

## FEATURES

# DEBT AND DEVELOPMENT.

JUAN C SANCHEZ ARNAU

Sanchez Arnau of France's Centre International du développement (CID) maintains that a grave debt crisis is emerging in the Third World as a consequence of the recurring deficits in the balance of payments of most Third World countries, and which have so far been financed mainly through external borrowing. Those poor countries whose deficits have been met so far by the transfer of concessional resources could also be strongly vulnerable to the present recessionist trends. The dramatic growth in the foreign debt of Third World countries threatens the very autonomy — both economic

and political — of these countries and effects their sovereignty.

Primarily, the underlying cause of increasing indebtedness is the belief in and pursuance of a "development" model predicted on rapid increases in the GNP through the massive use of capital — both foreign and capital-absorbing. This strategy has led to increased dependence and the marginalization of large segments of the population. To trim only another approach to development, based on the enhancement of endogenous, creative and productive capacities, could assist the Third World out of this debt trap.

### PRESENT SITUATION AND PROSPECTS

Much has been said and written about Third World indebtedness problems and much more will be in the future. Industrialized countries are showing clear symptoms of generalized recession, and contrary to developments a few months ago, no optimism is now expressed about short and medium-term economic prospects. Recent OECD estimates, in the light of the latest increase in oil prices, are much more pessimistic than estimates made earlier this year. As in the past, industrialized countries will probably transfer much of the effects of this recession, or of its implicit costs of adjustment, to Third World countries. Greater protectionism, lower imports, export subsidies, a drop in official financial flows, more or less disguised expulsion of immigrant workers, will be amongst the measures bringing about this transfer. To these will be added the drop in some raw material prices due to the fall in demand.

The impact on the Third World will depend on the scale of the recession, and the time it will take industrialized countries, in particular the United States, to react, under the assumption that this is a more or less traditional cyclical crisis albeit aggravated by new elements, which can be escaped by adopting traditional neo-classical economic remedies. If, however, as many suspect, the present recession

is rather an expression of structural problems affecting the very basis of the functioning of present growth models of the industrialized countries, then the impact of the recession on Third World countries will be greater and more prolonged. In such circumstances, the "debt" problem will become particularly relevant, since it will be the most obvious expression of the incapacity of many Third World countries to resist an aggravation of their balance of payments problems.

If the vulnerability of the external payments situation of many Third World countries has not yet emerged, this has been thanks to a sub-product of the recession and of the international monetary disorder: the high level of international liquidity. Without such a recession the transnational companies and the large companies of the industrialized world would have already absorbed most of the liquid resources available in world financial markets, which are at present being used to finance the Third World's indebtedness. Hence one of the paradoxes of the present situation: the same recession depriving many Third World countries of external resources derived from their exports or remittance of their migrant workers, is generating the liquidity enabling them to contract debts, thus escaping the risk of economic collapse.

This paradox can become a trap with few exists. If the industrialized countries took measure to limit this liquidity, which for ortho-

dox economists is one of the main causes of the monetary disorders at the root of the present crisis, many countries resorting massively to indebtedness would be deprived of these resources, but continue to be faced with the other aspects of recession which have compelled them to contract new debts. And when there is a continuous series of increases in interest rates in industrialized countries and there are daily demands for a greater control on the issue of dollars and the activities of the Euro-market, is such a moment still far away?

In more cases than one, indebtedness may well have been a well-calculated risk, and even a considerable drop in international liquidity within the framework of generalized recession would permit more than one considerably indebted country to escape the risk of problems, and the present situation and future prospects differ greatly default.

However, reservations must also be expressed on this possibility because there is not just "an indebtedness problem" but several from one country to another.

### SIZE AND CHARACTERISTICS OF THIRD WORLD INDEBTNESS

The statistics published by the OECD on public and private disbursed debt show that from 1970 to 1977 the external indebtedness increased from 72.9 billion to 244.0 billion dollars, growing at an annual rate varying from 12% in 1972 to 25% in 1975.

Non-official loans have increased their share of the total from 28.1% in 1969 to 41.1% in 1976, and this share has certainly continued to increase since.

