The International Debt Crisis and the Craxi Report

1. The subject of this article is the external debt crisis and adjustment processes, with reference to the Craxi Report. In November 1990, it became an official United Nations Report when it was unanimously adopted by the United Nations General Assembly as its own.[1]

What has been published so far is the summary document – in other words the "report", in the strict sense of the term, of the "policy" document. Annexed to it is a document of about 400 printed pages, analyzing the text which is currently being edited. The "policy" document itself provides the fundamental elements underlying the reasoning and the proposals, which are set out at the beginning and at the end.

Before I begin discussing adjustment processes – which is the main subject of this paper – I will briefly examine these proposals, summarizing the introduction and the conclusions of the document, entitled *"A systemic approach to debt relief addressed to major country groupings"*.

The term "systemic" is really the key to understanding this reasoning. It is based on the idea that partial debt reduction is often not convenient to the creditor countries or to the debtors, whereas it does become convenient when the reductions are global and involve all the creditors of one single debtor country, while at the same time mobilizing new financial resources leading to the adjustment process.

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[1] UNITED NATIONS, *External Debt Crisis and Development*, New York, 1990, referred to here and throughout this paper as the "Craxi Report". For a recent illustration of the international debt problem, *cf.* G. GOMEL, "Il debito estero dei paesi in via di sviluppo: la situazione attuale e le prospettive", *Moneta e Credito*, no. 173, March 1991, pp. 15-37. Another article, written a few years ago on the Baker plan, is "Il problema del debito nei PVS: sviluppi e soluzioni alternative", *Moneta e Credito*, no. 159, September 1987, pp. 329-344.

The systemic approach is based fundamentally on three pillars: global debt reduction negotiated with the various public or private creditors, new financing, and adjustment processes. The systemic approach also requires the simultaneous presence of four parties: the private creditors (to reduce the debt), the debtor countries (who must implement adjustment processes), the international financial institutions, and the governments of the industrial countries which provide the resources to foster the adjustment processes and stimulate the new financing. All of these undertake to reduce the debt burden and provide guarantees in order to make it convenient to private lenders to do the same. By providing these guarantees and implementing sound adjustment processes, despite being reduced, these debts become credits of greater value because they are less doubtful than before, given the borrowing countries' greater capacity to repay them.[2]

2. However, even though this may be true in theory, in practice only a partial debt reduction system has in fact been implemented. On the one hand there is the Brady plan for a number of countries, limited to commercial bank debt, and this is proceeding extremely slowly even though it looks like a bold step in the right direction. Secondly there is debt rescheduling with the governments of the Paris Club, following the terms agreed upon by the G7 Toronto summit in June 1988. But these only relate to bilateral official debt between governments, and not commercial debts with public guarantees. Moreover, they are only available to the low-income countries, and in some cases they make certain provisions which in reality tend to increase the debt burden in time.[3] In addition, a number of official bilateral debts with poor countries have been written off completely. Nevertheless, all these initiatives have been taken on a piecemeal basis.

With its systemic approach, the Craxi Report endorses different proposals for the low-income and middle-income countries with heavy and medium debt burdens, and for heavily indebted middle-income countries (in which the Eastern European countries are partially included).

[2] This whole issue can be analyzed in terms of "games theory", involving negotiations between three types of parties, each of which is seen to benefit from this global action in terms of their "contribution" towards the global commitment and the breakdown of the benefits.

[3] *Cf.* the diagram on page 23 of U.N., 1990, *op. cit.*

3. The low-income countries, namely those with per capita incomes up to 545 current dollars,[4] comprise most of the African countries, a few of the most important Asian countries, and virtually no Latin American country except the odd Caribbean country. In their case, the Craxi Report calls for a write-off of virtually all the "concessional" debts (which in development cooperation jargon are known as "aid credits") in the case of the IDA-eligible countries, namely those whose per capita income is up to 300 dollars or which have other features that put them among the "poorest countries".

For these countries the report suggests converting the non-concessional bilateral debt into 30 to 40-year credits with a 1-2% service charge in local currency (indexed to the dollar or to the ECU) to be deposited with trust funds for economic development, environmental protection and enhancing human capital. It is naturally assumed that other international agencies or bilateral aid institutions, both public and private, could contribute. This conversion of concessional and non-concessional loans should also apply to the "virtual" write-off of the government debt of other low-income countries.

Nowhere does the Craxi Report advocate "total debt write-off", but even in the case of aid loans to the poorest countries, it suggests cancelling the interest charges and indefinitely postponing debt repayment. However, even when it proposes 30 to 50-year repayments at interest rates of 1-2% in local currency, as in the case of the other loans referred to above, this is tantamount to virtual debt cancellation. It could be defined as "high potential cancellation" because it makes it possible for the creditors not to write off the principal of the loan from their balance sheets, and therefore merely to account for the loss of their annual revenue. Naturally, this annual revenue loss, spread over time, becomes only a small problem for the public accounts of the countries in question, particularly when the outstanding interest and the repayments are then used for economic, social and ecological local initiatives of priority concern. In practice, this results in increased development aid in the form of "conversion".[5]

[4] In the World Bank classification the figures are given in 1988 dollars, and so they are not always comparable.

[5] An Italian government Bill has taken up the proposal of the Craxi Report relating to aid credits to the poor countries, making it possible to write-off partially or wholly the service charges on these credits. The Bill was enacted in 1991.

4. Apart from the questions of debt write-off and debt conversion, another important issue, as far as the low-income countries are concerned, is the increase in concessional loans by international financial institutions, and private debts, which are normally a negligible proportion of the debts of the low-income countries.

