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INTERNATIONAL CAPITAL MARKETS

and the

FINANCING OF ECONOMIC DEVELOPMENT

Paper by

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A striking change has occurred in recent years in the sources of funds available to finance economic development in those countries still struggling to modernize their economies: a significant number of these nations have been able to raise a record amount of capital on terms which were previously available to only the most creditworthy borrowers normally found only in the most advanced industrial countries. Partly reflecting these changed circumstances, private capital has assumed a much more important role in developing countries than was thought possible only a few years ago.

The improved market standing and the increased ability to borrow of many of the less developed countries (LDC's) have clearly brought numerous benefits. The ready availability of funds is obviously the most important of these. Greater flexibility in project planning and the

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I am grateful to several members of the Board's staff for assistance in the preparation of this paper. Mr. Rodney H. Mills, Jr., and Mrs. Ruth Robinson compiled much of the statistics on Euro-currency borrowings, and Mr. Mills also helped trace recent changes in lending practices by Euro-currency banks. Mr. Yves Maroni helped with the analysis of capital flows and uses of funds by developing countries. Mr. Reed J. Irvine assisted with the assessment of the implications of increased Euro-currency borrowing by developing countries.

However, while I am grateful for the staff's assistance, the views expressed here are my own--and should not be attributed to the staff nor to my colleagues on the Board.

freedom from restraints (such as competitive bidding) imposed by multi-lateral lending institutions have also been hailed by LDC borrowers. On the other hand, the greatly expanded participation by the newcomers in the Euro-currency markets also raises a number of questions:

- Why are so many LDC's able and willing to borrow in the Euro-currency and Euro-bond markets--when it appears that they might obtain financing on more advantageous terms from the international lending institutions, if not under the bilateral aid programs conducted by some of the advanced countries?
- What are the implications of these recent international capital market developments, and what are the prospects for the future?
- How dependable as sources of financing for economic development are the Euro-currency and Euro-bond markets likely to be?
- Are there inherent in the recent evolution of these markets excessive risks for the Euro-currency banks which extend the loans? For the developing countries which have come to rely so heavily on such a highly volatile source of funds?

These questions are examined in this paper. To place these recent developments in perspective, long-term trends in capital flows to developing countries are summarized in the next section.

#### Trends in Capital Flows to Developing Countries

It has long been generally agreed that the LDC's must rely primarily on their own savings to finance their economic development. But, it has also been agreed that foreign capital has an essential role to play in raising investment in those countries to a more adequate level.

Following the Second World War, it was believed that foreign capital was unlikely to be available to the less developed countries from private sources in sufficient amounts to finance the wide range of projects necessary to launch them on the road to self sustaining growth. Consequently, steps were taken to mobilize capital through official channels. The International Bank for Reconstruction and Development (the World Bank) was organized. It was later expanded by the addition of two sister institutions--the International Finance Corporation (IFC) and the International Development Association (IDA). Regional development lending institutions were created to serve specific areas--the Inter-American Development Bank (IDB) for Latin America, the Asian Development Bank (ADB) for Asia, **and the African Development Bank (AfDB)** for Africa. National governments in the advanced countries undertook to provide economic aid to the less developed countries under bilateral programs.

In 1962, the LDC's received about \$8.4 billion of financial resources in the form of net official and private capital transfers from the 16 countries belonging to the Development Assistance Committee (DAC) of the Organization for Economic Cooperation and Development (OECD)<sup>1/</sup> (See Tables 1 and 2, attached). Just over \$4.3 billion (about half of the total flows) originated in the United States in 1962. France was second--supplying \$1.4 billion, or one-sixth of the total. Net official flows to the LDC's amounted to \$6.0 billion in 1962 representing 70 per cent of the total.

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1/ The DAC statistics refer to the amount provided to the LDC's and the multilateral development agencies. For the sake of simplicity in exposition, it is assumed that the amounts received by these agencies are equal to the amounts which they in turn provided to the LDC's.

The United States supplied approximately \$3.5 billion of this amount, or nearly three-fifths of all official transfers to developing countries. Nearly 90 per cent of the official capital was for development assistance. France provided \$977 million in the form of official transfers--accounting for just over one-sixth of the total. Private capital flows to the LDC's in 1962 amounted to \$2.5 billion. Approximately one-third of this sum (\$819 million) came from the United States. In this case France was again in second place--accounting for \$418 million, also equal to one-sixth of total private flows.

Between 1962 and 1972, the volume of capital flows from DAC countries to LDC's more than doubled--climbing from \$8.4 billion to \$19.4 billion. The United States remained in first place as a source of funds, but its relative position declined substantially. Of the total flows, \$7.4 billion--or 38 per cent--originated in the United States. A decade earlier, the U.S. accounted for just over half of the total. By 1972, Japan had replaced France as the second most important supplier of capital to LDC's. Last year, Japan provided \$2.7 billion to these countries--representing one-seventh of the total. The United States' share of official transfers and of development assistance was of roughly the same magnitude as its share of total capital flows in 1972--35 per cent; 39 per cent, and 38 per cent, respectively. In contrast, Japan supplied 14 per cent of total capital flows and 14.5 per cent of official transfers--but only 7.1 per cent of the official transfers for development assistance.

During the decade 1962-72, private capital flows to the developing countries more than tripled--rising from \$2.5 billion in 1962 to \$9.3 billion in 1972. Private capital represented just over one-quarter of total flows in 1962, but the proportion had risen to almost one-half a decade later. The United States private capital amounted to \$3.8 billion--or two-fifths of all private flows to LDC's. In 1962, the U.S. had accounted for about one-third of the total. Moreover, slightly more than half of all capital flows from the U.S. to LDC's in 1972 arose from private sources--in contrast to only one-fifth in 1962. In the case of no other major country did such a dramatic shift occur in the composition of capital flows to LDC's, except for Japan, which was a relatively small donor in 1962. In the United Kingdom the direction of change was the same, but the extent of the shift was less striking. On the other hand, several industrial countries (especially Canada, Denmark, Italy, Sweden and Switzerland), provided proportionately less through private channels--and more through official means--in 1972 than they did a decade earlier.