On the basis of figures for the end of 1976, eleven Third World countries accounted for 60% of total public and private debt, i.e. some 115 billion dollars of a total of nearly 195 billion dollars.

While the debt problem is basically concentrated on this group of countries, the situation of many other Third World countries must also be studied to determine the future development of the problems.

On this basis, four types of situation could be considered. First, that of the two major debtors — Brazil and Mexico, with 25% of total Third World countries debt (25.9 billion and 21.7 billion dollars respectively at the end 1977). Their debt service ratio (debt service as percentage of exports) was in 1976 around 45% and 32%, on the basis of "World Financial Markets" data.

These countries' indebtedness is growing and involves significant amounts of their future external resources, considerably burdening their present resources. But these are not exactly the countries which could present major problems in the short term. In the case of Mexico, because of its oil resources could enable it to meet debt service and in the case of Brazil, if its balance of payments problems worsened, its present creditors would be well advised to avoid a collapse which could have repercussions on the entire international banking system.

The second type of debtor country are countries like South Korea, Philippines, Argentina, Chile, Peru and Yugoslavia. Most of them have adopted economic policies of increasing integration with the international market and are strongly oriented to promoting exports of manufacturers and semi-manufacturers. The debts of these countries will probably continue increasing so long as the present international liquidity situation prevails.

There will probably be exceptions, but in any case, this is a group of countries presenting many signs of external vulnerability with increasing indebtedness. Thus the debt service ratio of some of these countries is reaching high levels: 45% in Chile, 41% in Argentina, 28% in Peru (1976 data).

The third type of situation consists of the varied group of countries with fairly low per capita incomes, with an external debt essentially originating in public loans, with debt service ratios between 40 and 18 percent, whose external vulnerability arises from the lack of diversification of the economy, and low rates of growth. This group could include Pakistan, Egypt, Bolivia, Jamaica, Angola, Congo, Guinea, Dominican Republic, Mauritania, Sudan, Togo, Bangladesh, Burma and Sri Lanka. Several of these countries also have debts of commercial origin — either bank loans of suppliers' credits — with a significant share in their indebtedness.

According to the World Bank, countries with a per capita income of between 161 and 300 dollars — the category where the majority of this group of countries is included — showed the highest increase in indebtedness during the 1970's — 25% a year between 1970 and 1976. Private bank loans multiplied by 30 growing at 75% a year. Debt service increased at 26%, while interest

payments increased faster than amortizations. Some countries inside this group might soon encounter serious payments difficulties.

Finally, the fourth group of countries is that which does not have debt, but depends, to a major degree, on grants of industrialized countries to finance their basic imports. This group includes many African countries. Some, like Ethiopia, often finance up to 100% of their current deficit with grants. The vulnerability of the group is very great. Serious concern for their economic future can be expressed if present recessionary trends worsen.

#### THE CAUSES OF THE INDEBTEDNESS PROCESS

The question now arises as to how such a large number of Third World countries could have arrived at such a high level of indebtedness, especially when most of their leaders realize that historically, indebtedness has been one of the most usual ways of losing important areas of economic autonomy, or even political independence.

However one analyzes the indebtedness of the Third World it becomes clear that it is a central circular mechanism within the numerous vicious circles of underdevelopment. It is astonishing that this problem has so far been given only limited attention and that it has been viewed more as a consequence of underdevelopment than as one of its causes or at least as one of the principal means by which underdevelopment perpetuates itself.

In trying to give an answer to these questions, two basic types of situations should be distinguished. First, that corresponding to countries totally lacking in resources, with limited capacity or autonomy for self-financing. These countries, extremely dependent on foreign aid, have been unable — although in some cases one may wonder whether they had no other alternative — to escape from strong external indebtedness to maintain essential imports to ensure basic consumer levels.

The second, more common case relates to those countries whose indebtedness is strongly linked to the type or model of growth which they have chosen, or to the economic and

social policy followed as a consequence of the adoption by the dominating groups of the ideology of development. This is the case that we shall now analyze.