The Craxi plan maintains that for these credits, public intervention is necessary at all events, to redeem them at a suggested 10 to 20 per cent of their original values, with the service charge on the outstanding principal paid in local currency (always indexed to the dollar or the ECU) to be deposited in trust funds for economic development, training human capital, the environment, combating drugs and other priority local initiatives, that have already been mentioned above.[6]

5. We will now deal specifically with the middle-income countries which have not been mentioned so far. The Craxi Report identifies the need to focus on this group of countries and take specific measures for them, classifying them amongst those with a per capita income of between 545 and 13,000 dollars.

At the present time, according to debt reduction philosophy, there is an imbalance because the "poor" and the "very poor" countries are considered on the one hand, while focusing attention on the so-called middle-income developing countries on the other. And yet there exists an intermediate category, whose problems are growing worse because of their debt burden. This category includes Bolivia and Peru in Latin America, while in Africa there are the Mediterranean countries like Egypt (with a per capita income of 620 dollars before the Gulf crisis) and Morocco (about 700 dollars), plus a number of sub-Saharan African countries, such as Ghana, with similar incomes. These countries cannot be considered in the same way as Brazil or Poland: their problems relate to their incapacity to pay, poverty and economic under-development, which are totally different from those of middle-income countries. One of the major achievements of the Craxi Report was to highlight the specific problems of these intermediate countries, in a category lying between the heavily and the medium indebted countries, and excluded from the Toronto-type plans of the Paris Club, or only partially included by pretending that, even though their per capita income is supposed to be 600 dollars according to official statistics, it is really only 550 according to a more accurate assessment of purchasing power. But instead of playing with the figures in this way, it would be much more meaningful to admit that there exists an intermediate category which needs specific and appropriate treatment.

For these countries, the Craxi Report suggests converting the debt into highly concessional loans, both in the case of official concessional and non-concessional bilateral loans, with interest paid into the local currency trust funds mentioned earlier. One of the main differences between these and the low-income countries is that there will be no "virtual cancellation" of aid credits, namely concessional loans, in their case. Moreover, in the case of both concessional and non-concessional bilateral loans (which are often private commercial loans insured by the institutions), the Report suggests converting them into 30-year credits with an interest rate reduced by 60% to 70%, with a partial instead of total repayment of the remaining service charges in indexed local currency into the special trust funds, selected by joint agreement with the governments of the countries concerned.[7]

6. At this point one can see even more clearly than in the case of the low-income countries with a heavy or medium debt burden, the problem of the Brady plan with regard to the commercial banks. Some have said that, in their case, the Brady plan should be given support from special agencies or IFI (International Financial Institutions) windows in order to reduce the debt burden by around 60% or 70%, using the various formulae we shall be discussing below.

The Craxi Report does not take up the suggestion advanced by a number of Latin-American economists and politicians that the debt

[6] During the early months of 1991 this solution was adopted for Niger with the full support of a special IDA window, as part of an operation in which Niger's debt was almost wholly written-off.

[7] It has been calculated that the range of these reductions and conversions of government debts, or government-guaranteed debts, from almost total write-offs in the case of the poor countries to reductions of approximately 70% for intermediate countries and 40% to 50% for the middle-income countries, should add a further 0.1% of the annual GDP to the public finances of the donor countries, which would therefore raise development aid from 0.35% to 0.45% of the global gross domestic product.

It should be noted, however, that most of these debt service charges are not paid at all. Budgetary losses to the industrialized countries are therefore minimal. The fact that these debts are not being repaid, but are officially still outstanding, makes these countries legally insolvent with serious repercussions in terms of their eligibility for other ordinary and concessional loans and government-guaranteed credit.

should be reduced to the same level as the debts on the secondary market. This is considered to be dangerous, in view of the fact that these countries would eventually have to return to the capital markets with an appreciable level of credit-worthiness which would be difficult after repudiating a substantial portion of their debt as these sources propose, because on the secondary market it is worth very little.

There is an important negative argument in terms of the so-called "moral hazard": if debt reduction has to be based on the secondary market price, it might suit the debtors to try to push these prices down. Instead of rewarding the "cooperative" countries and thereby attract more lending, this would reward unfair conduct which would discourage the lenders.

7. The third point for the middle-income countries is to increase concessional loans. In various parts of the Craxi Report it is argued that the infrastructure, particularly in the low and middle-income countries, cannot be financed using the present system of loans for which the interest rate charged covers the cost of raising the resources, like World Bank loans. These are not concessional loans in the technical sense of the term because they are granted at money market rates, without intermediation costs: this puts them just slightly below the prime rates. (The concessional rate is, in fact, lower than the real interest rate, less intermediation costs, because it contains a subsidy element.) Now, even if the loans are able to effectively bring about recovery and development, it is unlikely that debtor countries would automatically have a greater capacity to service their debts out of tax revenues, in view of the many demands placed on these, and the difficulties of increasing taxation (which is sometimes impossible or inopportune). It is therefore necessary to recognize, from the very outset, that loans for infrastructures which are non-income generating must be viewed as development aid and made in the form of a grant or as a highly subsidized IDA-type aid credit. Otherwise the debt crisis will re-emerge after short time.[8]

In its regional analysis, the Report shows how the low-income countries like India, Pakistan and Bangladesh do not have a foreign debt crisis, but might well have one if the aid system were not *highly* concessional (partly because Japan practises a system of IDA-type highly concessional loans, mainly in Asia). These loans, with a very low rate of interest and long repayment periods, contribute towards the creation of infrastructures which these countries could not acquire unaided. In other cases where these infrastructures depend greatly on the international institutions which are financed from the market, and which lend their money through revolving funds without concessionality (save for the operating costs of their institutions), problems have arisen even for countries with a higher per capita income than those just mentioned.