Between 1962 and 1972, the net flow of official and private financial resources from the advanced DAC countries to LDC's declined slightly in relation to the gross national product (GNP) of the donor countries. In 1962, the proportion was .80 per cent of the DAC group's GNP, and in 1972 it was .77 per cent. (See Table 3.) The major share of this decline was accounted for by the United States--where capital transfers to LDC's as a percentage of GNP decreased from .76 per cent in 1962

to .64 per cent in 1972. In the case of France, Italy and Switzerland also total capital flows to developing countries declined in relation to GNP. All other countries maintained--or raised--the proportion of GNP transferred to LDC's. If the four countries which recorded a decline had maintained in 1972 the same capital flow--GNP ratio that prevailed in 1962, the LDC's would have received about \$3.8 billion (or one-fifth) more than they actually received. The United States alone would have supplied a total of \$8,733 million--or \$1,379 million more than it actually provided. France would have supplied an additional \$1,603 million; Italy \$504 million, and Switzerland \$277 million more than it actually supplied.

The decrease in official capital transfers in relation to DAC countries' GNP was particularly dramatic. In fact, for the group as a whole, all of the net decline centered in this category. For all DAC countries combined, official capital supplied to LDC's decreased from .57 per cent of GNP in 1962 to .40 per cent in 1972. Six countries (Austria, France, Germany, Italy, United Kingdom, and the United States) accounted for the net decline. If the 1962 official capital--GNP ratios for these countries had been maintained, the LDC's would have received in 1972 an additional \$5,306.6 million. The United States would have provided \$3,465.0 million more to LDC's. For other countries, the additions would have been: France, \$1,224.1 million; Germany, \$387.9 million; United Kingdom, \$167.5 million; Italy \$39.2 million, and Austria \$22.9 million.

On the other hand, the countries which raised their official capital-GNP ratios between 1962 and 1972 were responsible for an additional \$997.5 million in official transfers above the amount they would have supplied had the 1962 ratios been maintained. Combining these results, if all the DAC countries had provided official capital to the LDC's and the multilateral agencies in 1972 in the same proportion to their GNP as in 1962, the amount transferred would have been \$4,309.1 million more than it actually was.

To a considerable extent, however, the short-fall in official transfers to LDC's (measured by the decline in the official capital-GNP ratio) was made up by the substantial rise in private capital flows. For all DAC countries, the private capital-GNP fraction climbed from .23 per cent in 1962 to .37 per cent in 1972. Reflecting this increase, the LDC's received \$3.5 billion more in 1972 than they would have if the 1962 ratio had prevailed. Nine countries accounted for an additional \$4,221.5 million--which was partly offset by a short-fall of \$738.8 million attributable to those countries whose private capital--GNP ratio declined or remained unchanged between 1962 and 1972. Countries which lifted this ratio provided additional amounts as follows: United States, \$2,200.3 million; Japan, \$672.9 million; United Kingdom, \$446.0 million; Germany, \$343.2 million; Canada, \$262.4 million; Netherlands, \$168.9 million; Belgium, \$55.9 million; Austria, \$47.2 million, and Sweden, \$24.7 million.



In summary, the foregoing figures tell an important story: the decline in the official capital-GNP ratio of DAC countries between 1962 and 1972 resulted in LDC's receiving \$4.3 billion less than they would have gotten if the ratio had remained constant. Over the same period, the rise in the private capital--GNP ratio provided the LDC's with \$3.5 billion more than they otherwise would have received. So, the relative rise in private capital flows held the short-fall in total capital flows to only \$826.4 million--using the 1962 ratio as a measuring rod. In the case of the United States alone, the decline in the official capital-GNP ratio cut the volume of these flows by \$3.5 billion. On the other hand, the rise in private capital in relation to GNP lifted such flows by \$2.1 billion above what they otherwise would have been. Thus, the net effect of the relative expansion in private capital was to keep the short-fall in total U.S. capital flows to LDC's in 1972 in the neighborhood of \$1.4 billion--again using the 1962 ratio as a benchmark.

#### Changing Composition of Private Capital Flows

Not only has the volume of private long-term capital flows to LDC's expanded greatly but the composition of such flows has also changed appreciably. Three principal types of flows can be identified in the available OECD statistics: portfolio investment, direct investment, and export financing. (See Table 4.) The OECD figures show that, between 1960 and 1970, the flow of portfolio capital rose by roughly 50 per cent--from \$830 million in 1960 to \$1,250 million in 1970. During the same

period, the flow of direct investment capital doubled--rising from \$1,770 million to \$3,560 million. Export credits quadrupled--from \$550 million in 1960 to \$2,210 million in 1970. Export financing accounted for about 30 per cent of the \$7,880 million in total private capital flows from the advanced countries to the LDC's in 1970--up from roughly 17 per cent a decade earlier. The share of direct investment had shrunk to 50 per cent from 56 per cent, and the share of portfolio investment had declined to 18 per cent from 26 per cent.

The rapid growth of export credits occurred even though the terms on such credits are relatively hard, and the short maturities as well as the comparatively high interest rates which they generally entail inevitably burden the borrowing countries with increasingly serious debt servicing problems. For this reason, a number of the less developed countries have taken deliberate steps to hold down the growth of this type of indebtedness. These moves have often been made as part of a comprehensive set of policies supported by standby agreements with the International Monetary Fund.

But an even more important development has occurred since 1970. There has been an upsurge in portfolio investment, especially that part which flows directly from the advanced countries to the LDC's. The indirect flows channeled through the private bond flotations of the multilateral lending institutions have also gone up. However, the direct

bilateral flows tripled between 1970 and 1972, and the volume probably continued to expand rapidly in 1973. The preliminary OECD figures for 1972 place the total bilateral portfolio investment flows to the less developed countries at about \$2.3 billion, representing about 25 per cent of the total private flow to these countries in that year.

Clearly, a part of the increase in the dollar size of the capital flows between 1970 and 1972 reflects the exchange rate changes which have occurred since the middle of 1971. The available information does not permit the necessary correction to be made. But it is clear that the upsurge of portfolio investment was larger than any change that occurred with respect to direct investment or export credits.

#### Euro-Currency Market Borrowing by Developing Countries

More important still is the fact that there has been a dramatic rise in borrowings by the less developed countries in the Euro-currency and Euro-bond markets. These borrowings are only partially reflected in the statistics of the OECD, since there is no comprehensive system for reporting them. But the evidence from other sources is striking.

