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FINANCING NEEDS OF DEVELOPING COUNTRIES: PROPOSALS FOR INTERNATIONAL ACTION

CONSTANTINE MICHALOPOULOS

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
Princeton, New Jersey

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The author, Constantine Michalopoulos, is Deputy Director of the Office of Policy Development and Analysis, Bureau for Program and Policy Coordination, in the Agency for International Development. His most recent articles on trade and payments issues of developing countries include "Expanding Trade among Developing Countries: The Role of Limited Preferential Arrangements," Journal of Common Market Studies *(March 1975), and Essay No. 102 in this series,* Payments Arrangements for Less Developed Countries: The Role of Foreign Assistance *(1973). The present essay represents the views of the author and does not necessarily reflect the position of the U.S. government or the Agency for International Development.*

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PETER B. KENEN, *Director*
International Finance Section

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Financing Needs of Developing Countries: Proposals for International Action*

The dramatic changes in commodity prices, particularly of oil and food, during the past two years pose unprecedented problems of international adjustment. Many have argued that the magnitude of the payments problems is such that the international trade and financial system will collapse, with untold repercussions for all. The main thesis of this paper is that, while there are many grave dangers ahead, there is a good chance that the world will be able to muddle through the crisis but that, in doing so, the weaker constituents of the international community, the developing countries, are likely to be hurt disproportionately unless specific measures are taken on their behalf.

The recent changes in relative commodity prices can affect real income and employment through two mechanisms: (1) They involve drastic shifts in the terms of trade, with attendant gains or losses in real income. (2) They necessitate huge changes in the patterns of international payments between oil exporters and the rest of the world. These changes should not be significantly moderated through exchange-rate adjustments, if only because such adjustments are all too likely to be of the beggar-thy-neighbor type, leaving oil importers as a group in an unchanged or worse payments position vis-à-vis oil exporters. Thus, unless countries in deficit can obtain financing to accommodate the payments they must make in the short and medium term, they may be forced to adjust by means of domestic policies that are likely to result in a reduction of real income and employment.

The purpose of this paper is to address the second problem: whether and how capital flows can be redirected to enable countries, especially developing ones, to finance the projected imbalances on current account attendant upon recent price changes. The focus is the medium term, three to five years. I assume that the problem will not disappear during this period through a restoration of pre-1973 price relationships. Oil prices will not revert to pre-1973 levels, and inflationary tendencies in the developed world will erode but not fully offset the higher oil price for developed countries, while exacerbating the problems of some developing

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ones. Longer-term analysis would be highly speculative, because potential increases in supplies of oil or energy from alternative sources and increases in food production will have important but hard-to-evaluate effects on energy and food prices.

My analysis will stress the different problems faced by various groups of developing countries, since the ability to accommodate huge payments imbalances without resorting to policies that would result in reductions in real income and employment varies significantly between country groups. I also hope to reach some conclusions about the kinds of additional instruments that are required to assist the international adjustment process in general and the developing countries in particular.

Relative Price Changes and Shifts in Current-Account Balances

Strong inflationary pressures have afflicted the world economy since 1972. The inflationary spiral is not something that developed overnight. It evolved over time. But it has been marked by some spectacular increases in the prices of individual commodities, of which oil is the most important only in terms of the aggregate payments shifts it has caused. Prices of food and manufactures have also increased and, for some countries, may have been more important than the price of oil. Relative to a base of 100 in 1967-1969, the price of oil in current U.S. dollars stood at 751 in 1974, compared with an index of 315 for food, 193 for nonfood agricultural commodities, metals, and minerals, and 182 for manufactured goods. Price projections for 1975 show declines in the prices of metals, minerals, and nonfood agricultural products; relatively constant or slightly decreasing food prices (e.g., cereals); and continued increases in the prices of manufactures. Deep recession in many developed countries is exerting a significant downward pressure on many developing countries' primary exports. The situation in oil continues to be fraught with uncertainty, but relatively constant nominal prices may well be the best bet at this time.

The implications of recent price increases for the current-account balances of various countries will be reviewed by reference to three major groups: developed, developing, and oil exporters. Further subgroups will be identified later on, in the discussion of the need for capital flows to developing countries.

Developed Countries

The International Monetary Fund estimates that the current accounts of developed countries moved from a surplus of $4.8 billion in 1973 to a deficit of $41.6 billion in 1974, for a net deterioration of $46.4 billion. For

1975, IMF projections show that developed countries will improve their current-account balances by approximately $7 billion, running a deficit of approximately $34.8 billion. Over the two-year period 1973-75, the net deterioration in the current-account balance is estimated at $39.4 billion. This is equivalent to 29 per cent of the total reserves of these countries in the third quarter of 1974.