[8] The Italian law mentioned earlier, which took up the approach of the Report, provides that in the case of countries with which the Italian government has an agreement to write off bilateral aid loans, any future aid will be given in the form of grants, except where the economies of the countries being aided substantially improve.

8. The role of the regional banks' loans, according to the Craxi Report, is also important in the case of the intermediate countries for the marketing of their export commodities and for their industrialization. In their case, the interest rates can be reduced to a lesser degree, even though they must still be below market rates.

The main international financial institutions are not suitable for merchant banking, or for similar new financing initiatives through their normal channels. However, these activities are vitally important to encourage the development of the intermediate economies whose enterprises are in need of modernization and stimulus.

9. Turning now to the "middle-income" developing countries or countries undergoing transition, namely those with a per capita income of over 1,300 dollars, reaching a maximum of between 2,500 and 3,000 dollars, the Craxi Report advocates that non-concessional bilateral aid loans should be converted as indicated above, but to a lesser degree. The parameter used is a reduction of 40% to 50%. Strengthening the Brady plan along the lines already mentioned, should be more or less in line with the same parameter.

But here again, as far the countries considered above are considered, the Report advocates concessional loans and a role for the regional banks with lower concessionality in order to ensure that the adjustment process into which the "systemic" debt reduction policies fit is successful.

With regard to the Brady plan, rather than redemption the Report considers alternative instruments to its conventional "menu" to be much more important, of which the primary one is the conversion of bank debt into low-interest bonds, or bonds with a reduced principal. However, it emphasizes that these formulae should be more generous than the 35% reduction which has been offered so far, and they could take advantage of clauses for partial payment in (indexed) local currency, dollars or ECUs.

10. Generally speaking, according to the Craxi Report, the Brady Plan must be financed more substantially than it is at present in order to provide bridging loans and finance buy-backs, particularly appropriate for the lower middle-income countries, guaranteeing the payment of debts in local currency, providing incentives for refinancing and, lastly, offering even more substantial reductions in interest rates or in the amount of the principal outstanding, converted into medium- and long-term bonds.

The overall objective indicated in the Report for bank debts should be a debt reduction of about 50%, reaching 60% to 70% for the lower middle-income countries and 40% for the middle-income countries. 1% of the interest on the outstanding debt should be paid in local currency. The Report reaches this conclusion using calculations that take account of the problem of a country's repayment capacity in terms of the ratio between the growth rate of the GNP and the real interest rate, and the growth rate of exports (which is connected to the growth in exports and the world markets). These considerations reveal debt service difficulties when the debts are not reduced to at least 50% for countries whose growth is being seriously hampered by their debt problems. Since the fundamental theorem for the absorption of the surplus debt burden states that the real interest rate must be below this percentage,[9] a country with a medium term growth rate of about 0.75% of GDP (and this is the most one can expect from these countries in view of their low rate of accumulation) can only cope with a maximum interest rate of 3%. If a country is heavily indebted and has growth difficulties without inflation, an interest rate that is sharply above 2.5%-3% will create problems. A rate around 3% could work, but the re-absorption process will be slow and uncertain. The target of 2.5% requires the real interest rate to be half the present rates, which are at least 5% and often around 6%.

[9] On the relationship between debt and real monetary interest rates, *cf.*, for example, L. PASINETTI, "A Note on the Evaluation of Public Deficits: Net or Gross of Interest?", in this *Review*, no. 170, September 1989, pp. 303-311.

These considerations therefore lead to the idea of reducing the debt burden by an average of one-half rather than the 35% indicated by the Brady plan. Indeed, the Craxi Report often says "at least 50%", because in some cases even a 50% reduction is unlikely to be sufficient to enable some countries in a dramatically serious debt crisis to carry out an economic and financial adjustment process to pull them out of it. Moreover, on the secondary market many of these bank loans are worth 20-30%, and sometimes even 10%.

11. The Craxi Report states that the conversion of debt into equity could have a role to play, particularly to create new forms of financial collaboration other than mere indebtedness. The inflationary effect of increasing the money supply – which is what happens when debt is converted into equity that does not belong to the Treasury – is reduced if the conversion relates not to the principal but to a small part of it (for example the 2-3% debt service charge).

12. With regard to the Eastern European countries, the Report maintains that their financial transition needs to be financed by restructuring bilateral debt following the patterns indicated, and by extending the repayment periods (or consolidating the debt) in the case of short- and short-medium-term debts. The Brady plan would only apply to a few countries, such as Poland and Yugoslavia, in which it is impossible to do otherwise. But in the case of other countries, such as Hungary and Czechoslovakia, the most important thing would seem to be the need to provide the bilateral debt restructuring instruments mentioned earlier with "new financing" to underpin the transition to the market economy, and to implement the kind of formulae referred to in the previous section. In the case of countries which seem to be able to work on the market using these measures, it would be very dangerous to adopt real debt reduction measures that would affect their creditworthiness, and therefore hamper progress towards the full convertibility of their currencies.[10]

At this point, one issue emerges which is of great importance to the Craxi Report: the application of innovative financial instruments, with particular reference to the BOT (Build-Operate-Transfer) and

[10] On the difficulties and the prospects for this see J.M. VAN BRABANT, "Key Problems of Creating a Central European Payments Union", in this *Review*, no. 177, June 1991, pp. 119-149.