#### DEVELOPMENT AS IDEOLOGY AND ITS CONSEQUENCES ON INDEBTEDNESS.\*

In the Third World "development has become an integral part of the national ideology". The simple-minded idea that one or two five-year plans making massive use of equipment supplied by the industrialized countries can give a country a chance of quickly "catching up" with the industrialized countries has often been the corollary of such an ideology. Bogus pseudo-scientific mathematical equations of the growth of revenue, based on investment/production ratios through capital coefficients, have lent additional legitimacy to the plans of Third World countries. These mechanistic calculations have been enriched by various more or less brilliant and superficial theories, which are almost always designed to justify a special drive for massive investments in the "modern" industrial sector, which is supposed to generate spin-off effects which will greatly accelerate a country's progress.

The majority of these theories leave aside an important historical consideration, that practically no country has industrialized or "developed" only with foreign technology, and much less by importing capital goods. Examples of exaggerated "Europeanization" and "modernization" in the 19th century (Ottoman Empire, Egypt, Tunisia, Iran, certain Latin American countries) were numerous but in all cases the final result was financial bankruptcy and the strengthening of foreign presence in the administration of the countries, and even, in some cases, the loss of political independence.

Generally speaking, the "development" theories based on this ideology have all helped set in motion a scramble for investments intended to bring about modernization; these investments have thus led to massive and abrupt imports of production equipment from abroad and have driven the Third World deep into the technological trade circuits run by the TNC, with

\* For the drafting of this section and the final conclusion of this paper, extensive use has been made of a document prepared by G. Corm for CID ("L'endettement des pays en voie de développement. Origines et mécanismes") within an IFDA project on "Debt and development"; but, of course, responsibility for the ideas expressed here is the author's.

a final result — the deepest indebtedness process of modern history.

The enquiry into the origins of the Third World led us to emphasize the sequence: process of acculturation — transfer of technology — indebtedness. From a historical point of view, the process of acculturation initially manifests itself in the military sphere, where the overwhelming superiority of the industrialized countries since the 19th century has obliged the Third World to borrow Western technology. It then spreads gradually to the other spheres of the life of a society, and it is in this way that the aspiration to the model of consumption of the industrialized countries becomes generally accepted, and it is not possible to satisfy the demand of a model but through technological borrowing, usually taking the form of the massive and indiscriminate import of the products of technology, and not of a global and sustained effort to acquire a command of technology. Whether they are military or whether they consist of capital equipment for the production of consumer goods, the equipment imported by the Third World is no sense a transfer of technology. At most they constitute a transfer of productive capacity, the excessive cost of which is apparent only over a long period and blocks the dissemination of progress locally, and the egalitarian and profitable insertion of the country into the circuits of international trade.

The real accumulation of capital which enriches society is that which lies in the capacity to produce productive capacity, and not in the expansion of the capacity to import productive capacities from abroad. In this sense the mechanisms for the "transfer" of technology from the industrialized countries to the countries of the World, as they have been used in practice since the last century, are precisely those which help the industrialized countries to develop even further their technological capacity, while the Third World becomes more and more dependent and lags farther and farther behind. Whatever capital is imported, the added value created in the exporting country far exceeds that in the importing country; the genuine spin-off effects takes place in the country of origin of the equipment and not in the receiving country.

On the basis of this ideology of "development", a model has been developed for an accelerated process

of industrialization based on external investments and massive indebtedness to import capital goods or generating new exports, the hypothesis has been that it would be finally possible to amortize those capital flows and debts contracted abroad. In fact, this type of approach has perfectly coincided with the interests of the transnational companies, in favour of a new international division of labour better suited to their global interest.

It is evident that the industrialized countries and their TNCs are doing their best to promote a new international division of labour (IDL) in keeping with the technological evolution of their production apparatus and its profitability. Nonetheless we feel it is risky to attempt to formulate a global theory for the functioning of the IDL as a mechanism from which the Third World countries cannot escape, because the very essence of the IDL is the fact that countries cannot escape, because the very essence of the IDL is the fact that it is constantly moving in response to the obstacles or the opportunities with which the TNCs — the main actors on today's economic scene — are faced.

