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No. 51, March 1966

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EXTERNAL DEBT AND DEBT-BEARING  
CAPACITY OF DEVELOPING  
COUNTRIES

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*International Finance Section*

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# EXTERNAL DEBT AND DEBT-BEARING CAPACITY OF DEVELOPING COUNTRIES

**N**EVER before has the problem of accelerating the economic growth of less developed countries been of such fundamental importance, both politically and economically, as today. Not without reason have the 1960's been proclaimed the "development decade." The present generation is becoming increasingly aware that the world is confronted by (1) a widening gulf between the average standards of living of two groups of countries, the industrialized countries and those still predominantly in a primitive state of economic development; (2) a growing disparity between the poverty of the countries belonging to the second group and their greater political influence on world events; and (3) the need for the countries in the first group to take better account of the special demands that are placed on sound financing of the economic-growth process in the developing countries and on increasing their creditworthiness. This paper deals with the third of these points.

## FOREIGN-CAPITAL REQUIREMENTS OF DEVELOPING COUNTRIES

Acceleration of the process of economic growth and diversification of production in the developing countries is predicated among other things on increased internal capital formation and/or an increasing, or at least continued net capital inflow from the industrialized countries. In most of the developing countries the possibilities of internal capital formation are restricted by low productivity and by growing consumer demand, in both the private and the public sector, due to the rapid increase in population. Moreover, in order to accelerate their economic growth, most of them urgently need imports of capital goods, raw materials that are not available locally, technical know-how, etc., which for the time being they are not in a position to finance by stepping up their exports. The chief reasons for this are the following:

1. Balanced growth calls for substantial investments in what is known as the infrastructure—roads, ports, means of transportation, electric and other power, water supply and flood control, education, etc.—all of which are prerequisites for further expansion and usually

require considerable amounts of foreign exchange, while they do not in themselves contribute towards increasing export revenue.

2. Generally speaking, growing investments in a developing economy result in increased demand for imported raw materials, mechanical equipment, and replacement parts.

3. Acceleration of investment activity in developing countries generates incomes that tend largely to be spent on the purchase of imported goods.

4. Investment projects which may assist in raising the export capacity of developing countries frequently require a considerable period for execution and start-up and usually set these countries the difficult task of attaining a level of efficiency that will enable them to compete in world markets.

5. The traditional exports of many developing countries, consisting of agricultural produce and raw materials, afford little opportunity for raising their export earnings rapidly; changes in the production structure with a view to greater diversification call for entrepreneurial initiative and investment capital which are scarce, and the process is usually time-consuming.

6. An important factor limiting the rapid expansion of export earnings in the less developed countries is the slow rate at which demand for the traditional imports from these countries increases in the developed countries.

7. A further limiting factor is the willingness of the developed countries to increase their imports from the less developed countries, in view of their reluctance to open their markets any wider for such imports and to adapt themselves to a rational, international distribution of labor based on the comparative-cost principle.

If the increase in exports, or the substitution of imports by domestic production in the developing countries could keep pace with the rise in their external spending, which is both directly and indirectly connected with more satisfactory economic growth and with the investments that growth requires, no net capital import would be required (even though in that case no margin would be left for building up the desired foreign-exchange reserves). Analysis and experience, however, go to show that in general this is not possible. In most cases, the capacity to step up domestic production and reorient the economic structure, which is essential if the import-export ratio is to be changed to such

an extent that capital imports become superfluous or can be substantially reduced, is, in the shorter term, very restricted, while the attainment of a reasonable measure of economic growth by self-financing is a protracted business. Countries rich in raw materials that can readily be exploited and exported, such as petroleum, and with a relatively small population in relation to the wealth of their natural resources, therefore enjoy a favorable position. In most of the developing countries, however, this is not the case and the only alternative is: substantial capital imports, extending over many years—or economic stagnation.

TRADE DEFICITS OF DEVELOPING COUNTRIES: EXTERNAL FINANCING

A recent study (Loan terms, debt burden and development, Agency for International Development, Department of State, April 1965) showed that in the seven-year period from 1956 to 1963 the deficits on the goods-and-services accounts of all less developed countries combined rose from \$5 to \$7.9 billion a year. This was accompanied by an average annual increase of 4.4 per cent in the total gross national product of those countries. The table which follows presents the comparative figures for 1956 and 1963, from which these results are derived, together with a summary of the funds applied to covering the current-account deficits.

