhat from the steep declines of the past three years.

The decline in primary prices in 1980-82 was precipitous and the worst since World War II. At the end of 1982, non-fuel primary prices had fallen 45% below the 1951 level in real terms. Fluctuations in supply, and slow growing or stagnant demand have caused volatility in prices and foreign exchange earnings. Attempts to alter the characteristics of commodity markets have been largely unsuccessful because of the difficulties in co-ordinating numerous suppliers, and unwillingness — or inability — of major consuming countries to go along with price fixing and bufferstock schemes. No wonder the UNCTAD VI documents lament the lack of action on the proposed Common Commodities Fund and International Commodity Agreements. Few experts believe that the basic market characteristics can be changed and that price and earnings stabilization will be achieved. Yet stable and dynamic export growth is essential for improved creditworthiness. Greater price stability or improved mechanisms for safeguarding against the risk of fluctuation are essential conditions for investment planning, execution, and finance in all primary fields and especially in energy.

Faced with the realities of commodity markets, international action has sought to provide some relief through partial compensation for fluctuations in export earnings and prices. In addition to operating a Buffer Stock Facility, the International Monetary Fund has liberalized its compensatory Financing Facility (CFF) a number of times since it was instituted in 1963, most recently in 1981. Assistance has been extended by STABEX under the Lome Convention. The CFF has been an important part of the Fund’s activities and has provided essential help for several countries suffering balance of payments setbacks. However, when the decline in export earnings is as severe as in 1981-82, the Fund’s compensation scheme can make up only for a portion of the deterioration in earnings and of the impact of adverse terms of trade on the balance of payments. The Brandt Commission and UNCTAD, among others, have called for further expansion and liberalization of the CFF. An expansion of the CFF could alleviate some of the liquidity problems of debtor countries. One would expect the facility to be self-financing over a 3-5 year period.
But even if expanded, a revolving fund will necessarily be limited in scope and cover only a part of likely shortfalls in the future. The cost of any expansion must be weighed against alternative uses of scarce resources.

Any compensation scheme like the CFF is at best a security measure which can provide only temporary relief and buy time for more fundamental action. More lasting improvement must be found through a restructuring of output and exports. In fact, given the constraints on the growth and stability of commodity markets, the more dynamic countries have managed to strengthen their creditworthiness through export diversification — both through agricultural policy and industrial development. On its part, the World Bank has sought to support diversification through greatly expanding its lending for agriculture and widening its direct and indirect support for industrialization. The World Bank is now also assisting export development programs in several countries.

The performance of the newly industrializing countries is testimony to what can be achieved through diversification. They expanded their manufactured exports by more than 13% per annum in real terms in the 1970s. This was sufficient to sustain high levels of external borrowing from private sources. A major debtor like Brazil developed major new agricultural exports like soya beans and orange juice, and its dollar earnings of manufactured exports rose by 23% per annum in the seventies and now account for half of its total exports. But looking to the future, Brazil and other debtors will have to go much farther in export expansion. Even after its considerable growth in the seventies, Brazil’s export sector still accounts for only 9% of its national economy, a rather small percentage roughly comparable with China or India which have relied to a much smaller extent on external capital. In contrast, South Korea has had a stronger emphasis on export development; its export sector now accounts for 39% of its economy and manufactured exports are 90% of total exports. Korea and other countries, which placed greater stress on export development, weathered the recession without interruption in debt service obligations. Korea has also taken forthright action in restructuring its industry and controlling its public sector deficit and inflation.

Prospects for vigorous growth in manufactured exports hinge on the extent of critical policy improvements in the debtor countries and on the policies in OECD countries to avoid intensifying protection and to maintain an open and expanding world trade system.
Strong revival of trade among developing countries is also essential for increased exports. The greater part of the most promising exports from debtor countries such as machinery and other relatively more sophisticated products have gone to other developing countries. Especially in Latin America products of this kind are exported to other Latin American markets. For strong export growth, debtor countries must develop new markets, while developing countries in general should reduce protection. General measures to strengthen growth worldwide and open trade policies by both developed and developing countries are of crucial importance.