But the gradual take-over of the economies of Third World countries by the TNCs is not merely a result of the excessive power of the industrialized countries. As in the 19th century, the integration of the Third World on unequal terms in the trade circuits dominated by the industrialized countries is due quite as much to the nature of the local economic policies, which reflect, above all, the interests of the dominant groups in Third World countries. It seems to us that the 20th century is repeating the unfortunate experience of the 19th century, when the lack of interest in an autonomous effort to achieve a mastery of the technological processes at the national level meant that the policies of modernization were doomed to be nothing more than an instrument for the promotion of the supremacy of the industrialized countries. The current phase, which, for the countries of the Third World has lasted since 1950, indicates that there has been a dangerous acceleration of their technological/financial dependence, in the form of a faster rise in rates of indebtedness as well as the undisputed supremacy of the TNCs in the execution of all major investments in the Third World. Whether the technological-consuming countries have

liberal regimes favouring joint ventures with the TNCs or whether they have regimes of State capitalism and use turnkey arrangements the result is the same: a passive consumption of technology, and an increasingly fragmented economy and the loss of control over the ecosystem implied by the decline of agriculture and by uncontrolled urban growth.

#### MECHANISMS OF INDEBTEDNESS

Following the description of the basic causes of indebtedness, the mechanisms through which it is achieved will be described.

The "development" model generally adopted in Third World countries with more or less chronic indebtedness problems is centered on the satisfaction of the demand of those groups in society with the highest purchasing power, interested in copying consumption models in industrialized societies. This is achieved through a process of modernization of the infrastructure and an accelerated industrialization process based on import substitution.

Both processes are linked and mutually reinforced. This can be illustrated by the introduction of motorcar manufacture or assembly, requiring the construction of roads, which in turn require the development of a road equipment industry. This kind of process leads many development theorists to maintain that it is self-sustaining. But the reality is slightly different.

The establishment of the motorcar industry is within the reach of only very few countries. Capital needs are huge and though technology is very dispersed it is always in the hands of the transnational companies dominating the world car market. Consequently, there is a need for foreign investment by TNCs at least to establish terminal plants.

Local sub-contracting factories then develop around these plants, many of which are small or medium-sized national companies resorting to public credit to start up and develop operations and needing State guarantees to obtain foreign credits needed to import capital goods. Many in turn are associated to other foreign firms providing them with the technology necessary to manufacture automobile parts. Generally, the percentages of national integration of the final product is not very high, since often the TNCs controlling the motor car plant prefer to import parts from other countries

as a function of their overall costs or intra-firm financial movements. On the other hand, the State embarks on ambitious road construction programmes, even though they have a low coefficient of use, except around the big cities, and although other public services such as railways are outdated and overloaded with passengers — most of whom, moreover, will never be able to own a car.

In order to build these roads, the State will resort to credits extended by international organisations and will use the services of foreign consulting engineering firms to satisfy the technical requirements of these organisations. Also, the State will import road equipment, or if the programme is very ambitious, will promote the establishment of a road equipment industry, resorting to other specialised TNCs, which in turn will resort to local companies for the manufacture of some of the necessary parts.

The result of this series of operations will imply: a degree of indebtedness with respect to credits accompanying the entry of foreign capital; further indebtedness for capital goods imports of local companies manufacturing parts; the increase in imports corresponding to parts not manufactured locally and further sums for inputs to be used in the manufacture of parts. If the country has no oil, then there will also be an increase in oil imports, and in refined products, and perhaps also a plant to refine imported oil. Most of these imports except for oil, will be on credit, backed by a government guarantee. The State will have in turn contracted debts for the roadbuilding programme.

The volume of debt generated in this way can be considerable, but it is assumed that the development of the motorcar industry will result in an increase in economic activity permitting increased exports of other products. This increase will cover the payment of debt service and the regular increase in imports of inputs, renewal of equipment and fuels.