TABLE I  
GROWTH, CURRENT-ACCOUNT DEFICIT AND FINANCING OF ALL  
DEVELOPING COUNTRIES—1956-1963  
(in billions of dollars)

	1956	1963
Gross national product	148.0	200.0
Imports of goods and services (excl. from developing countries)	28.1	39.7
Exports of goods and services (excl. to developing countries)	23.1	31.8
Balance on current account	5.0	7.9
Loans payable in convertible currency, gross	1.8	5.4
Interest and amortization	0.8	2.9
Loans payable in convertible currency, net	1.0	2.5
Other sources (grants, "loans" to be repaid in the currency of the recipient country, direct private investments etc.)	4.0	5.4
Total financial resources	5.0	7.9

The most interesting conclusions regarding financing that can be drawn from the above figures are that in the space of those seven years (a) there has been a considerable increase in the amount of loan funds used to cover the current-account deficits of the developing countries and a corresponding decrease in the contribution from other sources; (b) the contribution from net loans has risen from one-fifth to more than one-third; and (c) gross loans have risen by 200 per cent, interest and amortization by 263 per cent, and net loans by 150 per cent.

The 1963 figures for financial resources received by the developing countries, which were used in the above study, are to a large extent borne out by another recent study (The flow of financial resources to less-developed countries, 1956-63, Organization for Economic Cooperation and Development, Paris, 1964), which was based on the financial resources made available by the industrial countries. The latter study concludes that of the net transfers from the developed to the less developed countries in 1963, more than one-third were in the form of loans repayable in the currencies of the creditor countries. Somewhat less than half were in the form of grants and transfers repayable in the currencies of the debtor countries. The remainder (approximately one-fifth) were accounted for by direct private investments. The total amount of the transfers analyzed in this (OECD) study is, however, higher, namely not \$7.9 but approximately \$9 billion, owing to the inclusion by the lending countries of approximately \$1 billion in the form of technical assistance.

#### *Growth of External Debt*

A study recently published by the World Bank (Economic growth and external debt, Dragoslav Avramovic and Associates, IBRD, 1964), shows that the external debt of all developing countries, comprising public indebtedness and government-guaranteed private debt, but excluding loans to be repaid in the currencies of the recipient country, repayment obligations to the International Monetary Fund, and debts with maturities of less than one year, rose from \$8 billion in 1956 to \$22.5 billion by the end of 1962. This corresponds to an average annual growth of somewhat more than 15 per cent (compared with an average annual growth of 4.4 per cent in the gross national product). If the payment obligations to the IMF, private debt not guaranteed by the government, outstanding commercial debts, and other similar obligations (excluding debts with maturities of less than one year) are included, then the figure for the end of 1962 must be increased by an estimated \$5 billion to \$27.5 billion.

The geographical distribution of the debt burden of all developing countries combined at the end of 1962 is shown in the following table.

TABLE II

EXTERNAL DEBT OF ALL DEVELOPING COUNTRIES AT END OF 1962  
(in billions of dollars)

	Public debt according to narrow World Bank definition	Other	Total
Latin America	8.9	2.5 <sup>a</sup>	11.4
South Asia and Middle East	6.7	0.5	7.2
East Asia	1.0	1.7 <sup>b</sup>	2.7
Africa	3.5	0.1	3.6
Southern Europe	2.4	0.2	2.6
	22.5	5.0	27.5

<sup>a</sup> owed principally by Brazil and Argentina.

<sup>b</sup> for the most part a rough estimate for Indonesia.

According to the latest available figures, the external debt of the developing countries rose in 1963 and 1964 by 17 per cent in each case (whereas the growth in the GNP declined to 4 per cent per annum) and stood at the end of 1964, according to the narrow definition, at an estimated \$33 billion and, according to the broader definition, at more than \$38 billion. Expressed as a percentage of the GNP, external debt rose, according to the narrow definition, from 5.9 per cent in 1956 to 11.3 per cent at the end of 1962, and to 15.3 per cent at the end of 1964. According to the broader definition, the last two figures had risen to 13.8 per cent and 17.8 per cent.