According to the Bank for International Settlements, Euro-currency claims on the LDC's reported by banks in eight Western European countries increased by \$8.0 billion in 1972. This includes both short-term and long-term claims--i.e., those with a maturity of less than one year and those with a maturity of more than one year, respectively.

Total Euro-currency claims of banks in the eight reporting Western European countries rose by the amounts indicated in each of the last three years: 1970, \$19.5 billion; 1971, \$22.2 billion; 1972, \$31.7 billion. Thus, the LDC's share of the total increase climbed from one-sixth in 1970 to one-quarter in 1971 and 1972.

All indications are that these claims have increased even more rapidly so far in 1973. Since the great bulk of these Euro-currency claims was denominated in dollars, there is little reason to adjust the data reported in dollars for exchange rate changes since mid-1971.

The figures just cited are useful indicators of trends, but they are imperfect in two respects. On the one hand, they do not include medium- and long-term Euro-currency credits extended by banks in Germany, the Netherlands, and France. Nor do they include Euro-currency credits, of whatever maturity, extended by banks in Japan and Canada. On the other hand, they include credits to Australia, New Zealand, and South Africa, which cannot be regarded as "less developed countries" in the sense used in this paper. Nevertheless, the order of magnitude of the flows which they reflect is sizable. By comparison, the flow of official capital from 16 OECD countries to the less developed countries and to the multi-lateral lending institutions totaled \$10.1 billion in 1972.

The statistics showing claims of the Euro-banks on the less developed countries do not provide a breakdown between short-term and long-term claims. But there is strong evidence that the greater part

of the total is in short-term claims. At the same time, from other sources, it is clear that claims of more than one year have increased especially rapidly in the last two or three years. A compilation of such credits places the total new credits announced in 1972 at about \$3 billion, up from about \$1 billion in 1971. (See Table 5.) In the first half of 1973, announcements of new Euro-currency credits to the LDC's with a maturity of more than one year totaled nearly \$2.4 billion--an annual rate more than 50 per cent higher than that recorded in 1972.

In addition to these Euro-currency borrowings, in 1972, twelve of the less developed countries sold bonds in the Euro-bond markets for a total of over \$490 million. (See Table 6.) Only four less developed countries had sold bonds in the Euro-bond markets in 1971 for a total of only \$71 million, and only five had done so in 1970 for a total of \$128 million. Moreover, as recently as 1969, only those few LDC's which had made the most progress in economic development (e.g., Brazil, Mexico, Iran, and Netherlands Antilles) were borrowing in the Euro-bond market. Since then, participation has broadened significantly.

The importance of the borrowings by the LDC's in the Euro-currency markets is best shown in the statistics relating to their share of total long-term loans extended. For example, in 1971, total long-term Euro-currency loans amounted to \$4.1 billion, and \$985 million went to LDC's. In 1972, the total rose to \$7.8 billion, and loans to LDC's jumped to \$3.1 billion. So, the LDC's share of the total climbed from one-quarter in 1971 to two-fifths in 1972. Estimates of the total volume of long-term credits

advanced so far in 1973 are not available. However, Euro-currency credits extended to LDC's were \$2.4 billion during the first six months of the year. These figures suggest that LDC's share of the market will probably increase further during the course of this year. In fact, one experienced market participant has estimated that the borrowings of the less developed countries in the Euro-currency markets in 1973 will probably exceed the total Euro-currency loans to such countries outstanding at the end of 1971.

Probably, some of the Euro-currency borrowings by the less developed countries substituted for financing from other sources, such as suppliers' credits. The fact that the flow of suppliers' credits to these countries in 1972 was one-third smaller than in 1971 suggests that, in part, the borrowers were shifting some of their financing to the Euro-currency markets. Also in this category are Euro-currency loans to re-structure debts, which may have substituted for more traditional refinancing operations. But a part of the financing was undoubtedly for projects or purposes which would not have been eligible for loans from more traditional sources. This is especially true of loans for which the traditional lenders (such as the international lending institutions) would have imposed conditions unacceptable to the borrowers, or which the borrowers could not meet. Moreover, insofar as projects were financed promptly through Euro-currency loans--instead of being delayed for protracted periods for study by--and negotiation with--the international lending institutions, the financing provided by the Euro-currency markets added to the capital flows that

would otherwise have occurred. However, it is not possible to measure statistically either the extent of the substitution or the magnitude of the additionality of the capital flows attributable to the Euro-currency borrowings of the less developed countries.

Among the less developed countries, the heaviest recipients of Euro-currency loans in 1972 were Brazil, Mexico, Iran, Algeria, Venezuela, Argentina, and Peru--in that order. These seven countries together borrowed nearly \$2.5 billion in this form or 81 per cent of the total of \$3.1 billion borrowed by all of the less developed countries. (Table 5). The balance went to eighteen other countries. In the first half of 1973, Algeria alone accounted for one-third of the total amount borrowed in this form by the less developed countries while five other countries (Brazil, Iran, Indonesia, Peru, and Mexico) accounted for another 40 per cent. Thirteen other countries shared the rest.

#### Uses of Euro-Currency Loans

Available information indicates that most of the Euro-currency loans to less developed countries were obtained by borrowers in the public sector of these countries. The list of borrowers includes national, state, and local governments, central banks, state-owned development and commercial banks, and public entities in the fields of transportation, telecommunications, electric power generation and distribution, petroleum and natural gas, and mining. Private sector borrowers include basic industries such as steel, aluminum, and cement, as well as private banks. Of course, a part of the resources raised by the official banks was intended to finance private sector activities.

National governments and central banks borrowed in connection with economic stabilization programs, to bolster the balance of payments, and to finance economic development projects. General budget support was also a purpose for some of the borrowings. The development projects involved included road building; construction of airports, subways, and shipyards; purchases of equipment for airlines, urban transportation, shipping lines, and telecommunication systems; construction of facilities to produce and transmit electric power, to produce steel, liquified natural gas, and fertilizer; expansion of petroleum and copper production; construction of government buildings and tourist hotels, etc. In many cases, the purpose of the borrowing is not known, while in others it is known only in general terms--such as when the borrower is a bank which is planning to re-lend the funds locally, presumably for the whole range of purposes which it normally finances. In this manner (and also through borrowings obtained directly in the Euro-currency markets by the enterprises concerned), a part of the resources raised was used to provide working capital to industry and commerce. Some of the borrowings were intended to restructure debts.