It is of considerable importance that, over the same two-year period, the deterioration on current account attributable to oil is $53.5 billion for the developed countries as a group. Thus, in just two years, the developed countries are expected to improve their current-account position on items other than oil by $14 billion. This improvement has to occur primarily at the expense of the developing countries.

Developing Countries

The current-account deficit of developing countries is expected to deteriorate from $9.6 billion in 1973 to $23.7 billion in 1974 and $30.4 billion in 1975, or a total deterioration of approximately $20.8 billion between 1973 and 1975. While this is smaller in absolute terms than for developed countries, it represents 96 per cent of the third-quarter 1974 reserves for these countries. The deterioration is only in part ($6.3 billion) attributable to the increase in oil prices. The rest ($14 billion) is due to changes in other commodity trade. Despite increases in the prices of some developing countries' exports, especially in Latin America, the current-account balances of these countries have been adversely affected by overall price changes in commodities other than oil, especially food, fertilizer, and manufactures, combined with price declines in 1975 of major raw-material exports. In some instances, increases in the prices of manufactures, though not large in comparison to the increase in the price of oil, may have a serious effect, because a large portion of the developing countries' imports is accounted for by such goods, generally from developed countries.

Oil Exporters

The broad facts about the oil exporters are well known. In 1974, the major oil exporters (Algeria, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Saudi Arabia, Venezuela) are estimated to have run surpluses on current account in the neighborhood of $72 billion, or 185 per cent of their reserves at the third quarter of 1974. In 1975, the oil exporters' surpluses on current account are predicted to be of the order of $66 billion, the decline reflecting primarily increased imports of goods and services.

There is no indication at present that this pattern of payments will

drastically change in the immediate future. Thus, current-account surpluses for oil exporters and corresponding deficits for the rest of the world can be projected beyond 1975, until alternative sources of energy flow to the market. While the rate of inflation in the rest of the world, combined with the development of alternative energy or oil sources, may well diminish the surpluses toward the end of the decade, it is reasonable to expect them to persist on a large scale in the next two to three years.

Implications for Different Country Groupings

This situation poses different types of problems for each of the three country groups identified above:

1. Developed countries, normally capital exporters as a group, find themselves in need of capital inflows on a large scale.
2. Most developing countries, which were already facing considerable difficulties in obtaining the capital transfers needed for their development, now are faced with large additional needs for capital inflows.
3. Oil exporters, whose economies share most of the characteristics of underdevelopment, are faced with a dual problem, (a) how to assure reasonable rates of return on their earnings from oil and (b) how to utilize these earnings to develop their economies.

The problems of the developed countries and the oil exporters appear manageable in the aggregate. Oil exporters are tied inextricably to the international financial centers and, by and large, have few options other than to invest their earnings in financial or real assets, primarily in the developed world. This is likely to result in an aggregate capital inflow from the oil exporters to the developed countries roughly comparable to the increment in the latter's payments for oil.

The problems of the developed countries are of rather a different nature: (a) While capital inflows to these countries may be assured in the aggregate, the question is whether financial markets can channel the flows to the various countries in proportion to their varying needs. (b) At present, there appears to be substantial divergence in the maturity preferences of lenders and borrowers, with the former seeking short-term instruments and the latter long-term.

Oil exporters are also a differentiated group: Some, like Iran and Venezuela, are well along in the development process and can use larger oil revenues for internal development; they will accumulate large surpluses only in the short term. Others are heavily populated countries with low per capita income and established development programs, for example, Indonesia and Nigeria. Their longer-run absorptive capacity is quite large, but they will probably accumulate large external financial assets

even over the medium term. Finally, there are underdeveloped areas with small populations, like Libya, Saudi Arabia, and some of the smaller Arab states, where large additional developmental imports will still leave them with substantial assets to invest abroad in the near- and longer-term future.

The developing countries have less manageable problems. These countries can be divided into two broad categories. In the first are those in the higher-per-capita-income range, for example, Argentina, Brazil, Korea, and the Philippines, which have been able to meet relatively large portions of their capital-inflow requirements by access to foreign private investment and borrowing in the international capital market on nonconcessional terms. In the second are those with per capita incomes below about $300, whose capital inflows have been predominantly official and on concessional terms.

The problem faced by the first group is how to assure continued and, in absolute terms, higher borrowings from their main source of nonconcessional funds in recent years, the Eurocurrency bank-loan market. In a way, their problems are similar to those of the developed countries, but their creditworthiness is viewed by the private markets as inferior. And, in a period when banking liabilities are increasing rapidly relative to capital base, bankers may be less willing to lend increased amounts to relatively inferior customers.