BTO (Build-Transfer-Operate) arrangements and commodity bonds. These are instruments which should be encouraged and supported by public insurance agencies, which unfortunately seem to view them with unjustified hostility. With both these formulae, the foreign investor does not make a loan but an investment, evidently supported by his own bank which gives the money to the foreign investor and not to the debtor country. Under a BOT arrangement, the foreign investor creates and operates the infrastructure or the business activity and earns income with which he pays the service charge on the loan. At the end of the repayment period the infrastructure, or the facility, is assigned to the country concerned which, during the intervening period, receives royalties. Under a BTO scheme, the foreign operator builds the facility and immediately afterwards assigns the proprietorship of the investment or the company, while continuing to manage it for a period of time to repay the investment from current income from operations, after deducting royalties paid to the host country.

13. Build-Transfer-Operate is almost obligatory for ethical, legal and political reasons in the case of mining investments: it is unlikely that a developing country would allow foreign investors in a mine to become the owners of the mine even up to the day on which the loan is repaid. It is much more natural for the mine to remain the property of the borrower who has placed this natural resource at the disposal of the creditor.

Other cases where it is much more logical to imagine a Build-Operate-Transfer system are motorways, power stations or airport facilities. In these cases the foreign party makes the investment, remains the owner of the infrastructure, maintains and manages it throughout the pre-established period or until the loan is paid off, while paying a royalty to the public authority (or to the party granting the franchise) in the developing country throughout this period. This system makes it possible to finance all the infrastructures from which there is a possible financial return, even in local currency, if the country in question has a certain degree of solvency, avoiding the traditional kinds of indebtedness.

14. The Craxi Report stresses developing financial innovation capacities in order to prevent improper recourse to foreign borrowing, and above all to external public debt which, being so rigid, can create

crisis situations when the foreign debt reaches significant proportions. Moreover, the formulae mentioned above and similar ones, unlike pure public debt, involve the transfer of technologies and the development of entrepreneurial cooperation and training.

Another formula on which the Craxi Report focuses in this connection is *commodity bonds:* these are bonds of the developing country which are indexed according to the market values of the commodities which will be obtained through the investment financed with them. For many basic agricultural commodities and mineral raw materials, coffee, petroleum, wool and so on, one could imagine bonds whose service charge is linked to a stock of commodities for which the investment is made for the purposes of providing a guarantee.

Apart from the guarantee function, reference could be made to the foodstuffs for which the investment is made, as a way of indexing the loan to the market value of the commodities in question. On one hand, this would provide linkage to a real value instead of a purely monetary value (this is important for bonds issued by a country with a weak currency), and, on the other, it would solve the problem of raw material price variations (which can be quite steep), thus enabling the borrower to pay less when the prices of that commodity falls, in terms of other commodities, the dollar or some other currency, and obliging him to pay more when the price improves. Instead of linking the debt service to the world interbank rate – which is a non-correlated variable, when it is not linked to the debtor's ability to pay – it links the debt service to the price of the commodity, which is a good index – *coeteris paribus* – of the country's capacity to pay.

Public insurance for the industrial countries' exports should take a much greater interest in these forms of financial innovation than has been the case so far.

15. A long chapter of the Craxi Report sets out to show that one of the main causes of debt is excessive government control, which has increased fixed income financing as a public debt, coupled with a lack of diversified financial instruments. In this way, development as well as the deficits have been increasingly financed from public debt. This has not only created rigidities but also takes away the possibility of selecting the most convenient options, by not motivating the borrower to make the investment pay.

When there are unfavourable variations in real interest rates, exchange rates and market rates, difficulties or crises arise which can be overcome using different financial formulae, mostly based upon "joint ventures" which are closer to the market.

The Craxi Report stresses the fact that it is necessary to ensure that once the external debt burden has been reduced, it is not reproduced in the same way because of a need for "new money".

It is paradoxical to maintain that it is necessary to reduce bank debt because the borrower cannot repay it, while at the same time maintaining that we have to provide new financial resources for the development of the less developed countries, not only with aid, but also by resuming the traditional flow of loan capital. One of the "ways out" of this apparent contradiction is by these new financing arrangements. The other, according to the Report, is to develop regional cooperation schemes which make it possible, to a certain extent, to convert "domestic debt" into foreign debt, thereby playing down the "country risk" issue.

II

1. We will now look at the adjustment processes which are one of three components in the strategy of the systemic debt reduction game. First of all, it should be noted that, for the purposes of ensuring that the adjustment processes are successful, the Craxi Report maintains that new fiscal and monetary measures must be available for economic development.

This greater availability is crucially important because the governments of the developing countries have to "sell" the adjustment processes to their own people, and it is to be hoped that these processes take place in a democratic regime. It is therefore a question of establishing a consensus in exchange for the prospects of development. But development prospects are enhanced when there is external aid. An adjustment process which makes it possible to have that aid not only increases the capacity to pay the foreign debt, but can also be more easily accepted.

Hence the importance which the Report attributes to the suggestion to increase official development assistance by doubling it from 0.35 % to 0.7% of the gross domestic product of the "affluent countries" throughout the 1990s. 0.35% of the gross domestic product is about 50 billion dollars.

By doubling development assistance in this way, according to the deliberately elementary calculations given in the Report, the developing countries could increase their rate of growth by about 1.5%. This obviously implies a significant change in the medium- to long-term. In all events, it would markedly improve the chances of solving the debt problem because it would make it easier to meet the condition of the "fundamental theorem", namely, that the interest rate charged on the debt must fall below the GDP growth rate. One can imagine various ways of multiplying the positive effect of increased aid. One of these methods is linked to the role of the international financial institutions in the broad sense of the term; in other words, not only the International Monetary Fund and the World Bank, but also the main regional development banks.

2. The Craxi Report suggests using the increased Special Drawing Rights (SDRs) recently adopted in relation to increasing quotas in the International Monetary Fund. The rich countries which, because of the overall doubling of their quotas, receive a very substantial supplementary amount of SDRs, should use them to place new resources, including funds for concessional loans, at the disposal of the international financial institutions.