Bank Competition and the Expansion of Euro-Currency Loans to Developing Countries

The increased lending to the developing countries did not come about because the banks suddenly became aware of the demand for capital by these countries. Nor did it result from any overnight improvement in the creditworthiness of these countries as a group, making them more



attractive as borrowers. On the contrary, there was a growing awareness in the late 1960's and early 1970's that the developing countries, as a group, had incurred very large foreign debts and were faced with heavy debt service requirements in the years ahead.

For example, in 1969, the Commission on International Development headed by Lester Pearson stated that "debts already contracted by many developing countries cast a pall over the short- and long-term management of their economies." Debt servicing problems were also highlighted in the report of a Special Presidential Task Force headed by Rudolph Peterson which was also released in 1969. In 1970, the World Bank undertook a thorough study of the growing indebtedness of the developing countries and the problems this might pose. This study found that, by the end of 1969, 80 developing countries had incurred almost \$59 billion in external public debt, over half of which was concentrated in only nine countries. The biggest borrowers were India, Pakistan, Brazil, Mexico, Indonesia, Iran, Argentina, Chile, and Korea--in that order. Four of these countries (India, Pakistan, Mexico, and Argentina) had debt service payments equal to over 20 per cent of their annual earnings of foreign exchange. In the other countries--except for Indonesia, which had just undergone a debt rescheduling--the debt-service ratio ranged from 12 to 18 per cent.

In the light of the growing concern about the debt servicing problems of the developing countries, one might be surprised to learn that bank lending to the LDC's began its sharp rise just at the time

that these concerns were being widely discussed. Factors other than generally increased confidence in the creditworthiness of the developing countries were obviously at work.

The main explanation for the change appears to lie in the abundant supply of funds to the Euro-dollar market and the failure of demand for loans from borrowers in developed countries to keep pace with the expansion in credit availability. The demand for this type of financing by well-established customers in Europe and the United States slowed noticeably in the last few years. This was related to tightened restrictions in some European countries on incoming capital and to the ample supply of funds in the United States for business borrowers.

As a result, the Euro-currency banks (especially those in London) began to push loans to the developing countries with considerable vigor. In order to do this, it was necessary to reduce the spread between the cost of money to the bank and its lending rate. The cost of money is typically measured by the 6-months London interbank rate (LIBO). Previously this spread had been much higher for LDC borrowers than for borrowers in developed countries--ranging up to as much as 3 percentage points over LIBO. The spread has been sharply reduced--in some cases being set as low as 5/8 of one per cent. In addition, the maturities of the loans have been stretched considerably. From a range of 5-8 years as recently as 1970, some banks are currently offering loans for up to 15 years.

Under the pressure of competition--much of it from American and Japanese banks recently arrived in London--the institutions are borrowing short and lending long, a practice that has traditionally been looked upon with disfavor. The growth of this type of lending has been encouraged by the adoption of the floating interest rate. While the loan may be committed for as much as 15 years, the interest rate is ordinarily committed for one year at most--and frequently for six months. This enables the lending banks to make sure that its cost of money is always slightly below the rate of interest charged on the loan. The borrower is assured a medium or long-term loan at the short-term rates prevailing over the life of the loan.

#### Advantages of Euro-Currency Loans for Borrowers and Lenders

The expansion of Euro-currency loans to the developing countries has provided a new source of capital to many of these nations. The interest rates, however, have been substantially higher than rates on comparable loans from international lending institutions such as the World Bank or the Inter-American Development Bank. Moreover, they may even have been higher in many cases than rates charged on officially guaranteed supplier credits.

Why have the borrowers in so many poor countries been willing to accept this relatively expensive money?

The answer seems to be that the loans can be obtained relatively quickly, with a minimum of red tape, and without the imposition of policy

conditions to which they may object. There are no requirements that the projects they finance be carried out on the basis of international competitive bidding. The goods and services financed are not tied to any stipulated country of origin. The loan may not be tied to a project and it may not cover any imports. It may be a simple balance of payments loan, or it may be used to restructure a country's external--or even internal--debt. It may be used to avoid lengthy and unpleasant debt rescheduling negotiations with other creditors. This flexibility has considerable appeal for many borrowers.

In addition, the credits may enable the borrower to switch indebtedness from currencies that are appreciating relative to its own to currencies that are expected to maintain their parity or even depreciate. They also enable the borrower to take advantage of possible declines in the cost of money, since the interest rate is variable.

An advantage to the lending banks is that they are able to employ the large volume of funds pouring into the Euro-currency markets. These loans have probably spelled the difference between breaking-even and incurring losses--and perhaps earning a profit--for some of the 136-odd foreign bank branches or subsidiaries operating in London. While the interest rate spread has been reduced to a level that many banks consider uncomfortably thin, many of the credits are large in size, and the costs of arranging and servicing are relatively low.

Many of the loans are provided by a consortium of banks, with a lead bank making credit investigations (frequently not very thorough)

and handling the arrangements. This relieves the other participants in the consortium of much of the effort and expense associated with the arrangement of the loan, although individual banks may in some cases wish to make their own independent investigation. The consortium arrangement permits a spreading of the risk among a number of banks and an economizing of labor in loan preparation. The quality of the supporting documentation for the loan may be exceptionally high in some cases, while in others it may be quite inadequate.

In addition, the banks perhaps believe that these credits produce goodwill for them in the borrowing country--assisting them in other interests that they may have, such as establishment or maintenance of branches in the borrowing country.

#### Disadvantages for Borrowers

The ease with which these loans can be contracted and the rapidity with which they have grown in volume is encouraging to the developing countries, but it is also a danger. Borrowers may be induced to contract debts that they may have difficulty servicing. This is especially likely to be true if the credits are not used wisely and in ways which increase the economic strength of the borrower. The World Bank made this point in its Annual Report for 1971, which said:

In a narrow sense, good debt management implies restraint in the assumption of external debts except where there is a reasonable presumption that the borrowed capital will generate production which can, directly or indirectly, be transformed into additional foreign exchange resources over a period appropriate to the service of the debt.