Few options are open to the second group of developing countries, which include the so-called "Most Seriously Affected" by the energy crisis (MSAs). On the terms prevailing in private markets, their capacity to borrow additional funds is limited. Even if they were able to borrow, it is questionable whether they should, given their limited capacity to repay and their existing debt burden. At the same time, they cannot expect substantial increases in official flows from the developed countries. Public attitudes in many developed countries, including the United States, seem generally hostile to increased appropriations for concessional transfers to developing countries to enable them to meet increased oil bills. And with good reason: Why ask the developed-country taxpayer, who has already been hurt by OPEC policies, to pay also for the impact of those policies on the developing countries? In some countries, however, as noted above, the problem resulting from increased food and fertilizer prices is at least as important as the one generated by higher oil prices.

In summary, the financial problems faced by the MSAs result both from increased prices of oil, food, and other commodities and from a limited capacity to address this problem through use of their own reserves or increased private borrowing. Their need is for increased concessional

assistance, at a time when the major countries, the sources of concessional assistance, are themselves in financial difficulties and when the climate for foreign assistance has been deteriorating.

Muddling Through

The Problem Will Go Away or Disaster Will Strike

Soon after the posted oil prices were raised by OPEC in January 1974, the broad dimensions of the financial problem faced by the world became apparent. The reactions were predictable: Some argued that the problem would go away because such oil prices would be "untenable." Presumably, the prices would be untenable because either (1) OPEC members were "reasonable" governments and would realize that it was not in their interest to cause trouble to the whole world or (2) the prices would be forced down through a combination of efforts involving various degrees of coercion and conservation. The United States for a time argued that no action should be taken to assist countries, especially developing ones, likely to be in serious trouble because such action would tend to validate the oil-price increases.

Others, and their voices are still heard among us, predicted that the international monetary system would collapse and we would go through a period of unprecedented worldwide economic depression. Among the disasters that can still befall us, the following have been stressed:

1. The volume of capital flows needed to accommodate payments is so great that the international capital market and especially the Eurocurrency market will not be able to recycle oil exporters' funds to countries needing capital inflows.

2. The divergence between the maturity preferences of lenders and borrowers will make it impossible for the Eurocurrency market to play the important role it has to play as a conduit of capital flows.

3. As a result, developed countries facing payments difficulties will resort to a series of trade restrictions, deflation, or competitive devaluations, resulting in diminished trade, income, and employment.

4. Developing countries will be squeezed out of the private capital markets and faced with further problems as a result of reduced exports caused by trade restrictions and/or slower growth in developed countries.

The problem has not gone away, and we have not had worldwide disaster. Half-hearted confrontation with OPEC on price soon gave way to cooperative arrangements—even by the United States, which had taken the most rigid stance originally. Although demand growth slackened off and there has been downward pressure on the oil price, the price has

not come down; predictably, OPEC has cut back production to maintain it. On the other hand, disaster was averted not because we have been able to design and implement a comprehensive mechanism to deal with the problem, but rather because, "as usual," we have muddled through. While there are grave dangers ahead and possibilities of disaster lurk behind many bends the system will have to take in the next year or two, past experience with monetary reform suggests that we will continue to be able to manage through incremental changes and marginal shifts rather than through broad-scale reform or global responses to global problems. Yet there are two problems with this muddle-through approach to international finance:

1. It is not intellectually satisfying. It would be far more satisfying, for example, to have a worldwide organization to channel OPEC funds to other countries with appropriate guaranties, or to establish under UN auspices a general fund to help all developing countries in trouble.

2. More bothersome is the fact that, when muddling through, the weakest constituents of the international community, the developing countries, are less likely to manage well and more likely to suffer in the wake of international malaise. This is due to the limited adaptability and flexibility of their economies as well as to their poorer management of resources.

The remainder of this essay is devoted to a discussion of how we have muddled through so far and what we can do to continue to muddle through somewhat more effectively and equitably.

How Has It Worked So Far?

The Eurocurrency market. The Eurocurrency market has shown vast potential for acting as an intermediary for capital flows. In 1974, publicly announced borrowing in this market amounted to $27.3 billion compared with $22 billion for 1973. This total does not reflect placements not publicly announced, which may account for 30 to 40 per cent more.

In the absence of this expansion, the financing situation for many developed and developing countries would have been vastly more serious. Developed countries have accounted for $16.6 billion or 61 per cent of this borrowing, developing countries for $8.4 billion or 31 per cent, and oil exporters, international organizations, or non-IBRD members for the remainder. The United Kingdom, France, and Italy together accounted for $11.1 billion of the credits, mostly in the first half.

