World Depression by Third World Default?

The need to link debt guarantees to tri-cycling*

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The Background

Brandt argues that both developed countries (dcs) and less developed countries (ldcs) can gain from a deal on:

—food: world supplies would rise, costs fall, and the hungry benefit, from redirecting aid and investment, water-control and fertilisers, towards poor family-farmers in ldcs;[1]

—energy: shortages and risks could be alleviated least expensively by concentrating exploration on ldcs,[2] and conservation on dcs;

—debt: major default risks for dc banks, shortage of cash for the lowest-income developing countries (LICs), and uncertainty and high cost of credit for middle-income developing countries (MICs), all require attention;

—recycling: if OPEC surpluses are not placed in ldcs to permit extra imports from dcs (tri-cycling) ldcs will cut their purchases of such imports, and will be driven towards costly borrowing, reduced growth, or IMF loans conditional on domestic deflation; then *world* demand and incomes would fall.

There is widespread agreement on the 'real' issues: food and energy. However, three obstacles frustrate the implementation of Brandt. First is the evasion of the financial issues: debt and recycling. Second is the resultant trapped, stagflationary mode of thinking of some dc politicians and bankers, who come to see extra ldc demand—whether out of aid or out of recycled oil surpluses—as a source of dc inflation, not of extra real output. Third is the non-involvement of OPEC in post-Brandt analysis and negotiation.

The financial log-jam has to be broken, the seriousness of the risks recognised, and OPEC involved in a twin approach to debt guarantees and surplus placement in ldcs. Otherwise the world is headed for deep, prolonged recession. The long-run causes of that danger are monetarist contractionism in the financial sphere, and—ironically, given the free-market pedigree of monetarism—the *resulting* protectionism, in the real-exchange sphere, of nations in recession. The short-run trigger will be major defaults on ldc debt, inducing cumulative cash contraction by the lending banks. The worst-damaged victims will be the LICs—Bangladesh, India, the Sahel. They borrow little from the world's banks and are unlikely themselves to default, but they will suffer grievously from the cumulative contraction of aid and trade if MICs do so.

Hence it is imperative to galvanise or improve upon the diffuse, poorly-articulated systems for implementing Brandt.[3] The starting point is the debt threat. Effective consolidation here has to be linked with longer-term recycling. OPEC has to see clear economic benefit from this joint process.

The Problem

Third World debt: the menace of optimism

'The consensual optimism of professional commentators'[4] leads them to oppose 'efforts to create new facilities with a view to dealing with a generalised [debt] crisis'.[5] As the optimists see it, despite 'prophecies of doom, the international private capital markets have [managed] to function smoothly and to absorb and channel funds'.[6] The frequency of error has not risen; 'since 1956 there have been 38 multilateral debt renegotiations', with 'two to three reschedulings a year'[7] both before and after 1973. The World Bank stresses that ldc debts grew more slowly in real terms in 1973-77 than in 1969-73; are concentrated on 'few countries, most [with] good growth prospects and reasonably sound economic management'; and are used in part to build up reserves.[8]

Yet—as the banks recognise—people who show that they are 'doing their job' by lending, whether in regional offices of the World Bank or in foreign branches of commercial banks, tend towards over-optimism about repayment prospects. This over-optimism even extends to 'sensitivity analysis', of the extra risk of default if various things go wrong. Objective head-office systems to evaluate default risk are not used in some banks; are reviewed against experience in few (where they perform badly); and anyway generate lending criteria that are 'relaxed [when] banks need to lend',[9] eg when they are awash with OPEC cash.

What reasons, apart from pressure to lend, account for this tilt toward optimism?

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1) The debt service ratio (DSR) (ie the borrowers' recent burden of debt repayment (capital plus interest) as a proportion of its recent export earnings) is commonly used as measure of default risk. The use of average DSRs for *groups* of ldcs understates the difficulties of *particular* ldcs.[10]

2) Many important debts are omitted from these DSRs.[11] Short-term loans (for less than a year) are always left out; few countries report loans to buy arms; and fewer than one in three of the World Bank's sample of 'important' borrowers informs it about private debts that are not publicly guaranteed. The last category alone, at the end of 1977, was estimated to raise MIC long-term and medium-term debt from $149.4 million to $192.6 million, or by 29 per cent—presumably concentrated on particularly risky loans, and hence with higher interest-rates, shorter maturities, and thus much greater percentage effect on the DSR[12] than the 29 per cent figure suggests.

3) It is assumed, after the 1979-80 oil price rises, that OPEC (and therefore the banks) will have lots of loanable cash for ldcs with otherwise dangerously high DSRs. However, such cash will not readily be placed by OPEC with high-risk banks, or by banks, especially newcomers, with high-risk customer countries. OPEC can leave its oil in the ground, or its cash in gold. Banks can recycle to dcs. Nor can 'swap arrangements' be assumed to funnel cash smoothly towards at-risk banks, especially under stress.