In the situation now prevailing in which the lenders are competing intensively to make loans, there is a genuine danger that the borrowers will be permitted or encouraged to incur large debts for purposes which will add little or nothing to their capacity to service debt.

The floating interest rate has disadvantages also. A capital intensive project that might promise a satisfactory rate of return when the interest rate is at 5 per cent can get into serious difficulty if the rate climbs to the range of 8-10 per cent. That has happened in the Euro-currency market.

The easy availability of funds without any requirement for competitive bidding for engineering and construction may also be disadvantageous to a poor country. This can result in contracts being let for the wrong reasons. The country may place large orders with inefficient or high-cost suppliers--domestic or foreign--resulting in far more costly procurement than could have been obtained had the procedures required by the international lending institutions been followed.

If Euro-currency loans are used as a substitute for drawings from the International Monetary Fund (IMF) to help tide a country over a balance-of-payments crisis, there is the possibility that the country will continue to follow economic policies which contributed to the difficulty initially. If the IMF were called upon, the country would have the advantage of its counsel and suggestions for overcoming basic

problems. Of equal importance, it might be supported by the international community in taking politically unpopular measures necessary to restore domestic economic health. A large Euro-currency loan for balance of payments purposes made without any reference to the views of the IMF could enable the country to continue to follow counter-productive policies and thus further aggravate the situation.

#### Problems for Lenders

The rapid growth in Euro-currency loans to LDC's also presents problems that must be of concern to the lenders. First and foremost is the question of risk. Although some of the less developed countries have an excellent record of debt-servicing, one cannot escape the fact that the developing countries as a group have traditionally demonstrated less political and economic stability than the developed countries. The volatility of commodity prices on which many of them depend can create cycles of excessive optimism when prices soar followed by depression when they decline. If the country over-extends itself during the optimistic phase, it may have serious trouble meeting its obligations when the boom subsides. Even government guarantees of credits may be of little help when this happens. The result can be a default or at least an urgent request that the debts be rescheduled.

There is no foolproof way of telling when a country is getting too deeply in debt. The ratio of debt service payments to foreign exchange earnings is not an infallible indicator. However, a prudent

lender must have a good idea of what the overall indebtedness of the prospective borrower is, and he should have some impression of the resources likely to be available to service the debt.

The rapid expansion of credits to the developing countries in the Euro-currency market has raised doubts about the adequacy of the information available to the lenders regarding the indebtedness of their clients. Since the Euro-currency market as such is unsupervised and unregulated--unlike the domestic banking business--there is no official published record of the volume of lending to individual countries. It is possible that, in some borrowing countries, the governments themselves are not fully aware of the volume of credit that is being contracted.

It is becoming increasingly important for both the governments of the borrowing countries and potential lenders to be informed much more fully of the new commitments being made and the total debt outstanding. The data now available are admittedly imperfect. Moreover, there is a fear that information is becoming less complete as this activity grows in volume and as Euro-currency loans to the developing countries are treated as routine matters not deserving of special public announcements. One country (Japan) has already instituted a reporting procedure covering Euro-currency credits by its banks. I believe that the time has come for others to follow suit. The World Bank is now doing a good job of collecting debt statistics for the developing countries. There is also an indication that some American banks--at least--would



be happy to see its capabilities for collecting Euro-currency debt statistics improved. I personally hope that the World Bank will further strengthen its own efforts, and also assume leadership by urging member governments to join in the program.

#### Concluding Observations

Better data would be useful to the lenders and borrowers alike and might help avoid excesses. However, there is no easy solution to the problems posed for LDC's by the volatility of the Euro-currency market itself. The International Finance Corporation pointed this out in its 1973 Annual Report, observing in part:

It is not inconceivable that a reversal of the recent favorable circumstances which have facilitated the entry of the developing countries into the Euro-currency market, or other international monetary developments, might result in a sudden drying up of this new source of funds. Historically, high levels of economic activity in the industrial countries have created large internal demands for capital which in turn have impinged upon the cost and availability of private capital to the developing world. Although a tightening of monetary conditions, accompanied by rising interest rates, can currently be observed in countries of Europe and North America, these do not appear so far to have affected the availability of funds in the Euro-currency market. Moreover, there should continue to be, at least for some time to come, sizable additions to the supply of funds in the Euro-currency market, not only from traditional sources, but also from the rising payment surpluses of the developing countries themselves, especially the oil producing countries. Nevertheless, the developing countries which have borrowed heavily in the market should expect sharp fluctuations in the liquidity conditions in the market, and they should allow for significant changes in the cost of their outstanding borrowing as part of overall debt management.

Bearing these problems in mind, the willingness of commercial banks to finance promising projects in developing countries that are managing their economies well is a welcome development. There is no reason to assume that only advanced countries should have access to the Euro-currency markets while only official institutions are qualified to undertake this type of financing for LDC's. The weakening of support for official foreign assistance reflects in part some feeling that foreign aid has not achieved all that was expected of it. As the growth of official aid flows slackens, it is encouraging to see that private capital has come forward to provide the funds needed to maintain the developmental pace in a number of countries.

However, it is also clear that private investors and lenders can find themselves and their clients in an excessively exposed position if they do not exercise the judgment and caution characteristic of prudent participants in international markets. They must be careful not to be driven into unduly risky loans and investments merely by the pressure of competition. Suppliers of funds have a responsibility to themselves and to their clients to evaluate with care both the overall debt situation and the particular project for which financing is sought. And they must not hesitate to give their best advice to all their customers, attaching conditions to loans when it seems appropriate to do so.

With their improved access to capital markets, developing countries may take justifiable pride in their ability to attract private

capital and large banking credits. At the same time, however, it is also important that the justification for that pride not be diminished by excessive and indiscriminate reliance on currently available--but highly volatile--funds obtainable through the international capital markets. Unless the risks inherent in these markets are recognized and appreciated, the effort to launch and sustain a solidly based drive for economic development is likely to be frustrating--and perhaps disappointing--in the long-run.