In other words, what is being suggested is to increase development aid, not only through fiscal instruments but also by monetary means, so that a worldwide monetary policy can be implemented which is more favourable towards expansion. However, the Report does not stress this point because it is for the G7 to decide whether, and to what extent, to increase development aid from the OECD and the oil-producing Arab countries, using fiscal and/or monetary policy. However, the understanding is that new money is needed, albeit in amounts which are quite limited compared with the resources of the "rich" countries, in order to solve the problems of development of the less developed countries.

3. The Craxi Report, in the analytical part, places particular emphasis on the "philosophy" of the adjustment processes, according to the "Washington views" as they emerge from the book by Williamson, which refers explicitly to the problems of Latin America.[11]

[11] J. Williamson "What Washington Means by Policy Reforms", in J. Williamson (ed.), *Latin American Adjustment. How much has happened?*, Institute for International Economists, Washington. D.C., 1990.

Washington not only means the United States of America, but also the international institutions headquartered there: the World Bank, the International Monetary Fund and, in the case of Latin America, the Inter-American Development Bank, as well as the experts of various institutions (such as the one to which Williamson belongs, the Institute of International Economics, where two schools have a dialectical relationship: one "conservative" and one "progressive") plus the distiguished Brookings Institute. The reference is therefore to a non-homogeneous group of institutions which have different opinions and whose members often adopt different stances, but in which one can summarize the consensus in terms of ten themes which we will now examine, and which the Craxi Report deals with in its various sections.

4. The first theme refers to reducing the budget deficit of the global public operator. It is obvious that since foreign debt is very largely public debt, it has to do with the budget deficit. There would not be such a huge external public debt in the Latin American countries (and in the developing countries in general) if there had not been public finance deficits, in the broadest sense of the term, to include the public corporations.

It should also be noted that in cases such as Brazil, where the bulk of the debt is linked to loans to public corporations, they are not always debts contracted for capital investment purposes. Often they are debts contracted to cover operating deficits. However, from the point of view of the public budget, any shortfall in revenues over expenditure, whether on capital or current account, is always a deficit, and it is a burden on public debt and generates inflation because it is financed by issuing money.

With regard to reducing the deficit to acceptable proportions in the countries suffering from hyper-inflation, there are some very complex accounting problems. Calculating the real deficit in terms of the effect of inflation upon the full amount of the debt is a very delicate question and the solutions are controversial.

Very often the *ex post* deficit, adjusted for inflation, seems to be small compared with the GDP (as in the case of Brazil or Argentina) because inflation erodes the loan contracted to finance it.

However, one must wonder whether the *ex ante* deficit, which is destroyed by inflation, perhaps generates inflation. In Latin America it does, because they print money to cover it. In other words, there

are certain "unorthodox" ways of refinancing the deficit which generate inflation. Inflation partially eliminates the *ex post* deficit.

In this way, if the deficit is calculated in real terms, *ex post*, in certain countries like Brazil, it disappears altogether with certain methods of calculation.[12]

One thing is certain: if assets are invested of an equivalent value to indebtedness, and belong to public corporations, the assets can be revalued – at least in accounting terms – in such a way that the debt expressed in devalued currency gives rise to a surplus. But in order for this to hold good, there must be a return on the capital investment in question.

5. Apart from this, according to "Washington thinking" it is generally felt that in order to balance the budget, one can neglect the secondary deficit, namely the deficit which relates to the debt-servicing charge, and concentrate solely upon eliminating the primary deficit. However, the "Washington view" pragmatically maintains that by removing the deficit connected with the debt service charge a much more reliable benchmark is obtained, for the simple reason that by so doing the controversy over the effect of inflation on the capital value of the debt is removed from the discussion altogether. In the Craxi Report this theory is indirectly rejected by its emphasis on the "fundamental theorem" of the excess GDP growth rate over interest rate as a method of gradually eliminating the secondary deficit.[13]

Williamson does not accept this "Washington view" either, because it ignores the whole problem of "debt service" which is too heavy for the public finances to bear when they are already in deficit and which can generate inflation. He argues that it is too limited an objective merely to aim at eliminating the primary deficit. One can see this from the Italian deficit where the primary deficit has practically disappeared, while there is still a deficit of 10% of GDP, as a result of accrued debt service charges, that is not easy to contain without public finance intervention, which is anything but easy. Furthermore, in a highly indebted developing country, a debt burden of 10% of GDP is a very heavy burden,

[12] In Italy there has been a similar controversy over the budget, in which Professor MODIGLIANI maintained that the Italian budget was at break-even or even in surplus. This has occurred mainly in periods in which inflation exceeded expectations, when the interest rate tended not to rise in real terms but to fall, while the asset values on pre-existing debt was destroyed.

[13] L. PASINETTI directly attacks this thesis, based on opposition to the "fundamental theorem", in the article mentioned earlier (Note 9).

because it could easily account for 50% of the value of its exports. The secondary deficit should therefore not be ignored.[14] Moreover, it has to be seen, as in the Craxi Report, in terms of the "fundamental theorem".

6. The second point is that the deficit must also take into account the direct loans which the central bank makes to the economy.

This is a matter of "concealed deficit". Very often, the central bank issues subsidies to agencies and companies which do not appear in the national budget, but they generate inflation.

Moreover, account must also be taken of the future charges in terms of social insurance, after deducting social contributions.

The question of reducing public deficits also raises ambiguities on the revenue side. Income from privatization, when there is a budget deficit, should not be included among the resources to be used to cut the public deficit, but rather among the funds to reduce the debt stock.