The problem begins when it becomes evident that the massive introduction of the motor car, while satisfying the expectations of most of the middle and upper income groups, not only has not solved the transport problem, but has not generated greater exports, whether directly or indirectly, which can look after the indebtedness on which

it was based. Something similar happens with the television industry, with refrigerators, radios and other consumer durables, which will have contributed to increasing the welfare of population groups with purchasing power and increasing GNP..... but also indebtedness.

In relation to the economy as a whole, when based on the economic model described here, various factors cause the indebtedness which are reflected in the following manner in the balance of payments. First, the increase in imports of capital goods not financed by foreign investments. To these should be added increased imports of inputs. Significantly, the further the industrialisation advances according to the model described, the more difficult it becomes to limit or diminish such imports of inputs. The reason is that industrial sectors which have emerged through this process become the most dynamic centres of the economy and thus becomes almost impossible to restrict imports of inputs without endangering the rhythm of economic activity and the level of employment. Thus when balance of payments problems start becoming serious, it is usual for governments to run away from their problems by promoting new investments to increase import substitution, but since investments are usually made on the same basis as their predecessors, the balance of payments effects of this substitution are cancelled out over time.

Second, there is an increase in payments and remittances made by foreign companies. These can become so large that normally the balance of inflows from investments plus eventual exports they generate are less than outflows for dividends, capital repatriation of part of the principal, royalties for patents and trade marks and additional imports.

Factors such as overbilling which takes place in intra-firm transactions, the burden on Third World countries arising from R and D expenditures already amortized in the industrialised countries, have also a role in this process. Statistical analysis carried out in Latin Ameri-

can countries clearly demonstrate the above. In addition, a good part of the profits made by the TNCs are at the expense either local credit, or external credits with the official guarantee of the host country, when not based on tax breaks offered to attract investments. Taken together, all these factors give a clearer view of the negative impact of this type of investment on the balance of payments.

But balance of payments problems also have other origins. One of them, little analysed until the present, is the financial cost of their external debts incurred to promote public works. Due to the basket of currencies in which the loans of some international financial organizations are expressed, their real cost is much higher — due to the constant appreciation of some of these currencies — than the nominal rate of loans.

Thus, for example, the IBRD, which is financed largely on the Japanese, German and Swiss national markets, passes on exchange rate risks wholly to its debtors, who thus find the actual rate of interest charged on their borrowings from the IBRD marked up several points above the nominal rate.\*

Also, expenditures on armaments should be mentioned as one of the usual causes of excessive indebtedness.

Data on this type of expenditure is scarce and is never reflected in official indebtedness figures but each time that a country has come forward to renegotiate its external debt, it has been possible to infer that most of the differences between figures by creditors and debtors was due to unregistered purchases of military material, due to its confidentiality, in the books of the central monetary authority. Of course this does not give even a vague idea of the burden of financing such purchases on the indebtedness of many poor countries, but permits the assumption that in many Third World countries indebtedness is considerably higher than the official figures.

\* An article published in 1978 in a Colombian review edited by former Minister of the Economy, stated that Colombia was: "...paying to the World Bank an approximate rate of interest in dollars of 18% for the portion of our debt expressed in Swiss francs, and a dollar interest of 15% for the portion of our debt expressed in DM" and it compared these rates with that of 7.6% payable on month to month Eurodollar loans in December 1977. In "Estrategia economica y financiera", Bogota: March 1978.

The theoretical models of this type of development assume that all these pressures on the balance of payments will be compensated by increased exports arising out of steeped economic activity. However, this is not normally the case, due to the weakness of the exporting sector of most Third World countries (with the predominance of products characterized by unstable prices, some declining over the long term) and difficulties in moving from export of primary products to exports of manufactures. Also it is due to the influence of the growth in internal demand, the inefficiency of industries which have been developed on the basis of high tariff protection and thus cannot compete with costs on the international market, and finally due to the increasing protectionism of industrialised countries against products in which Third World countries have managed to become competitive.

The result of this lack of symmetry between growth of imports and outflows on current account and the slow growth of exports is a more or less chronic deficit in the balance of payments, leading to increasing indebtedness, described earlier.