Table 1. Net Flow of Official and Private Financial Resources  
to Less Developed Countries and Multilateral Agencies, 1962 and 1972  
(Millions of U.S. Dollars)

| Country                | 1962           |                |                                       |                   |                  | 1972           |                |                                       |                   |                  |
|------------------------|----------------|----------------|---------------------------------------|-------------------|------------------|----------------|----------------|---------------------------------------|-------------------|------------------|
|                        | Total<br>Flows | Official Flows |                                       |                   | Private<br>Flows | Total<br>Flows | Official Flows |                                       |                   | Private<br>Flows |
|                        |                | Total          | Official<br>Development<br>Assistance | Other<br>Purposes |                  |                | Total          | Official<br>Development<br>Assistance | Other<br>Purposes |                  |
| 1. United States       | 4,304.5        | 3,485.5        | 3,181.5                               | 304.0             | 819.0            | 7,354.0        | 3,545.0        | 3,349.0                               | 196.0             | 3,809.0          |
| 2. Japan               | 286.2          | 168.2          | 85.3                                  | 82.9              | 118.0            | 2,725.4        | 1,467.5        | 611.1                                 | 856.4             | 1,257.9          |
| 3. France              | 1,395.2        | 976.9          | 945.2                                 | 31.7              | 418.2            | 2,072.7        | 1,337.0        | 1,320.5                               | 16.5              | 735.7            |
| 4. Germany             | 609.4          | 466.4          | 405.1                                 | 61.3              | 143.0            | 1,713.8        | 956.8          | 808.3                                 | 148.5             | 757.0            |
| 5. United Kingdom      | 743.9          | 421.0          | 421.0                                 | --                | 322.9            | 1,695.8        | 625.0          | 608.7                                 | 16.3              | 1,070.8          |
| 6. Canada              | 109.6          | 54.4           | 34.5                                  | 19.9              | 55.2             | 985.9          | 576.6          | 462.5                                 | 114.1             | 409.3            |
| 7. Netherlands         | 114.2          | 65.0           | 65.0                                  | --                | 49.2             | 652.9          | 314.9          | 309.6                                 | 5.3               | 338.0            |
| 8. Italy               | 390.4          | 111.2          | 80.1                                  | 31.1              | 279.3            | 539.3          | 253.8          | 103.9                                 | 149.9             | 285.5            |
| 9. Australia           | 73.8           | 73.8           | 73.8                                  | --                | --               | 424.8          | 276.3          | 271.9                                 | 4.4               | 148.5            |
| 10. Belgium            | 118.2          | 69.8           | 69.8                                  | --                | 48.4             | 391.0          | 206.0          | 192.6                                 | 13.4              | 185.0            |
| 11. Sweden             | 37.2           | 18.5           | 18.5                                  | --                | 18.7             | 272.0          | 197.7          | 197.7                                 | --                | 74.3             |
| 12. Switzerland        | 161.1          | 4.9            | 4.9                                   | --                | 156.2            | 172.8          | 67.0           | 64.4                                  | 2.6               | 105.8            |
| 13. Portugal           | 40.8           | 40.8           | 36.0                                  | 4.8               | --               | 163.2          | 135.0          | 115.0                                 | 20.0              | 28.2             |
| 14. Denmark            | 14.7           | 7.4            | 7.5                                   | - .1              | 7.3              | 119.9          | 98.3           | 95.6                                  | 2.7               | 21.6             |
| 15. Austria            | 31.0           | 13.8           | 2.3                                   | 11.5              | 17.2             | 111.6          | 16.6           | 18.5                                  | - 1.9             | 95.0             |
| 16. Norway             | 6.8            | 6.9            | 7.3                                   | - .4              | - 0.1            | 56.1           | 65.2           | 63.3                                  | 1.9               | - 9.1            |
| Total DAC<br>Countries | 8,437.0        | 5,984.5        | 5,437.8                               | 546.7             | 2,452.5          | 19,451.2       | 10,138.7       | 8,592.6                               | 1,546.1           | 9,312.5          |

Source: Organization for Economic Cooperation and Development, Development Assistance Committee, "General Statistics, 1972", July 1973, Tables 1, 2, 3, and 4.

Table 2. Net Flow of Official and Private Financial Resources,  
By Principal Types, 1962 and 1972  
(Percentage Distribution)

| Country                | Total<br>Flows | 1962           |                                       |                   | Private<br>Flows | Total<br>Flows | 1972           |                                       |                   | Private<br>Flows |
|------------------------|----------------|----------------|---------------------------------------|-------------------|------------------|----------------|----------------|---------------------------------------|-------------------|------------------|
|                        |                | Official Flows |                                       | Other<br>Purposes |                  |                | Official Flows |                                       | Other<br>Purposes |                  |
|                        |                | Total          | Official<br>Development<br>Assistance |                   |                  |                | Total          | Official<br>Development<br>Assistance |                   |                  |
| 1. United States       | 100.0          | 81.0           | 73.9                                  | 7.1               | 19.0             | 100.0          | 48.2           | 45.5                                  | 2.7               | 51.7             |
| 2. Japan               | 100.0          | 58.8           | 29.8                                  | 29.0              | 41.2             | 100.0          | 53.8           | 22.4                                  | 31.4              | 46.2             |
| 3. France              | 100.0          | 70.0           | 67.7                                  | 2.3               | 30.0             | 100.0          | 64.5           | 63.7                                  | .8                | 35.5             |
| 4. Germany             | 100.0          | 76.5           | 66.5                                  | 10.0              | 23.5             | 100.0          | 55.8           | 47.1                                  | 8.7               | 44.2             |
| 5. United Kingdom      | 100.0          | 56.6           | 56.6                                  | --                | 43.4             | 100.0          | 36.9           | 35.9                                  | 1.0               | 63.1             |
| 6. Canada              | 100.0          | 49.6           | 31.5                                  | 18.1              | 50.4             | 100.0          | 58.5           | 46.9                                  | 11.6              | 41.5             |
| 7. Netherlands         | 100.0          | 56.9           | 56.9                                  | --                | 43.1             | 100.0          | 48.2           | 47.4                                  | .8                | 51.8             |
| 8. Italy               | 100.0          | 28.5           | 20.5                                  | 8.0               | 71.5             | 100.0          | 47.1           | 19.3                                  | 27.8              | 52.9             |
| 9. Australia           | 100.0          | 100.0          | 100.0                                 | --                | --               | 100.0          | 65.0           | 64.0                                  | 1.0               | 35.0             |
| 10. Belgium            | 100.0          | 59.1           | 59.1                                  | --                | 40.9             | 100.0          | 52.7           | 49.3                                  | 3.4               | 47.3             |
| 11. Sweden             | 100.0          | 49.7           | 49.7                                  | --                | 50.3             | 100.0          | 72.7           | 72.7                                  | --                | 27.3             |
| 12. Switzerland        | 100.0          | 3.0            | 3.0                                   | --                | 97.0             | 100.0          | 38.8           | 37.3                                  | 1.5               | 61.2             |
| 13. Portugal           | 100.0          | 100.0          | 88.2                                  | 11.8              | --               | 100.0          | 82.7           | 70.5                                  | 12.2              | 17.3             |
| 14. Denmark            | 100.0          | 50.3           | 51.0                                  | - .7              | 49.7             | 100.0          | 82.0           | 79.7                                  | 2.3               | 18.0             |
| 15. Austria            | 100.0          | 44.5           | 7.4                                   | 37.1              | 55.5             | 100.0          | 14.9           | 16.6                                  | - 1.7             | 85.1             |
| 16. Norway             | 100.0          | 101.5          | 107.4                                 | - 5.9             | - 1.5            | 100.0          | 116.2          | 112.8                                 | 3.4               | - 16.2           |
| Total DAC<br>Countries | 100.0          | 70.9           | 64.4                                  | 6.5               | 29.1             | 100.0          | 52.1           | 44.2                                  | 7.9               | 47.9             |