This is an extremely important point. Some people, even in Italy, wrongly maintain that revenues from privatization are "genuine income". At best they are a *transformation* of the net worth of the public operator. The assignment of publicly-owned equity or real estate simultaneously reduces the value of assets (namely the value of the assets plus debt) and liabilities (namely the public debt) while the public net worth remains unchanged – if the capital assets are not sold in order to finance deficit expenditure.

In the latter case, if the expenses are for capital investment, once again there is a mere asset conversion, but it could happen that capital assets comprising interest-bearing investments could turn into non-interest-bearing investments, and *vice-versa.* But if the income from disposals is used to finance current expenditure, privatization is part of the financing of the current account deficit.

7. Another theme, following on from the question of reducing the public deficit, is public expenditure priorities. These priorities have to be defined in relation to public expenditure containment policies which are often, unfortunately, indispensable in view of the low level

[14] For an analysis of debt service and its component parts, *cf.* H.D. GIBSON and A.P. THIRLWALL, "An International Comparison of the Causes of Changes in the Debt Service Ratio, 1980-1985", in this *Review* , no. 168, March 1989, pp. 73-95.

of revenues – even though, according to the Craxi Report, public expenditure containment is generally a *second best* to increasing revenues in the indebted countries, in view of the fact that they are generally so meagre.

According to the thinking that is emerging with regard to the reduction of public expenditure in what we have been calling "Washington" circles, one should also consider subsidies as prime candidates for reduction or elimination. On the other hand, expenditure in "human capital" – education and health-care – and in infrastructures should be considered priority matters and, if possible, increased.

But here the Report makes a number of observations.[15] First of all, one should not imagine that all subsidies create distortions in the way they are allocated. Some of them contain corrective elements. They are useful, for instance, in developing new industries. This is the typical case of Korea, one of the countries which is quoted as having been "good" at removing its excessive foreign debt.[16] What is needed is selectivity, without "permissiveness".

The same applies to certain subsidies which have a strong social priority. Indeed, it would be contradictory to maintain the priority of expenditure on human capital while at the same time removing subsidies on food or other subsidies for the minimum essential survival needs of the poor.

8. By all means let subsidies be reduced, but not all of them. The Craxi Report suggests that it should be done selectively.

Moreover, with regard to public expenditure on human capital – and this is my own personal view – it cannot be denied that in these countries such expenditure is low, despite its substantial high economic and social value.

But we must understand exactly what we are talking about.

Education, for example, can be either basic vocational training or higher education. In many of these countries there is an excess of higher education and teaching of arts subjects, which creates intellectual unemployment and population shifts, and even causes people to emigrate to the OPEC countries after having studied in the poor

[15] See also WILLIAMSON, *op. cit.*

[16] On the Korean case, and the industrial policies of the NICs in general, see S. LALL and G. KELL, "Industrial Development in Developing Countries and the Role of Government Interventions", in this *Review*, no. 178, September 1991, pp. 271-292.

countries: a doctor earns much more money there than in the poor countries. The emphasis should be placed on primary education and vocational training.

Even with regard to health expenditure there is a selectivity problem that is largely ignored. Various research projects, for example, stress that for mother-and-child care, information is important above all else. Considering the very high mortality rates in the first five years of life, both for children and mothers, and the enormous numbers of children born underweight in many of these countries, what is needed is population education and social and health care assistance work, rather different from traditional health care intevention. Considering the high population growth rates, it is necessary to carry out a family information and education campaign, linked to the cultural traditions, but also based on the principles of modernization and rationality.[17]

9. The third issue, relating to adjustment processes, concerns tax reforms. Obviously, this is linked to the first theme because both of them, in addition to equity, share the main objective of reducing the deficit without oppressing the economy. This can often be done through income tax, by increasing the taxable base, improving tax audits and assessments, and reducing the marginal rates which are very high in theory but in practice create huge capital flights and widespread methods of tax avoidance and evasion. When raising the taxable bases, consumption taxes on non-essential goods, which are often imported and on which it should not be difficult to levy taxes, should play a major part.

Another matter which has not been given much attention in the developing countries has to do with wealth tax. In particular, the taxation of real estate, which obviously cannot "flee abroad", is widely neglected. Emphasis is often placed on personal income taxes, which are difficult to levy, while it would often be more intelligent to implement simple and effective forms of taxation such as real taxes on property, which are harder to evade. And yet many rich people in the developing countries, as the Craxi Report points out, are living in their own country on money that they have spirited away abroad.

[17] *Cf.* World Bank, *World Development Report 1990 - Poverty*, New York, Oxford University Press 1990, particularly pp. 81-87.

10. The fourth theme is the question of the interest rate to be used in the indebted developing countries. According to "Washington" thinking, there are two principles which are sometimes contradictory, but both make sense. The first is that the real interest rate should be positive in order to encourage domestic saving and discourage capital flight. The other is that the real interest rate should be determined by the market.

If it is determined by the market, the interest rate is likely to be positive, and it could be very high for the at-risk countries. That creates a twofold problem: very high interest rates place an enormous burden on domestic public debt and, at the same time, discourage investment.

According to the Craxi Report, interest rates in general should be sufficiently high to encourage savings, but not to the extent that they discourage investment and generate difficulties in placing public finances on a sound footing. In order to make allowances for this, Williamson suggests a formula which we can go along with: a positive but moderate interest rate.

Naturally, measures must be taken to ensure that this positive but moderate interest rate is commensurate with the country's growth capacity in terms of its available resources. In other words, the interest rate should only give rise to a volume of investment which is compatible with the country's productive resource availability, bearing in mind the rigidity of the supply. In this connection, the Report notes that enormous errors were committed in Chile, because for a long time the country pursued a restrictive monetary policy which for many years merely generated unemployment and depression. The careful adjustment of this policy and other favourable circumstances have helped Chile to pull out of its debt crisis.[18]

One must realize that the adoption of a policy to expand money supply to reach full employment, using a Keynesian recipe, can be dangerous if there is no flexibility on the supply side. On the other hand, one must remember that dismantling the existing production system with a very steep increase in interest rates, pinning one's hopes on reconversion or something else, may not generate new employment precisely because of this supply side rigidity.