4) Extrapolation from past non-default at a given DSR is over-hopeful in three ways. First, the proneness of DSRs to shoot up suddenly is not realised. Second, the capacity of each MIC, and of the world financial system ('the market') to handle a *given* DSR is overstressed, on the basis of 1973-75 experience. Third, the factors 'converting' a given DSR, handled in a particular way, into a repayment crisis are assumed to be more favourable and more stable than they really are. This over-hopeful extrapolation overlooks several points.

a) The success of 'the market' in avoiding default after the 1973 oil price explosion was substantially due to the expansion of aid; partly due to the entry of OPEC donors, aid rose by 105 per cent in cash terms between 1972 and 1975, while prices of goods in aid contracts rose 'only' by 39 per cent.[13] There seems little hope of a corresponding increase now. Yet the real price of oil rose by at least 80 per cent from 1978 to 1980,[14] implying almost as big a rise in the MIC's need for balance-of-payments finance as in 1973-75.

b) Export volume or price can fluctuate more violently, or grow more slowly, than expected—turning DSR up sharply. Even after 1973, primary commodity price falls severely damaged the creditworthiness of the Philippines and Zaire, and bad cotton harvests had analogous effects in Peru and the Sudan.

c) In particular, and alarmingly, World Bank projections of ldc exports appear to depend on 'high case' assumptions regarding growth in dcs and their willingness to accept ldc imports. Growth of industrialised countries at 3.3 per cent yearly in 1980-85 and 4.0 per cent in 1985-90, and corresponding import growth at 4.3 per cent and 5.3 per cent, seems a hopeful view to take.[15] If it is hopeful, ldcs lose all ways: export revenues, aid prospects, and private capital flows all decline. Can they meet debt then?

d) Whether a country can service debt—the relevance of a DSR—also depends on its import bill. Oil prices, harvest fluctuations, and other instabilities also limit the usefulness of extrapolating from today's DSR to tomorrow's repayment.

Despite all this, official documents often assume that improvements in ldcs' economic performance under debt stress are attainable by ldc action, will be sufficient to achieve adequate debt management with likely future DSRs, and if nothing else, are likely because necessity is the mother of invention. All three assumptions are dubious. Debt stress associated with 'Western' protectionism, and with what MICs may perceive as usury, may instead cause Latin American MICs, in particular, to conclude—conveniently for their politicians, but not wholly unjustly—that debt burdens prohibit good domestic performance; that if attained it will be punished by creditors, (who will insist on repayment instead of rescheduling); and that financial respectability is therefore less rewarding than joint, pre-emptive and orchestrated default.[16]

The default risk

In the late 1960s, aid comprised over two-thirds of ldc debt. Now it is below one-third. Even the full Brandt proposals would barely raise this share.[17] The new debt is owed mainly to commercial banks. Unlike aid—or direct and portfolio private investment—this new commercial debt is:

—very concentrated: seven ldcs (all MICs) owe about half private ldc debt; ten US banks account for 75 per cent of US private claims on ldcs; and a few banks (directly or via offshore subsidiaries) are heavily exposed in one or two high-risk ldcs;[18]

—quick-maturing, often in two years or less (to meet $131.3 billion owed to commercial banks by Latin America on 1 January 1980, its bank reserves totalled only $54.9 billion, yet $56.7 billion fell due in 1980);[19]

—at full commercial rates, floating up or down with LIBOR but ¾—2½ per cent higher, and often supplemented by hidden fees or commissions;

—seldom directly linked to a project's repayment capacity: a public guarantee will do—and many loans support consumer imports, or investments that increase profit at the cost of wages (eg tractors that replace ploughmen) or of other firms' profits, rather than raising the recipient nation's GNP and hence repayment capacity.

In a frightening pyramid of musical chairs, each bank expects repayments out of the borrowing countries' capacity to borrow still more, rather than out of the yield of the purchases financed by itself. Yet countries' ability to borrow more is erratic.

Increased world political instability, and its effects on prices of gold, currencies and oil—and on demand for arms—can *suddenly* divert surplus cash away from ldcs. 'New lending to non-oil ldcs shrank from $12.2 bn in the fourth quarter of 1979 to $4 bn' in the first quarter of 1980.[20] Table 1 shows the results of cumulated borrowing, and of the over-optimism discussed in the previous section. In Table 2, various risk factors are shown. This table does not purport to be scientific but it does bring out several points:

—that net oil exporters are sometimes at risk, too;

—that copper production goes with a high debt/GNP ratio;

—that some very weak DSRs are offset by strong bank positions (but can these be 'mobilised' to meet a debt crisis?)

—that others are offset by large economies (low ratios of debt service, and of current deficit, to GNP);

—that some risky DSRs are made riskier by high imports (bad current balances of payments) relative to GNP;

—that a few MICs, and even some oil exporters, score 'Yes' or 'Almost' in alarmingly many columns.

The nature of a possible debt crisis

Too often, the optimists have not been effectively challenged because the crisis has been specified much too vaguely. It is not a 'general crisis of capitalism' in any Marxist sense. It is not that 'the viability of the international monetary system would be undermined', or that ldcs' 'failure to meet their obligations will trigger an international crisis that will endanger the viability of the international monetary system'.[21] Michalopoulos rightly rejects such blurred images, in which the world falls off an unspecified cliff, or numerous big banks cannot repay depositors.