The balance of payments crisis in debtor countries has induced essential measures such as real devaluation, reduction in public sector deficits and in subsidization of state enterprises. These measures lay the basis for stronger export orientation and the lower and more rational protection rates essential for industrial efficiency. They will also help domestic financial markets which are so important for the resumption of private investment.

The counterpart to improved export policies in the debtor countries must be greater import opportunities in the industrial countries. There is room for optimism in assessing trade prospects. The relatively small shares of products from less developed countries in the markets of the industrial countries leave ample scope for further expansion. On average, LDC products account for only 3% of the enormous market in industrial countries. The relatively larger shares for some products (e.g., more than 10% for textiles and clothing), and protectionist measures against imports of many of these products suggest only moderate growth ahead. However, protectionist measures in OECD countries, especially in textiles and clothing, did not stem the dynamism of the most successful exporting countries: they upgraded the quality of their products and diversified into new markets.

For many items, especially all kinds of tools and machinery, the market shares are still minimal, and the export potential is large. Indeed, the experience of the past 15 years suggests that given a generally favorable environment one simply cannot foretell

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9 See e.g. Helen Hughes and Jean Waelbroeck: "Can Developing Country Exports Keep Growing in the 1980s?" The World Economy (June 1981).

the many possible export opportunities which may be realized.¹¹

But there is no denying that the export environment in the years ahead will be far more competitive than in the past 15 years. While LDC products have but a small market share in the OECD countries, imports of LDC products nevertheless account for some 20% of total OECD imports of manufactured products. Unless import markets grow, LDC products can increase only by displacing products from industrial countries. Many of these products originate in industries like textiles, clothing, steel or shipbuilding which are undergoing a process of restructuring by adjusting to lower labor costs or more modern techniques abroad, by seeking to become more competitive through modernization, often with substantial government help and protection. Expanding trade in the products of these industries involves continued restructuring and progressive transition toward newer activities where the industrial countries have greater competitive advantage. Without this transition in the industrial countries, exports from developing countries and the ability of LDCs to manage their debt will be weaker. The longer term solution of the present debt situation is interrelated with a restructuring of the world economy as a result of which the major debtor countries, as well as other developing nations like China and India, will produce a greater share of many manufactured goods. The process of restructuring is an essential aspect of international economic development to which national policies in both industrial and developing countries must make a positive contribution.¹²

Debt Prospects and the Provision of Long-Term Capital

Restoration of dynamic and diversified export growth is the best base for renewed creditworthiness for long-term borrowing. The financial system should respond to positive trade developments by increasing the volume of long-term lending. As already discussed, financial institutions must also assist in the restoration of short-term liquidity; this itself may require substantial institutional reform and is an essential requirement for a widened role of long-term capital.

The distinction between short-term finance and long-term capital has become blurred in the past 10-15 years. Contributing

¹¹In 1968-73 Latin American countries increased their exports of certain products substantially, some 10 times or more. See Barend A. de Vries: “Exports in the New World Environment: The Case of Latin America”; CEPAL Review, 1977.

factors were the adverse impact of international inflation on long-term finance and the deterioration in the climate for official assistance. At the same time, commercial banks increased their share and volume of financing of developing countries. The banks increasingly charged floating interest rates and lengthened their maturities, but, while they are increasingly interested in project finance, most of their lending continued to be for general purposes, balance of payments and budget support.

The provision of short-term finance has traditionally been a principal role of commercial banks. In times of liquidity difficulties they would normally receive support from Central Banks. At the international level, the IMF helps countries deal with disequilibria in the balance of payments including those caused by export fluctuations, and provides external finance in support of measures to facilitate adjustment. Since the fall of 1982, the Fund has played a key role in preventing the Mexican and other debt situations from spreading into a wider international liquidity crisis. Its focus is on the functioning of the international monetary system, including liquidity, and it is essentially set up to operate as a revolving fund and not as a source of long-term finance. On the other hand, its financing terms are often extended over the medium term and the terms of its agreements have direct impact on longer-term structural policies.