This is a particularly important issue for the transitional economies of Eastern Europe in their present phase.

[18] On the effects of severely restrictive monetary policies in certain Latin American countries, see J. Lòpez, "Contractive Adjustment in Mexico, 1982-1989", in this *Review*, no. 178, September 1991, pp. 293-318.

11. The fifth point, relating to adjustment processes is exchange rates. According to the "Washington view", which incidentally seems to be one-sided, exchange rates should be such that they immediately generate "competitive" effects.

Often, however, precisely because they have fixed exchange rates which are not updated, the debtor countries find themselves with an over-valued currency. As a result, their agricultural or manufactured exports cannot find an appropriate market.

It is nevertheless true that if "immediately competitive" exchange rates were to be applied by the indebted developing countries, this could prove to be a dangerous game. The Craxi Report points out that if every country were to depreciate its currency in order to compete with the others, and if the overall foreign demand is fairly rigid, it worsens the terms of trade of all the countries concerned, without expanding their exports or reducing their imports enough to improve their balance of payments situation. In other words, situations of the "prisoner dilemma" type can arise, in which a particular choice which might be beneficial if taken by each country individually turns out to be damaging to every country if they all make the same choice together.

Williamson's solution is that all exchange rates should be sufficiently competitive to encourage a flow of exports which will enable the economy to grow at the maximum rate permitted by the supply side potential, while keeping the current account deficit at a level which can be financed on sustainable bases.

Quite rightly, Williamson points out that an exchange rate which is not so competitive might allow the economy to grow smoothly with a balance of payments deficit, in a situation of monetary stability or at all events in a climate of general economic viability. This brings with it a capital inflow which will make it possible to cover the balance of payments deficit, and hence obtain loans partly on the international market.

In other words, an exchange rate which is not fully competitive, but which eventually tends to guarantee the currency's purchasing power, can simulate a flow of foreign capital (or the re-entry of flight capital) and thereby make it possible to run a balance of payments deficit which will enable the country to grow by relying on international resources as well as domestic resources. This not only makes it possible to strengthen the political and monetary climate, but also raises living standards and real wages more than would otherwise be

possible if the country had aimed at removing the balance of payments deficits with a continual depression of its terms of trade and hence "selling off" its raw materials and commodities.[19]

This idea, even though not explicitly taken up in the analysis of adjustment processes set out in the Craxi Report, helps to clarify the conceptual basis of its prudent approach to exchange rate policy.

12. What any one single developing country is unable to do successfully in its policies to stimulate exports (drastically devaluing its currency) must be possible if done by all the developing countries taken as a whole, taking "reasonable" concerted action, if possible by forming a coalition between themselves and the developed countries.

The failure to develop "reasonable" concerted commercial policies and the failure of the IFIs to consider this "systemic" theme has sometimes given rise to suggestions regarding adjustment processes for foreign trade, with "perverse effects".

13. One of the errors that one notes, on closer examination of the exchange rate policies of these countries, is that they have been continually changed.

A country might choose a policy for the all-out defence of its exchange rate despite inflation differentials, attempting to boost productivity and, at all events, to reduce the inflation rate. This is a well-defined policy. The Bank of Italy has solemnly announced it and is implementing it. On the other hand, one can implement a flexible exchange rate with rapid adaptation, aiming at striking break-even in the current account of the balance of payments or some similar objective. In this case the real, not only the nominal, exchange rate continues to vary within the given exchange rate *policy*. Both policies, despite their substantial differences, share the virtues of consistency and certainty. If, on the other hand, the exchange rate *policy* is continually changed, uncertainty is created which puts the business community off investment, particularly in the sector of those commodities which are most exposed to international competition.

[19] One criticism which is similar in many respects to the idea of an equilibrium exchange rate equivalent to a zero balance on current account – a prevalent idea in US textbooks and academic literature – has been raised by S. BIASCO (*L'inflazione nei paesi capitalistici industrializzati*, Feltrinelli, Milan, 1979; "Currency Cycles and the International Economy" in this *Review*, no. 160, March 1987, pp. 31-60), proposing the alternative of a Keynesian-type analysis of exchange rates which are essentially determined by capital flows.

But even pursuing an unrealistic exchange rate policy in terms of the economy produces a similar result. In this case, the export and the import substitution industries are exposed to excessively high risks, and investments will no longer be made. Generally speaking, this rigorous line becomes increasingly impracticable as time passes, and reality eventually causes it to come to grief. When that happens, the government pursues a "non-policy", as happens in many countries in Latin America, including Argentina and Brazil. Pinochet's Chile, with enormous damage to its economy, pursued a policy with many ups and downs. A similar thing happened in Peru, which changed policy three times in the space of only a few years under the same government, with very negative results indeed.

14. The sixth theme relating to adjustment processes has to do with commercial and currency policies in connection with imports and exports. The prevalent "Washington view", as is widely known, is the total liberalization of currencies and trade in relation to GATT and the Uruguay Round. The Craxi Report is very circumspect in this regard.

But it is useful here to examine the qualifications which Williamson proposes to the Washington thesis. Industries in the less-developed countries may deserve temporary but substantial protection measures. The positive experience of the NICs cannot be ignored. A customs tariff of between 10% and 20%, with little dispersion, could bring in revenues, stimulate a regional policy and diversify production, which could be useful in a system with a rigid supply, when the Ricardian idea of specialization following comparative advantage might seem over-simplistic.