In the likely crisis scenario, two or three large private debtors among ldcs—faced by dearer oil, depressed export markets, and poor harvests necessitating food imports—cannot repay, say, three to five major Western banks. Some $10 bn, which these banks expected to be repaid, is instead formally defaulted, or must be 'rescheduled'. What does a bank, faced with a big cut in its cash base, do? It is easiest to answer the question if we look at it the other way round. By law or by custom, a bank keeps a prudential 'cash ratio', typically 10 per cent, between cash-in-hand and liabilities to depositors. If cash-in-hand *rises* by $10 mn due to extra deposits, such a bank will raise advances by (100-10) per cent of $10 mn, ie by $9 mn, and keep the extra $1 mn as cash. Most of the extra $9 mn—in a dc typically about 80 per cent—finds its way as cash deposits into the banks, permitting a second round of extra advances: (100-10) per cent of that 80 per cent of $9 mn or about $6.5 mn. This permits a third round . . . and so on; in this quite realistic example, a $10 mn cash expansion, for a bank, produces an ultimate credit expansion of $33,3 mn from the banking system. But a 'cash outflow', such as a default on a loan due for repayment, 'puts the credit multiplier into reverse, when it becomes the credit contraction multiplier . . . Loans are called, investments are liquidated, and deposits contract by a multiple'.[22] The multiplier of only 3.3, in the event of a series of defaults of $10 bn concentrated on loans due to a few banks, is too optimistic, because the affected banks would have to call in even more cash: partly to anticipate panic withdrawals by raising the prudential cash reserve ratio; partly to make good the cash actually lost through such withdrawals; and partly to attract funds by raising interest paid to depositors. A $10 bn cash contraction due to default could lead to reduction in lending by the banking system of up to $50 bn. Not only LICs, but even prime industrial borrowers who had been relying on renewed accommodations, would be at risk. Defaults and bankruptcies would echo, not mainly around banks, but around dc and ldc firms.

It might not in practice be quite that bad. First, the banks could restore part of the depleted cash ratio by selling securities, rather than by cutting advances; but this mainly transfers the cash contraction (to the buyers of securities) rather than eliminating it. Second, swap arrangements among banks could achieve something. Third, OPEC funds could help a little, though they are unlikely to go to banks, or even lender countries, over-exposed in defaulting (or 'rescheduling') ldcs; indeed, oil producers, if they lose trust in Western banks as a whole, will be tempted to leave their oil in the ground. Fourth, some banks might borrow from the Central Bank as 'lender of last resort'; but such credit might well be neither sought (due to its high price) nor supplied (because banks would be told to call in risky advances before the Central Bank admitted a 'last resort' was required). Fifth, dcs might bale out affected banks cheaply, or allow IMF to expand SDRs with similar restorative effect on the credit base; but would either time during a sudden crisis or monetarism

permit? In any event, neither central banks nor IMF lend direct to firms, in dcs or in LICs; and it is firms, not banks, that are at most serious risk in this scenario.

All in all, general cures *after* LIC defaults would do little for these firms, and almost nothing to restore the lending capacity of the particular affected banks. Even if it was restored, those banks would receive loan cash, corresponding to liabilities, which creates less willingness to re-expand risk lending than does the return of expected unencumbered cash owned by the bank itself. Failure of such return, through default or rescheduling concentrated by a few ldcs on a few banks, would have a large cumulative deflationary impact. If we are very optimistic, we could hope that OPEC, swaps, and governmental baling-out would reduce the contractionary effect of $10 bn LIC non-repayment upon dcs, from the $50 bn suggested above, to (say) $35-$40 bn.

How serious is the risk of such defaults? The tables speak for themselves. In view of recent pronouncements by such experts as David Rockefeller of Chase Manhattan, Dr Guth of the Deutsche Bank, the Governor of the Bank of England, and Peter Peterson, it is no longer possible to write off these short-term risks as 'scare scenarios'. What is 'around the corner' in a non-Brandtian world is not catastrophe for all. It is a steady series of deflationary shocks, starting from non-repayments or rescheduling, and multiplied by the effect of eroded cash upon bank lending. The worst sufferers will probably be the poorest developing countries, who borrow little from commercial banks, but partly depend for their precarious levels of living upon exports and concessional capital, which recession erodes.

Solutions, Bogus and Genuine

The problem is both too little credit and too much: too much loaned in search of quick profits at swift maturity and high risk, to a few increasingly overburdened MICs; too little long-term credit, at low but safe real rates of interest, both to reduce risks to MICs and to speed development in LICs. Deflationary treatment—less or harsher credit—could make matters worse. But an expansionary treatment might just pump more air into the unsound credit balloons of some MICs, and is anyway seen by some dcs as inflationary. Furthermore, some simple expedients (such as retrospective adjustment of terms of aid loans) are either exhausted already, or too weak to help, or palpably unfair. While the short-run danger has to be tackled—by a mixture of guarantees and credit planning that, nevertheless, preserves some freedom of responsible action for borrowers and lenders as well as intermediaries—it will recur unless the underlying issue, long-run credit tri-cycling, is tackled also.

Cutbacks will not do

Brandt rightly rejects a 'solution' that simply cuts back on private loans. This might indeed raise the share of 'sound' aid in total debt. However, many private loans do support genuine development. Others are needed to help debtor nations to refinance older debts.