There is, of course, no technical reason why the banks could not increase their role in evaluating and financing investment projects. They can do this directly by strengthening their own project capability, which though costly and time-consuming, is being undertaken by some of the larger banks. But the longer loan maturities needed by many debtor countries and especially by larger projects would still have to be provided by official institutions. For both financial and technical reasons one would expect an increased role of co-financing spearheaded by the World Bank. In addition to co-financing proper, private creditors would benefit from closer coordination with official activities, be they IMF standby arrangements or the Consultative Groups of the World Bank.13

The provision of long-term finance by both private and official institutions must take a longer view of countries’ economies in

which planning and execution of investment and restructuring of the economy take a central place. Long-term capital assistance is more directly linked to the investment process and in particular to specific investment programs and projects such as those financed with the help of the World Bank, the regional banks, or by long-term bond issues.

A stronger link between long-term capital flows and the investment process would require an expansion of the role of the World Bank both as provider and coordinator of long-term capital. An increase in co-financing and coordination between private and official creditors would be strengthened by a step-up in the World Bank’s own lending. It would be stifled by constraining the World Bank. At the same time, stronger institutional arrangements for private long-term capital and direct investment are needed. These include continued increases in financing by the International Finance Corporation to the private sector, an expansion of multilateral arrangements, to insure international investment, and, above all, a stronger confidence in the private sector of the developing countries themselves.

For both the recipients and the providers of capital a closer interrelation between international finance and the investment process will have considerable advantages. It will establish a closer relationship between long-term capital flows and the macro-economic policies on which the adjustment programs are based. It will channel finance toward investment with highest priority and economic yields, and reduce the diversion of scarce external funds for consumption purposes. It will help assure that major investment projects receive adequate financing terms rather than the often unduly short terms extended during the ‘seventies—and that in itself will help in avoiding a recurrence of the liquidity squeeze.

But all this assumes that in the future, financial markets will once again work smoothly and efficiently. the remedies for the present debt and liquidity difficulties should not obstruct the functioning of a competitive integrated financial system. Looking to the future, this may require some assurance that the overall expansion of international bank credit is consistent with global economic considerations and does not exceed the limits of prudence. Implementing global tests would break new ground, as is clear from Witteveen’s proposal for a cooperative system of controlling international bank lending.14 At the same

14H. Johannes Witteveen, op. cit.
time, as discussed above, it is in the interest of banks that their lending to individual countries is for high priority purposes and within the limits of countries’ creditworthiness. These interests could, in principle, be served with help from the World Bank’s Consultative Groups. They bring together officials from creditor governments and agencies and many individual borrowing countries. The Groups consider in-depth reports on countries’ investment and financing prospects and priorities. Assuming the participating governments agree, these Consultative Group discussions could also help guide private lenders and investors without encumbering their responsibility and freedom of action.

More immediately, the functioning of financial markets would benefit from improved information and analysis of debt and debt-bearing capacity, wider dissemination, and more systematic application of available information in lending decisions. Improvement can be made in the information about financial flows, especially of short-term finance. It is true that in any crisis available data underestimate the actual debt outstanding, but much can be done to improve available statistics and monitor financial developments. For example, many in the banking community knew about the rapid weakening in the debt positions of several countries after the second oil shock in 1979. Yet, when Mexico and Brazil started to resort to excessive short-term borrowing, much of it was from the smaller banks, and the extent and source of this borrowing were not known to the major credit institutions until after a critical lapse of several months, perhaps as much as a year. Even then, they did not have the full picture. Steps are now underway to improve statistical monitoring. Additional action is needed to strengthen and systematize knowledge about basic short and long-term economic trends and prospects in borrowing countries, and share it with a wider network of lenders. The new Institute for International Finance can play a useful role in this area.