Source: Calculated from Table 1.

Table 3. Net Flow of Official and Private Financial Resources  
in Relation to Gross National Product,<sup>1/</sup> 1962 and 1972  
(Percentages)

| Country                | 1962           |                |                                       |                   |                  | 1972           |                |                                       |                   |                  |
|------------------------|----------------|----------------|---------------------------------------|-------------------|------------------|----------------|----------------|---------------------------------------|-------------------|------------------|
|                        | Total<br>Flows | Official Flows |                                       |                   | Private<br>Flows | Total<br>Flows | Official Flows |                                       |                   | Private<br>Flows |
|                        |                | Total          | Official<br>Development<br>Assistance | Other<br>Purposes |                  |                | Total          | Official<br>Development<br>Assistance | Other<br>Purposes |                  |
| 1. United States       | .76            | .61            | .56                                   | .05               | .14              | .64            | .31            | .29                                   | .02               | .33              |
| 2. Japan               | .49            | .29            | .14                                   | .15               | .20              | .93            | .50            | .21                                   | .29               | .43              |
| 3. France              | 1.88           | 1.31           | 1.27                                  | .04               | .56              | 1.06           | .68            | .67                                   | .01               | .38              |
| 4. Germany             | .68            | .52            | .45                                   | .07               | .16              | .67            | .37            | .31                                   | .06               | .29              |
| 5. United Kingdom      | .92            | .52            | .52                                   | --                | .41              | 1.11           | .41            | .40                                   | .01               | .70              |
| 6. Canada              | .27            | .14            | .09                                   | .05               | .14              | .95            | .55            | .44                                   | .11               | .39              |
| 7. Netherlands         | .85            | .49            | .49                                   | --                | .37              | 1.43           | .69            | .68                                   | .01               | .74              |
| 8. Italy               | .89            | .25            | .18                                   | .07               | .64              | .46            | .21            | .09                                   | .12               | .24              |
| 9. Australia           | .43            | .43            | .43                                   | --                | --               | .96            | .62            | .61                                   | .01               | .33              |
| 10. Belgium            | .91            | .54            | .54                                   | --                | .37              | 1.12           | .59            | .55                                   | .04               | .53              |
| 11. Sweden             | .24            | .12            | .12                                   | --                | .12              | .66            | .48            | .48                                   | --                | .18              |
| 12. Switzerland        | 1.51           | .05            | .05                                   | --                | 1.47             | .58            | .22            | .21                                   | .01               | .35              |
| 13. Portugal           | 1.43           | 1.43           | 1.26                                  | .17               | --               | 2.15           | 1.78           | 1.51                                  | .27               | .37              |
| 14. Denmark            | .20            | .10            | .10                                   | --                | .10              | .57            | .47            | .45                                   | .02               | .10              |
| 15. Austria            | .42            | .19            | .03                                   | .16               | .23              | .55            | .08            | .09                                   | .01               | .46              |
| 16. Norway             | .13            | .13            | .14                                   | .01               | --               | .37            | .42            | .41                                   | .01               | --               |
| Total DAC<br>Countries | .80            | .57            | .52                                   | .05               | .23              | .77            | .40            | .34                                   | .06               | .37              |

<sup>1/</sup> At market prices.

Source: OECD/DAC, "General Statistics, 1972", July 1973, Tables 26, 27, 28, and 29.

Table 4.

Flow of Private Financial Resources  
from DAC Countries to Developing Countries and  
Multilateral Agencies, 1960, 1970, 1972  
(in billions of dollars)

|                                | 1960        | 1970        | 1972 <sup>1/</sup> |
|--------------------------------|-------------|-------------|--------------------|
| Bonds of Multilateral Agencies | .20         | .47         | .62                |
| Bilateral Portfolio Investment | <u>.63</u>  | <u>.78</u>  | <u>2.33</u>        |
| Total Portfolio Investment     | <u>.83</u>  | <u>1.25</u> | <u>2.95</u>        |
| Direct Investment              | 1.77        | 3.56        | 3.85               |
| Export Credits                 | <u>.55</u>  | <u>2.21</u> | <u>1.48</u>        |
| Sub-total                      | <u>3.15</u> | <u>7.02</u> | <u>8.28</u>        |
| Grants by Voluntary Agencies   | <u>n.a.</u> | <u>.86</u>  | <u>1.02</u>        |
| Total Private Flows            | <u>n.a.</u> | <u>7.88</u> | <u>9.30</u>        |

<sup>1/</sup> Provisional

Sources: IBRD, Annual Report for 1973, p. 86; and OECD, Development Assistance Efforts and Policies of The Members of DAC, 1969 Review, p. 38.

Table 5.