Nor is there a solution by simply expanding most current forms of IMF aid. It is too short-term, too little, and too deflationary in its conditions. The Jamaican case shows this dramatically. The IMF President, M. de Larosière, himself recognises it.[23]

The 'Paris Club' and analogous arrangements have rescheduled private debt about 40 times in 1956-80. However, the Club has several drawbacks. First, it could never defuse a widespread threat of possible defaults, because it acts only if a particular nation's default is almost imminent. Second, the 'Club' is very reluctant to reduce the severity of loan terms (as opposed to extending the repayment period), so that it buys time—a worthy aim—rather than solving problems at root; more seriously, this severe approach puts more strain on relatively ever-scarcer aid, which can then be represented as paying ldcs to repay harsh private 'risk' creditors. Above all, the 'Paris Club' normally lends only to ldcs that accept the IMF's conditions.[24]

Hence all these three options alone—less 'unsound' private lending, more use of the IMF, the 'Paris Club'—drive out the deflationary devil with a perhaps equally deflationary Beelzebub.

Soundness without tears?

Can an alternative be found, enabling ldcs in repayment difficulties—often not their fault but due to oil import prices, depressed export markets, etc—to escape without curtailing growth, and especially without unemploying and impoverishing their poorest people?[25] (Since capital can move abroad if profits fall, it is likely that 'unemployment and stagnant or declining real wages are more probable' results of ldc deflation.[26]) Can one have either

—a response, to external debt needs, that mobilises extra domestic *supply* of tradeable goods (but not equivalent import demand), instead of a response that deflates home *demand* and hence imports; or else

—if there must be a contractionist response, one that 'sheds its load' on the better-off instead of penalising mainly the poorest?

For example, could Jamaica and the IMF, in Spring 1980, have agreed on a solution that *both* enhanced Jamaica's repayment capacity, *and* allowed the Government to pursue socialist, or otherwise egalitarian

and growth-enhancing, policies? 'IMF loans'—and the Paris Club—'regularly require economic policies that rest on social and political repression. Today, there are probably no alternative policies that would permit ldcs in trouble to balance their external accounts'.[27] Yet neither Communist countries nor relatively egalitarian capitalist ldcs such as Taiwan have had bad default records.

The imperative—for short-run debt improvement and hence for IMF action—is to analyse and support policies permitting ldcs to develop 'sounder' debt positions *without* savage deflationism and inequality. This imperative is as much political as economic. In the world economy, however, it is needed to prevent the cure for default risks from being as contractionist—not least of dc economies—as the disease. After all, in EEC in 1980, 'there would be 3 mn more unemployed if the non-oil ldcs had cut their manufactured imports to meet the increased oil prices of 1973-74 rather than borrowing'.[28] There is a massive *Northern* interest, as Brandt stresses, in avoiding contractionist knee-jerk responses in debt crises by, and to, the South.

Currently favoured approaches

The deflationary cures to an ldcs short-run debt crisis can be worse than the disease. No acceptable domestic solution via supply expansion, or deflation of demand confined to the rich, has yet been devised (though I think this is a possible task). Three possible approaches are favoured instead.

The first approach involves aid debt forgiveness. Already 'retrospective terms adjustment' has softened past aid loans to LICs from most dcs, and already the grant element of new aid is well over 90 per cent. Some progress could be made if the USA accepted terms adjustment, and if Japan raised its grant element.

However, such improvement in aid:

—would be small in effect;
—could be at the expense of more aid;
—would rightly stress the LICs, not the MICs where the main debt problem lies;
—could divert aid from ldcs and dc banks; why should not the risk-takers sometimes lose their own money?

The second approach takes off from this final, somewhat moralistic objection. To avoid bankruptcies, bankers often give 'debt relief . . . out of enlightened self-interest'.[29] Can such specific remedies perhaps be anticipated and generalised? Under a guarantee scheme, both banks and direct OPEC lenders would trade in, say, half their ldc credits (not, of course, just bad debts chosen by them!) in return for bonds, guaranteed but bearing much lower interest. Whether the guarantor would be IMF, the World Bank, or a mixed or new institution is a secondary but important issue. So is the balance of finance for such a scheme, as between lenders (acting as mutual insurers), borrowers and international organisations.[30] In any case, it is an inadequate argument, against such a scheme, to claim that it is a *general* remedy, whereas crisis threats are particular to countries and general systemic collapse is vague and implausible.[31] As explained, the problem lies in the international transmission of deflation, starting from particular ldc defaults, via particular banks' cash-ratios, to multiple, general credit contractions by banks. The globe does not fall off a cliff; it gradually deflates! Debt guarantee systems can greatly reduce these risks.

The missing link: tri-cycling

The third currently-favoured approach involves 're-cycling' of OPEC funds towards dcs—or, if to ldcs, largely as a way to meet extra oil bills. Neither method suffices to secure the long-term credit base for world expansion.

Straight recycling of OPEC cash to dcs alone would leave ldcs with 'no relief for their massive trade deficits'. That would compel a 'decline in [dc] exports to the ldcs [and thus imperil] the fragile economic recovery of the West'. Unfinanced ldc deficits 'could also force a moratorium on payment of the outstanding private and official debt by the ldcs'.[32]

OPEC recycling to ldcs, fully matched by increased purchases by ldcs of OPEC oil, leaves no extra cash to expand ldc imports from dcs. Indeed, it compels contraction of such imports, as interest on OPEC commercial debt builds up. Further, it assumes no attempts by, or for, ldcs to replace imported fossil fuels. Since ldc growth would further expose all these raw inadequacies of a simple recycling procedure, they render such growth that much less likely.