The expansion of the market slowed down considerably over the second half of 1974 compared with the pace of the first half. The total for the second half was only $8.2 billion as against $19.1 billion for the first half.

Furthermore, developing countries' borrowing dropped 48 per cent from the first half. The reasons for the decrease were concern over the short-term nature of OPEC deposits and the future availability of these deposits, the apparent desire of some depositors to deal only with large banks, and decreased confidence in the system, as a result of a small number of widely publicized bank failures.

Another disquieting sign was the decline in long-term Eurocurrency borrowing. Eurobond issues in the first three quarters of 1974 were about $2 billion, compared with $4.6 billion for 1973. There were no compensating increases in foreign borrowing from any of the other long-term capital markets, despite the fact that the United States eliminated the interest-equalization tax. There was a slight resurgence in overall borrowing during the third quarter, primarily resulting from larger IBRD and Canadian borrowing. Only two developing countries, the Philippines ($17 million) and Brazil ($25 million) borrowed in the international market during 1974. Paraguay and Nicaragua made small placements in the United States, Korea $19 million with the United Arab Emirates, while Israel borrowed heavily by both public and private placements.

Developed-country cooperation. Developed countries have made substantial progress in cooperation. Early in 1974, a $2 billion German loan and similarly large European Community credits to Italy were important elements of initial cooperation in the financial area. They were followed by an agreement in January 1975 to establish a solidarity fund within the OECD of $25 billion for two years to provide developed countries with financial assistance as a last resort. Under this arrangement, the developed countries in the OECD are apportioned quotas that determine their borrowing rights, obligations, and voting power. Participants facing serious balance-of-payments difficulties can seek loans, which will be raised through borrowing in the private markets, credit arrangements through central banks, or direct contributions. Loans up to the quota limit require the approval of members holding two-thirds of the voting power and must be guarantied by all in proportion to their quotas. For loans larger than quota, stiffer voting requirements are necessary.

This agreement, at the very least, formalizes what may have occurred *de facto* through mutual support of Western central banks when a major developed country found itself in difficulty. Such cooperation existed before but became critical in current circumstances in light of the large payments deficits incurred. It represents the culmination of the American effort to organize a "safety net" for the OECD countries that is independent of cooperation by OPEC members.

On the trade side, little progress was made in the Multilateral Trade

Negotiations. The effort was delayed in large part by U.S. congressional inaction on the trade bill. Now that the bill has passed, the stage is set for future liberalization. Another reassuring sign in this area is that, despite heavy pressure, only limited instances of resurgent protectionism have occurred.

Oil exporters. The understandably cautious attitude of oil exporters, both with respect to the nature of the instruments in which they invest and the maturities at which they lend, has been the basis of considerable uncertainty so far. A large proportion of Arab official reserves is kept in very-short-term deposits. OPEC lenders have been concerned both about the political vulnerability and possible losses of captive funds in European and U.S. banks and about assuring themselves of a significant return. As time passes, however, significant shifts of attitude have been occurring in at least some countries, which are venturing into longer-term direct investment or lending. Typical among these investments are the Iranian purchase of a 25 per cent interest in Krupp and the complex arrangements in support of Pan Am, as well as the Kuwaiti bid of $250 million to buy control of one of the United Kingdom's major real estate firms, St. Martin's Property Corporation. Kuwait is reported to seek a diversified portfolio with 20 per cent of its investment in real estate. Iran, Iraq, Venezuela, and others have extended longer-term official credits to developed and developing countries alike. Yet the actual disbursement of funds has so far fallen far short of commitments (see below, page 10).

Developing countries. The international mechanism has probably worked least well in the case of developing countries. The expansion of developing-country borrowing in the Eurocurrency market in 1974 barely sufficed to meet the additional needs of the higher-income developing countries. These are the countries which are also best able to take advantage of the major new international instrument established to assist countries in difficulty as a result of the oil-price increase—the IMF Oil Facility. Through the end of 1974, the Facility had lent $2.0 of the approximately $3.5 billion in first-year pledges by oil producers. Of this total, 56 per cent was borrowed by developed countries, with the lion's share going to Italy. Of the 44 per cent going to developing countries, 32 per cent went to the MSAs, with both India and Pakistan borrowing heavily. The extension of the Facility for another year and its increase to about $6.5 billion implies that additional financing will be available to both developed and developing countries from this source. Even at present rates of inflation, however, the terms of the Facility—averaging 7 per cent for seven years—are more suitable to the higher-income developing countries than to the MSAs. The Interim Committee of the IMF