In theory, in a state of perfect competition with complete resource mobilization, it would be right to follow the theorem of comparative advantage, if one could suppose that there are no Marshallian external economies of development. But even leaving aside Marshall,[20] in an imperfect world, such as the economies of the developing countries and/or transitional countries typically are, it would seem more useful to have a tariff of between 10% and 20% as a sort of "safety belt". Tariffs of 100% and over, or the complicated systems of commercial and/or currency licenses used by many indebted countries have, are quite another matter, and the Craxi Report is strongly critical of them. The dismantling of protectionism, moreover, must be gradual in order to be able to convert, rather than destroy, resources and to avoid generating the unemployment which becomes inevitable in view of the rigidity of the growth in supply, if the excessively protectionist customs barriers are *suddenly* abolished.

[20] And ALLYN YOUNG, and all the modern literature on cumulative development process; *cf.* F. FORTE, *Manuale di Politica Economica*, Torino, Einaudi, 1970.

15. What is happening in the transitional economies, because of the "supersonic" liberalization recipes being suggested for many Third World countries, seems to ignore the positive experience of the European Community which has been following a gradual process as far as the removal of internal barriers are concerned. In the EEC the removal of customs barriers took twelve years, in the agriculture sector there is still a long way to go, and the final phase for non-tariff barriers will not be reached before 1993. Drawing on this experience, the Craxi Report comes down in favour of a gradual policy, moving decisively and unambiguously in the two-fold direction of internally liberalized regional areas and external policies for limited protection. In view of the obvious difficulties of reaching an agreement on the original objectives of the Uruguay Round, the Report suggests placing greater emphasis on regional areas without giving up the policy of global trade liberalization.

16. The seventh theme is direct foreign investment. According to the "Washington view" this should, as far as possible, be encouraged in the indebted countries because of their need of foreign capital.

As I have already mentioned, the Craxi Report devotes a great deal of attention to the question of international financial and technological cooperation, which can both help to increase domestic demand and diversify production. Lowering production barriers on a reciprocal basis, with greater linkage to the raw materials and intermediate commodity markets, a non-inflationary fiscal and monetary policy, in a climate of certainty with regard to exchange rate policies and regulation in general, guarantees national and international investors the right climate to diversify production and exports. Obviously, foreign investment must also be guaranteed by a framework of rules and specific procedures based on certainty and (comparative) simplicity.

By forcing investment into traditional commodities, their international markets become congested and the terms of trade mentioned above worsen.

The Third World countries have the unhappy record of being "single commodity" countries in terms of raw materials, intermediate commodities and finished products.

It is hard to understand, except for historical and cultural reasons, why it is that when these countries devote themselves to fruit farming they only export – say – grapefruit or bananas, while it is obvious that they are in a position to produce any type of fruit or vegetable. Apart from reasons stemming from tradition, one cannot understand why they should concentrate on cocoa and coffee (to mention but one example) instead of trying to produce other foodstuffs that have a greater market potential, or why Argentina insists on exporting its beef or wheat which come up against a protective agricultural policy of the EEC, which is unjust but hard to dismantle, instead of producing, for example, wool or pigmeat.

This also applies to processed products. For example, would it not be possible to envisage exporting salami, sausage and processed meats? Could they not envisage exporting, for example, selected breeds of cattle for replenishment purposes? I presume that the answer to these questions is that these innovations and this kind of diversification requires international investment.

17. The eighth theme, on which the whole debate relating to adjustment processes is based, is privatization. This is a field where extreme positions often dominate. The Craxi Report takes a balanced position: privatization should be pursued above all where it introduces greater efficiency and competition, even by developing new foreign investments. But it would be a mistake to believe that privatization is necessary "willy-nilly" because public service is always worse than private service, from the viewpoint of strategic decisions and motivational strength. In quite a number of indebted countries public services should be improved rather than privatized in order to enhance the economic efficiency of the *system*. Various formulae are possible here, including the privatization of public services and cutting red tape. This is one way of fighting a problem that exists in many debt-ridden countries. Their "hyper-bureaucratization" is often purely motivated by the lust for power.

18. The ninth point relating to adjustment processes concerns deregulation. In the case of banks, transport and the environment, total deregulation could create serious problems, as recent experience

in the developed countries has shown. In the light of this, it would appear correct to introduce a note of caution for the developing countries. After doing so, the Craxi Report points out that in Latin America and Africa there exist forms of oppressive, feudal regulation which are imposed more through administrative regulations than legislation and which make the institutional environment unsuitable for economic development.

Nearly all *dirigiste* policies have been implemented in the name of the people. Deregulation not only encourages efficiency but also democracy. As the Report points out, administrative arbitrariness needs to be replaced by the certainty of the rule of law.

20. With this we come to our twelfth theme: property rights. The protection of the right to property in the countries we are considering, according the Craxi Report, is also linked to the question of human rights. For what might be considered to be a problem of excessive property rights in the capitalist countries is often a problem of individual insecurity in the developing countries.

For economic development and freedom, property rights must exist, and cannot be taken away. The Report refers in this respect to the need for an economic and political constitution, under which the citizen is vested with rights, protected by a law grounded on the constitution, including the right to be protected by a monetary and fiscal constitution which prevents anomalous forms of public debt, such as those which have been strangling the developing countries, and which were largely due to the fact that the commercial banks took a short-term view in their dealings, without any international monetary and fiscal constitution, driven on by the quest for an immediate return, which has now turned out to be a trap.

But, significantly perhaps, this is a subject on which papers expressing the "Washington view" have nothing to say.

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