There are three requirements to restore balance, in a way neither deflationary nor inflationary, to OPEC, dc and ldc trading positions, after oil revenues transferred to OPEC from dcs and ldcs rise sharply:

—to enable OPEC to place its extra cash in sound investments (commercial or concessional) in dcs and ldcs, both to enable them to buy sufficient oil and to permit ldcs, in early development, to run import surpluses with dcs;

—to enable dcs to export more to ldcs and to OPEC, thus converting an almost unmanageable balance-of-payments strain into an easily-manageable small sacrifice (of domestic consumption to production for exports);

—to enable ldcs to run the current-account deficits needed to continue growth—ie to expand imports from dcs, and not to contract rapidly the volume of oil-based imports—while building up the sectors that will eventually produce the exports (or replace the imports) to repay the debts and to eliminate the deficits.

OPEC must therefore be involved in any programme of 'massive transfers' to ldcs. Ldcs will have to use substantial parts of those transfers to buy extra dc exports. And dcs will have to sacrifice some consumption to make those exports, and hence at first to pay for dearer imported oil, but increasingly for the balance-of-payments costs involved in investments in domestic energy conservation, exploration and development. This is tricycling: OPEC funds to ldcs to buy dc exports; the extra dc revenue (from exports to ldcs) to maintain, then partly replace, imports of OPEC oil; the ldcs' extra OPEC funds, in part, to buy extra goods from dcs (and in part to service OPEC loans).

The empty chair

Tri-cycling and debt guarantees—the long-run solution and the short—need each other. Brandt rightly stresses the gains to dcs and ldcs. But the empty chair, at the post-Brandt discussions, has been that of OPEC. If OPEC is absent, so is the ultimate creditor in a tri-cycling process, and the party to whom most risky debts are *ultimately* due.

What would be the costs and benefits to OPEC countries from a Brandt-style settlement? Much the same as to the intermediary banks. They would *gain* international guarantees against default, financed partly as mutual insurance, partly by new special funds (to be raised, perhaps, by the World Bank). In return, they would *lose:*

—some freedom to select objects and customers for lending (clearly loans can be guaranteed only if their quality is controlled);

—as debt was funded, some of the risk-premium implicit in the former high interest rates;

—some corresponding power to search out high interest-rates on risky loans.

Given present risks, that seems a good deal for OPEC. It should also be possible, with such guarantees, to steer much larger shares of OPEC tri-cycling towards the really poor countries of South Asia and Eastern and Central Africa. In any event, many senior civil servants in such countries (notably India) regard 'deflation via default' as their main single international nightmare, and its prevention as their top priority for world financial reform, even though their own countries are not now and may not be in future major borrowers from private banks. But there will be no remedy unless OPEC fills the empty chair.

There has been *some* tri-cycling. OPEC's aid, as a proporton of GNP, has been generous (but declining,[33] concentrated on a few, mainly Arab or Moslem, MICs; and insufficient—unless supported by large, private flows—to cope with, say, the $60 bn deficits of oil-importing ldcs in 1980).[34] Nor has OPEC's chair always been empty. The International Fund for Agricultural Development is a classic institution for tri-cycling, with OPEC, Northern donors, and ldc recipients equally represented. OPEC countries have participated in regional development banking; have organised their own banks for development investment overseas; have channelled cash to banks lending (but often riskily) to ldcs; and have, to a small extent, invested in ldcs directly. But most of these processes are one-off, small, unintegrated, and above all unlinked to a general post-Brandtian search for a new credit dispensation. Nobody can be sure that, lacking such a dispensation, the deflationary menace of echoing defaults will come to pass. But the risk is big, and serious, enough to require OPEC—in its own interests, not just in the Brandtian 'common interest' of dcs and ldcs—to fill the 'empty chair' in *global* negotiation about the whole Brandt package, financial and real.

Why the Silence?

Why has this crucial issue been so little discussed?

First, it is because obvious ways out—IMF, the Paris Club, fewer or 'sounder' private loans—are thought by some to be sufficient, and realised by others to be insufficient. The former see no need for discussion. Many of the latter see nowhere to go.

Second, it is claimed that the massive extra OPEC surpluses of 1979-80, as in 1973-76, can be successfully placed by the banking system. However, this is the same over-aggregative wishful thinking that led to the refusal to recognise a 'debt problem'.[35] 'OPEC as a whole' may seek to place vast, growing surpluses in 'ldcs as a whole' through 'the banking system', while *particular* countries providing major OPEC cash, especially Saudi Arabia and Kuwait, place no new cash in *particular* banks seen as over-exposed in *particular* ldcs.

Third, some people argue that discussions of debt crisis will, by reducing 'confidence', cause what they discuss. This assumes that bankers and lenders are unaware of the issues. It is more probable that matters will reach disaster point through neglect than through open analysis.

Inflation or reflation?

The main reason why dcs have been reluctant to discuss these issues seriously, however, is the fear of renewed inflation as extra ldc cash is spent. Many sceptics do not see a shared Western interest in higher ldc purchasing-power. They argue as follows: 'the last thing that monetarist dc governments, terrified of renewed inflations, want is extra monetary demand. Why should they revive the inflationary dragon by throwing dc taxpayers' cash at ldcs, while taking unpopular measures to dry up cash flows at home'?