The prospects of debtor countries will be vitally affected by the level of the interest rate. A substantial lowering of the interest rate is a critical factor in the ability of countries to service debt. Since mid-1981, nominal interest rates have come down, but real rates, i.e. interest rates after allowing for inflation, are still about 6 or 7 per cent, and well in excess of the critical rate for many countries and above the growth rate of output and exports that they are likely to sustain in the foreseeable future. It is important to observe that this high rate currently applies to new current borrowing undertaken as part
of the programs for Mexico, Brazil and other major debtor countries parallel with the IMF agreements. While this new borrowing is essential for the continued functioning of the countries concerned and for the international credit system, it adds nevertheless to an increasing debt servicing burden which can turn out to be excessive unless interest rates come down or real growth is much higher than currently foreseen. It may be good to recall that an unduly high interest rate can turn a liquidity problem into a solvency problem.

At the present high level of interest rates, borrowing countries face a difficult choice. They can forego new borrowing and risk the consequences of even deeper cuts and lower growth. Alternatively, they can borrow and risk increasing interest payment burdens in the hope that relief will be forthcoming. This relief should preferably be through higher export growth and a substantial decline in interest rates. It is possible that reduced fears of renewed inflation and of "crowding out" in capital markets will reduce the risk premium on international loans. But in the next decade or so interest rates may well remain on the high side.

Factors which push up interest rates seem to abound. Savings as a percentage of income in the industrial countries trended downward in the 'seventies; a significant reversal of this trend is needed to bring down interest rates. Governments, particularly in the United States, are taking a larger share of available savings. Internationally, financial savings have suffered from the dwindling of the OPEC surplus. In addition there has been much inefficiency in capital use, in part caused by protection in the industrial countries, and in part by overextension of public sector programs, price controls and subsidies in the developing countries. Rates may be under pressure, as industrial countries face up to the need for many capital intensive investments which have had to be postponed. Developing countries themselves will put pressure on long-term capital resources as they confront their requirements for large new investments in several sectors including energy. High interest rates are part of policies aimed at keeping inflation under control which is widely regarded as an essential pre-condition of sustained growth of the world economy. True, a resumption of strong inflation could once again temporarily reduce real interest rates. But few dare hope for such an eventuality, given its dire consequences for real growth worldwide.

15 See the 1983 GATT Annual Raport (The Economist, September 10, 1983).
Lenders will do well to allow for the danger of interest rates exceeding their critical level in individual country situations. In shaping lending policies, much can be said for an economic classification of borrowing countries indicating the ranges of interest rates beyond which debt servicing difficulties can be anticipated. When lending proceeds at unduly high interest rates, special caution or some form of subsidization is called for. Analysis of interest rate levels compatible with the prospects of individual borrowing countries should, of course, be made available to all lenders concerned. It could be undertaken by the World Bank and, for individual countries, be made a part of its economic reporting to consultative Groups.

Given the uncertain prospects of interest rates, the financial community should now consider what can realistically be done when debtor countries are unable to pay market rates on new external finance for strong and worthwhile investment programs. Immediate action can be taken to limit the currently high premia over the basic lending rate charged by banks. In addition, it may be necessary and possible to consider some form of compensation for high interest rates. Given the high cost to creditor institutions, such compensation would have to be selective and operate much on the same principle as the IMF scheme for the compensation for falling export prices (CFF). It could be limited to projects and programs supported by multilateral development banks, the IMF and co-financing commercial or private investment banks. Such schemes would build on the experience with IMF extended agreements and the World Bank’s structural adjustment or “special action” programs. Technical aspects of arrangements of this kind were studied in-depth during the ‘sixties and the urgency of the present situation deserves a renewed effort.

In the end, no single actor, no one creditor, or government can resolve the present debt situation. Both short and long-term action is required. Policies in both trade and finance must be adopted to the new situation, and authorities and institutions in these separate fields work together more closely than they have in the past. Debtors as well as creditors must initiate new measures in a collaborative spirit to overcome what is perhaps the most challenging task of 30-years of economic development efforts.

16 For an example of an economic classification of debtor countries, see Barend A. de Vries “The Debt-Bearing Capacity of Developing Countries — A Comparative Analysis”. Banco Nazionale del Lavoro Quarterly Review, March 1971.
No. 274. Ron Duncan and Ernst Luiz, "Penetration of Industrial Country Markets by Agricultural Products from Developing Countries," _World Development_


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