In recent years, the governments of some Third World countries, in particular in Latin America, have chosen to apply a model whose final objectives are the same — to satisfy the demand of the sectors with the highest purchasing power but which are achieved under different policies. These have consisted in eliminating external protection benefitting their industries, while proceeding to major income redistribution resulting in the notable drop in real wages, while promoting the entry of foreign capital and meeting balance of payments problems by increasing indebtedness in the form of bank loans.

These policies have been aimed at making their industry "competitive" and facilitating the increase of exports of manufactures and semi-manufactures, based on low labour costs and in some cases on the availability of comparative advantages derived from the low production costs of certain inputs.

Until now, the result has been almost the same in all cases. First, a huge social cost, in terms of high unemployment and repressive measures to oblige wage earners to accept the reduction of their real

earnings as well as the weight of income redistribution in favour of higher income groups, assumed to have a higher propensity to save and invest.

Second, a major recession which in many cases has resulted in significant drops in GNP. Third, the liquidation of a considerable part of national industry, due to the interplay of falling sales due to the recession, competition from imports whose entry is favoured by the dismantling of effective protection and by the exchange policies and the high cost of money, due to the freeing of interest rates. Fourth, the emergence of a new financial class, cornering most of the benefits of this type of policy and which has replaced the previous industrial — which has turned to speculative activities or the import of products it used to manufacture. The entry of foreign capital in the form of direct investments have not been very great in any case — except perhaps when it has been for the sale of public companies or the handing over to private interests of natural resources previously nationalised. Inflation has reached impressive levels and indebtedness which it was thought could be rapidly eliminated has either remained at the same level, or grown, due to the increase in imports arising from the liquidation of industry and tariff dismantling, as well as to the disappointing performance of exports — due either to internal production problems, to difficulties of access to markets of industrialised countries, or to decreasing demand due to the general recession.

In the case of countries which have not followed the traditional model, when they reach a critical point in their indebtedness, they have either had to postpone the markets for loans to amortize pre-problem by resort to the capital markets for loans to amortize previous debts, or to the International Monetary Fund to obtain short-term financing in exchange for applying the recessionary policies favoured by the IMF with their known consequences, or in most critical cases to further debt rescheduling, with equal or graver consequences.\*

As can be seen these are all dead ends arrived at by the development paradigm and adoption — or imposition — of development models only taking into account the interest of a part of society.

## CONCLUSION

An exhaustive study of the "development" paradigm clearly goes well beyond the limits of this paper. We hope, however, that our efforts to situate the phenomenon of indebtedness in a broader framework will help dispel the illusions of the purely economic approach, which prevails in the literature on development and underdevelopment as well as in the solutions advocated to escape the "bottlenecks" and "vicious circles" of underdevelopment.

For this reason we think that there is no isolated remedy to the problem of the excessive indebtedness of the Third World, and no neat financial prescription. The recurrence of indebtedness and its increase have to do with the overall functioning of exploited and blocked societies, and thus, in the last analysis, with the very nature of the kind of society intended by their ruling elites.

To change the pattern of development and breaking the thousand and one links between technological dependence and financial dependence is a long business which involves upsetting large numbers of conventional notions about development. Yet only such a break with the past is capable of bringing about new types of planning, based as a matter of priority on an internal command of the national economy and of technology, and in the mobilization of internal savings in order to disseminate local productivity. It alone is capable of breaking the mechanisms of excessive profit of the TNCs and, therefore, the mechanisms of unequal trade which is reproduced, on an amplified scale, from century to century, as the technological gap between industrialised and Third World countries continues to widen. It is only in this framework that alternative models for development can begin to take shape.

\* Sid-Ahmed, Abdelkader "The IMF Conditionality" document prepared for the CID project on "Debt and Development" to be published as a Third World Forum Occasional Paper; Lichtenstejn, S. and Quijani, José M. "LDC debt and international private banking" and Martner, Gonzalo G. "Multinational Debt Renegotiation", documents of the above project.