There are two rejoinders, one 'global' and the other 'local'. Globally, monetarism—whatever its virtues in explaining the rate of inflation in one country[36]—cannot account for world-wide inflation during recession, expecially with floating exchange-rates among main trading currencies. It is more plausible to interpret events since 1973-74, world-wide, as follows. Oil price-rises greatly inflated costs, but deflated domestic demand, in dc and ldc oil-importers. Many also had cost-inflationary transmission systems, allowing non-competing groups of workers and their employers—with near-monopoly control over coal, or garbage-clearing, or medical services—to pass on higher prices and costs. Governments, failing to restrain either cost-push (by cutting oil imports) or cost-transmission (by controlling, or getting agreement among, monopolists of key forms of labour or of outputs), have desperately responded to real cost-inflation by monetary demand-deflation. While enough of such nasty medicine can work, the patient may die first. Meanwhile, deflation of national demands for non-oil *imports* transmits recession internationally, stimulating the cry for protection. To the extent that this analysis is right—and only a *very* dogmatic monetarist would deny it major elements of truth—ultra-monetarist objections to Brandtian 'ldc reflation' are reminiscent of the man who, having murdered his parents, seeks clemency on the grounds that he is an orphan.[37]

There is also a 'local' rejoinder. Suppose we accept that *generalised* extra demand for dc products as a whole, while expectations remain inflationary, will generate inflation rather than extra real output, even in recession. Cannot extra *ldc* demand for a dcs exports nevertheless induce more real growth, and less inflation, than extra demand from other dcs or from domestic sources? During recession, some dc sectors suffer much more severe cutbacks than others. In particular the investment-goods sectors suffer severely. If recession reduces expected growth of real GNP from four per cent yearly to two per cent, and if each unit of output requires three units of extra capital, then net investment falls from 12 per cent of GNP to six per cent.[38] Massive spare capacity in investment-goods (and to a lesser extent other producer-goods) sectors is thus created, even if all the consumer-goods sectors experience is a gentle slow-down in growth. Hence extra export demand, if steered to the industries experiencing especially severe recession (steel, machinery, construction), will 'find' many half-idle machines and specialised workers; to re-employ these will not create excess demand for labour (bidding up wage-rates), and may even cut unit production costs.[39] There is good reason to expect ldc purchases from dcs, especially out of aid or carefully-supervised bank loans, to be geared much more towards acquisition of investment-goods than is the case for 'any old' extra demand. Hence the balance between induced growth and induced inflation, for dcs, is likely to be especially favourable if the inducing agent is extra demand from ldcs.[40]

One must agree with the IMF view: 'Increased financial aid . . . could increase global demand and thus contribute to a reactivation of world trade in a recovery of production. There is nothing in the present state of deflationary chain reactions in the industrialised world, stagnation feeding inflation, which would argue against such an increase in financial aid.[41] Aid is a stabilising, necessary, but *small* part of reliable 'massive transfers'. These, in turn, are only one component of the post-Brandtian package: debt guarantees (and softenings), tri-cycling, energy, food.[42] But fear of renewed dc inflation should not deter prompt work on the restoration, mainly through tri-cycling twinned with the restructuring of Third World debt, of ldc demand for dc exports. Few forms of reflation have a better prospect of expanding output, rather than price-levels, in dcs. Few, if any, carry such serious risks if *not* undertaken.

References and notes

1. For convincing proof of the greater efficiency in ldcs of small family farms, see A. Berry and W. Cline, *Agrarian Structure and Productivity in Developing Countries*, Johns Hopkins, Baltimore, 1979. Mr. Heath's 'fourteen points' (see *The Times*, 19 June 1980) accordingly include a scheme to finance the reallocation, to such farmers, of some of the fertilisers now used—with low marginal product, but cumulative environmental risk—on big farms in rich countries. Perhaps 30-35 per cent of the value of nitrogenous fertilisers comprises energy costs.
2. *North-South: a Programme for Survival* (Brandt Commission Report), Pan Books, London 1980, p 164; such prospecting currently runs at 2½ per cent the rate, per unit area, prevailing in comparable developed countries! The World Bank has tabled proposals to fund an affiliate for energy search and development in ldcs.
3. M. Lipton, 'Brandt: whose common interest?', *International Affairs*, Spring 1980, pp 317-27.
4. A. Fishlow, 'Debt remains a problem', *Foreign Policy*, 30, Spring 1978, p 133.