Euro-Currency Credits<sup>1/</sup>  
to the Less Developed Countries  
with a Maturity of more than one Year  
by Nationality of Borrowers  
(in millions of U.S. dollars)

|                                     | 1971<br>(Year) | 1972<br>(Year) | 1973<br>(First Half) |
|-------------------------------------|----------------|----------------|----------------------|
| <u>Latin America and Caribbean</u>  |                |                |                      |
| Argentina                           | 50.0           | 243.9          | 7.3                  |
| Brazil                              | 212.0          | 577.3          | 309.0                |
| Colombia                            | -              | 90.0           | 25.0                 |
| Dominican Republic                  | -              | 4.0            | -                    |
| Guyana                              | -              | -              | 12.5                 |
| Jamaica                             | -              | -              | 12.0                 |
| Mexico                              | 140.0          | 508.8          | 111.0                |
| Nicaragua                           | 10.0           | 15.0           | 40.0                 |
| Panama                              | 16.0           | 40.0           | 85.0                 |
| Peru                                | -              | 209.4          | 188.6                |
| Venezuela                           | 78.3           | 258.5          | 20.0                 |
| Total                               | <u>506.3</u>   | <u>1,846.9</u> | <u>810.4</u>         |
| <u>Middle East and North Africa</u> |                |                |                      |
| Algeria                             | 120.0          | 282.0          | 812.5                |
| Dubai                               | -              | 18.3           | -                    |
| Iran                                | 224.0          | 385.4          | 242.6                |
| Israel                              | -              | 10.0           | -                    |
| Total                               | <u>344.0</u>   | <u>695.7</u>   | <u>1,055.1</u>       |
| <u>Other Asia</u>                   |                |                |                      |
| Brunei                              | -              | 27.5           | -                    |
| Hong Kong                           | -              | 20.0           | -                    |
| Indonesia                           | -              | 97.6           | 200.0                |
| Malaysia                            | -              | 76.1           | -                    |
| Philippines                         | -              | 61.3           | 80.0                 |
| South Korea                         | 40.0           | 30.0           | -                    |
| Total                               | <u>40.0</u>    | <u>312.5</u>   | <u>280.0</u>         |
| <u>Other Africa</u>                 |                |                |                      |
| Gabon                               | 10.0           | 25.0           | 41.0                 |
| Guinea                              | -              | 40.0           | -                    |
| Ivory Coast                         | 22.0           | -              | 46.0                 |
| Kenya                               | -              | 15.0           | -                    |
| Mauritania                          | 8.0            | -              | -                    |
| Senegal                             | -              | -              | 25.0                 |
| Swaziland                           | -              | 3.2            | -                    |
| Zaire                               | 55.0           | 90.0           | 50.0                 |
| Zambia                              | -              | 25.0           | 50.0                 |
| Total                               | <u>95.0</u>    | <u>198.2</u>   | <u>212.0</u>         |
| <u>All Less Developed Countries</u> | <u>985.3</u>   | <u>3,053.3</u> | <u>2,357.5</u>       |

<sup>1/</sup> Amount of newly contracted loans.

Sources: Compiled from published loan announcements.



Table 6.

Euro-Bond Issues by  
Borrowers in the Less Developed Countries  
1969-1973  
by Nationality of the Borrowers  
(in million of U.S. dollars)

|                                     | 1969<br><u>Year</u> | 1970<br><u>Year</u> | 1971<br><u>Year</u> | 1972<br><u>Year</u> | 1973 <sup>1/</sup><br><u>First Half</u> |
|-------------------------------------|---------------------|---------------------|---------------------|---------------------|---|
| <u>Latin America and Caribbean</u>  |                     |                     |                     |                     |   |
| Argentina                           | -                   | 50.0                | -                   | -                   | -                                       |
| Brazil                              | 10.0                | 15.5                | -                   | 121.0               | 25.0                                    |
| Colombia                            | -                   | -                   | -                   | -                   | 20.0                                    |
| Jamaica                             | -                   | -                   | -                   | 10.0                | 14.0                                    |
| Mexico                              | 45.0                | 20.0                | 30.0                | 80.0                | 31.0                                    |
| Netherlands Antilles                | 38.7                | -                   | -                   | -                   | -                                       |
| Panama                              | -                   | 30.0                | 16.0                | 20.0                | -                                       |
| Venezuela                           | -                   | 13.3                | -                   | 39.8                | -                                       |
| Total                               | <u>93.7</u>         | <u>128.8</u>        | <u>46.0</u>         | <u>270.8</u>        | <u>90.0</u>                             |
| <u>Middle East and North Africa</u> |                     |                     |                     |                     |   |
| Algeria                             | -                   | -                   | -                   | 25.0                | -                                       |
| Egypt                               | -                   | -                   | -                   | -                   | 53.0                                    |
| Iran                                | 8.0                 | -                   | -                   | 20.0                | 20.7                                    |
| Israel                              | .9                  | -                   | -                   | 20.0                | -                                       |
| Total                               | <u>8.9</u>          | <u>-</u>            | <u>-</u>            | <u>65.0</u>         | <u>73.7</u>                             |
| <u>Other Asia and Pacific</u>       |                     |                     |                     |                     |   |
| Hong Kong                           | -                   | -                   | 15.0                | -                   | -                                       |
| Malaysia                            | -                   | -                   | -                   | 24.8                | 17.1                                    |
| Papua-New Guinea                    | -                   | -                   | -                   | -                   | 17.2                                    |
| Philippines                         | -                   | -                   | -                   | 50.0                | -                                       |
| Singapore                           | -                   | -                   | 10.0                | 51.0                | -                                       |
| Total                               | <u>-</u>            | <u>-</u>            | <u>25.0</u>         | <u>125.8</u>        | <u>34.3</u>                             |
| <u>Other Africa</u>                 |                     |                     |                     |                     |   |
| Guinea                              | -                   | -                   | -                   | 30.0                | 30.0                                    |
| Total                               | <u>-</u>            | <u>-</u>            | <u>-</u>            | <u>30.0</u>         | <u>30.0</u>                             |
| <u>All Less Developed Countries</u> | 102.6               | 128.8               | 71.0                | 491.6               | 228.0                                   |

<sup>1/</sup> Provisional

Source: IBRD, Annual Report for 1972, p. 93, and Annual Report for 1973, p. 99.