5. C. Michalopoulos, 'Institutional aspects of developing countries' debt problems', in *The New International Economic Order: a US Response*, New York University Press, 1980, p 315.
6. Michalopoulos, p 309.
7. Michalopoulos, p 302.
8. World Bank, *World Development Report 1979*, Washington, 1979, p 29.
9. Fishlow, p 145.
10. In 1965-76, some 40 cases of repayment difficulty were identified, as against 540 cases where there was no problem. In 90 per cent of the 'difficulty' cases, but in only 12 per cent of the 'no problem' cases, was the DSR above 20 per cent. But in 66 out of 102 cases of DSR above 20 per cent, no problem arose. Clearly no particular ratio can prove risk. But it is unfortunate that officials argue both
    a) that *particular* (sometimes 60 per cent +) DSRs in Brazil, Mexico, etc are no cause for concern—that such countries are growing, are well-run, contain a small proportion of total bank risks, etc;
    and
    b) that *aggregate* MIC ratios rising only from 10.2 per cent in 1970 to 11.8 per cent in 1977 (even if we later have to adjust these the 1977 ratio to 19.8 per cent for MIC oil-importers, rising to 25.7 per cent in 1980, with more upward adjustments on the way) are a cause for comfort, proof that exports are keeping pace with debts, not much above 1973, etc. For analysis and identification of cases see G. Feder et al, *Estimation of a Debt Service Capacity Index*, World Bank, Washington, 1979. (A 'case' is an observation on one country for one year.) For data on aggregate ratios see Michalopoulos, op cit p 310; for upward trends in MIC DSRs see World Bank, *World Development Report 1980*, Washington, 1980 (hereafter *WDR*), p 10 and below.
11. *WDR*, p 161.
12. Michalopoulos, p 297.
13. OECD, *Development Cooperation 1979*, pp 199, 207.
14. *WDR*, p 3.
15. *WDR*, pp 6-7.
16. B. Lietaer, *Europe + Latin America + the Multinationals*, Saxon House, 1979, pp 72-9.
17. By 1985, aid and private flows are each to expand by $30 bn (Lipton, p 324).
18. *World Development Report 1979*, p 31.
19. Bank for International Settlements, 'Maturity distribution of international bank lending—end-December 1979', mimeo, Basle, July 1980, p 2.
20. Bank for International Settlements, 'International banking developments—1st Quarter 1980', mimeo, Basle, 29 June 1980, p 4.
21. Michalopoulos, pp 293, 308.
22. D. Geldenhuys, *Money and Banking*, McGraw Hill, 1975, pp 10-11; see also A. C. L. Day, *Outline of Monetary Economics*, Oxford, 1957, pp 130-1.
23. *The Times*, 7 October 1980.
24. A. C. Cizauskas, 'International debt renegotiation: lessons from the past', *World Development*, no 7, 1979.
25. Michalopoulos, pp 301-2.
26. Fishlow, p 240.
27. R. S. Weinert, 'Why the banks did it', *Foreign Policy*, 30, Spring 1978, p 148.
28. R. Jolly, p 42, op cit.
29. Cizauskas, p 199.
30. Fishlow, pp 141-2; and A. Fishlow, 'The mature neighbour policy', Policy Papers in *International Affairs*, no 3, Berkeley, 1977.
31. Michalopoulos.
32. K. Lipper, 'Cartels are no solution', *Foreign Policy*, no 30, Spring 1978, p 157.
33. *WDR*, pp 28-30.
34. *WDR*, p 3.
35. See p 2 ff above.
36. Even these virtues are limited, in my view. Money, the control of whose supply is supposed to determine the rate of inflation, has typically several different definitions, and its quantum moves differently according to the definition chosen. Moreover, there is no evidence that the velocity of circulation is sufficiently stable for control of *any* money-supply to determine prices. It must be true that *indefinite* expansion of the monetary base will, eventually, raise prices faster than output or imports; but how much, when, what base, are *not* questions with scientifically precise answers, even ± 25 per cent.
37. L. Rosten, *The Joys of Yiddish*, Pelican, 1971, p 94.
38. This is the famous 'principle of acceleration'. Output of investment-good is not cut by as much as half, partly because replacement investment (and much public investment) are not cut back nearly as rapidly as new private investment. But investment-goods production *is* cut much more in slump than is consumer-goods production.
39. *Spending*, out of rises in the investment-goods wages-bill, is also rather less demand-inflationary (and more reflationary of real output) than spending out of wage-bill rises in other sectors. Wage-*rates* are bid up less in the more heavily-unemployed investment-goods sector. Also, that sector tends to be concentrated in depressed *regions*, where revived demand can call into play consumer-goods production that has more spare capacity than in other regions of the economy.
40. Alfred Marshall rightly suspected 'long chains of argument' in economics. The case made here (and in note 39) certainly requires empirical testing. I remain fairly confident that it is correct.
41. M. de Larosière, cited in A. R. Jolly, 'Restructuring out of recession', *IDS Bulletin*, vol 11 no 1, November 1980, p 42.
42. Inclusion of disarmament, and many other important matters, has unfortunately diverted attention from the central theme of Brandt (Lipton, especially p 326).

Table 1

Debt Positions of Selected Developing Countries, 1978 and 1979

	debt service ratio (%)			*debt service ± GNP (%)*		*current A/C balance of payments ± GNP (%)*	*position with commercial banks at 31 December 1979 ($mn)*		
	early 1980 est	*mid-1980 est*		*early 1980 est*	*mid-1980 est*			*liabilities:*	
	1978	*1978*	*1979*	*1978*	*1979*	*1978*	*reserves*	*total*	*due in 1980*
Low-Income Oil Importers									
Bangladesh	11.7	11.8	12.0	-1.3	-0.9	-4.0	385	85	36
India	9.4	9.8	8.7	-0.8	—	+0.8	3,873	908	336
Kenya	8.3	14.9	10.8	-2.4	-4.0	-9.8	1,173	755	224
Pakistan	12.2	12.4	13.8	-2.1	-1.2	-3.1	747	900	435
Tanzania	7.4	7.0	7.2	-1.1	-1.1	-11.3	175	232	96
Middle-Income Oil Importers									
Argentina	26.8	37.1	25.5	-3.5	-3.6	+5.0	8,108	13,427	6,946
Brazil	28.4	50.6	66.5	-2.2	—	-2.8	8,466	38,617	11,279
Chile	38.2	45.8	42.6	-7.3	-9.6	-4.4	2,408	4,864	1,980
Colombia	9.8	11.9	10.9	-1.7	-1.7	+1.4	3,897	3,560	2,163
Ivory Coast	14.1	20.1	23.3	-5.9	-7.6	-8.1	751	2,429	748
Korea (S)	10.5	11.3	11.4	-3.9	-3.8	-1.1	3,239	11,968	6,712
Morocco	18.7	19.7	24.8	-4.3	-3.5	-8.2	1,061	3,381	645
Peru	31.1	45.5*	41.8*	-7.4*	-10.0*	+1.0	1,780	3,751	1,894*
Philippines	13.4	26.6	18.1	-2.8	-5.1	-4.3	2,986	7,381	3,925
Senegal	14.9	14.9	15.4	-5.4	-4.8	-6.2	120	368	156
Sudan	9.4	9.4	20.2	-1.4	-1.4	-1.0	505	960	493
Thailand	3.7	16.1	10.3	-0.9	-3.4	-5.0	1,642	3,696	2,368
Turkey	11.0	26.7*	30.2*	-0.9*	-1.8*	-2.2	1,199	3,928	1,388*
Yugoslavia	3.2	12.3	16.6	-0.7	—	-1.6	2,134	8,247	1,866
Zaire	31.3	32.6	10.6*	-6.5*	—	+1.6	905	1,259	398*
Zambia	20.8	34.9	28.4	-7.1	-11.2	-7.5	289	565	258
Oil Exporters									
Algeria	20.9	23.0	25.7	-5.9	-6.2	-13.4	3,049	9,044	1,310
Bolivia	48.7	60.1	37.9	-8.5	-10.2	-11.1	250	1,432	676
Egypt	22.2	22.2	18.8	-8.7	-4.7	-3.5	4,166	2,217	1,274
Indonesia	13.0	16.7	16.7	-3.1	-3.5	-1.5	5,162	5,806	2,273
Malaysia	8.8	9.8	5.3	-4.6	-5.0	+2.0	3,302	2,235	818
Mexico	59.6	66.2	31.4	-6.9	-7.4	-1.1	8,013	30,914	10,679
Nigeria	1.2	2.0	1.8	-0.3	—	-8.2	1,967	3,461	1,017
Venezuela	6.9	9.6	10.6	-1.9	- 2.8	-12.2	14,196	20,804	1,260

*artificially low due to rescheduling.

Sources and methods: cols 1, 4: *World Development Report 1980* (hereafter *WDR*), pp 134-5; cols 2-3, 5: non-attributable information on debt-service/export ratios. plus (for col 5) *WDR*. p 119, on export/GNP ratios; col 6: *WDR*, pp 110-1 for GNP, pp 134-5 for current balance of payments (*before* debt interest). (Note that col 6 *excludes* current debt service; it also excludes capital repayments. which are on capital account; hence cols 5 and 6 can be *added*, to estimate the drain on reserves, or new borrowing not corresponding to new asset creation. required of the country as a percentage of GNP); cols 7-9: Bank for International Settlements, 'Maturity distribution of international bank lending—end-December 1979', mimeo. Basle. July 1980. table.

Table 2

Default Risk Factors

	debt service ratio: 25%+ in 1979	1978 ratio under-reported by 20%+ early 1980	*1979* debt service GNP ratio 5%+	*1978* current BOP deficit (exc. debt service) ÷GNP (%)	*end-1979* bank reserves÷ bank liabils. below 50%	*end-1979* bank reserves less than liabils. due in 1980
Low-Income Oil Importers						
Kenya	no	yes	no	yes (9.8)	no	no
Tanzania	no	no	no	yes (-1.3)	no	no
Middle-Income Oil Importers						
Argentina	yes (25.5)	yes	no	no	no	no
Brazil	yes (66.5)	yes	no	no	yes (22%)	yes
Chile	no	yes	yes (9.6)	no	yes (49%)	no
Ivory Coast	almost	yes	yes (7.6)	yes (8.1)	yes (31%)	almost
S. Korea	no	no	no	no	yes (27%)	yes
Morocco	almost	no	no	yes (8.2)	yes	no
Peru	yes (42)	yes	yes (10)	no	yes	almost*
Philippines	no	yes	yes	almost	yes	yes
Senegal	no	no	almost	yes	yes	yes
Thailand	no	yes	no	yes	yes	yes
Turkey	yes	yes	no	no	yes	yes
Yugoslavia	no	yes	no	no	yes	no
Zaire	no*	no	no?	no	no*	no*
Zambia	yes	yes	yes (11)	yes (7.5)	almost	almost
Oil Exporters						
Algeria	yes	no	yes	yes (13)	yes (34%)	no
Bolivia	yes (38)	yes	yes	yes (11)	yes (17%)*	yes
Egypt	no	no	almost	no	no	no
Mexico	yes	no	yes	no	yes (26%)	yes

*probably would be 'yes' but for rescheduling.