TABLE III

GROWTH OF EXTERNAL PUBLIC DEBT OF 37 DEVELOPING COUNTRIES  
FROM THE END OF 1956 TO THE END OF 1964

(in billions of dollars)

	1956	1958	1960	1962	1964
Latin America	4.3	5.7	6.6	8.9	10.6
South Asia and Middle East	1.4	2.5	3.3	5.1	8.6
East Asia	0.3	0.6	0.7	0.8	1.1
Africa	0.9	1.0	1.2	1.4	1.9
Southern Europe	1.1	1.3	1.5	2.0	2.6
	8.0	11.1	13.3	18.2	24.8

Source: 1965 Annual Report, International Monetary Fund.

The data on external debt collected by the World Bank made it possible to compile a survey of the annual growth in the external debt of 37 developing countries, according to the narrow definition, between the end of 1956 and the end of 1964 (the preceding figures related to 74 countries). Between them, these countries represent 73 per cent of the total population of the developing countries. The foregoing is summarized in the following table, which is also drawn up on a geographical basis.

A large proportion of the "other" debt (cf. Table II), which in the meantime has also risen, is accounted for by these 37 countries and about half of it was contracted by the Latin American countries. It would not be unreasonable to estimate the total external debt (public and "other") of the 37 developing countries at the end of 1964 at between \$28 and \$29 billion.

#### *Servicing External Debt*

Table I has already indicated the combined amounts in respect of the service of interest and amortization that the balance of payments of all developing countries had to bear in 1956 and 1963, namely \$0.8 and \$2.9 (0.7 interest and 2.2 amortization) billion, respectively. Expressed as a percentage of the exports (of goods and services) of those countries, the servicing of their public external debt in 1963 amounted to 9.1 per cent of their export revenue, as against 3.7 per cent in 1956. The 1964 figure was probably 10 or 11 per cent. If the service of "other" debt (estimated at \$1.5 billion) is also taken into account, an even higher percentage results.

The table below presents data on the external-public-debt service of the 37 developing countries covered by Table III.

TABLE IV  
GROWTH IN EXTERNAL-PUBLIC-DEBT SERVICE OF 37 DEVELOPING  
COUNTRIES—1956-1964  
(in millions of dollars)

	1956	1958	1960	1962	1964
Latin America	455	779	1,049	1,280	1,442
South Asia and Middle East	95	186	284	378	485
East Asia	22	26	56	62	99
Africa	37	49	63	104	131
Southern Europe	71	60	253	174	341
	680	1,100	1,705	1,998	2,498

Source: 1965 *Annual Report*, International Monetary Fund.

If these public-debt-service figures are expressed as percentages of the exports of the different geographical groupings of countries, the following result is obtained. In Latin America this percentage rose from 6 per cent in 1956 to 15 per cent in 1964; in South Asia and the Middle East from 4 per cent in 1956 to 13 per cent in 1964; in East Asia from 1 per cent in 1956 to 3 per cent in 1964; in Africa from 3 per cent in 1956 to 9 per cent in 1964; and in Southern Europe from 7 per cent in 1956 to 15 per cent in 1964. For all 37 countries together, the percentage rose from 4 per cent in 1956 to 12 per cent in 1964. It must again be pointed out that this still takes no account of the service on the short-term "other" debt (estimated for these 37 countries at \$1 billion).

### *Structure of External Debt*

The external-debt figures of the developing countries, stated above, relate to the loans obtained by these countries. This does not necessarily mean that the funds were transferred in the same year in which the loans were recorded, or that payment of interest and amortization has begun on those loans. Of the external public debt of 37 countries recorded by the World Bank, which amounted to approximately \$21 billion at the end of 1963, more than 1/5 was still unused on that date. The amount paid in 1964 in interest and amortization, namely somewhat more than \$2.4 billion, must therefore be referred to a transferred debt of \$16.5 to \$17 billion. Since the ratio between interest and amortization was approximately 1:3, which corresponds to more than \$600 million in interest and \$1800 million in amortization, it can be deduced that the average weighted rate of interest was in the region of 3.6 per cent and the average amortization period a little over 9 years. If the obligations arising out of "other" debts, whose maturities can be estimated at an average of 2 to 3 years, are included, the percentage of interest becomes somewhat higher and the average amortization period must be considerably shortened.

The table below gives an idea of the percentages of the external public debt of the 37 countries at the end of 1962, which had to be repaid in the 3-year period 1963-1965 and in the 5-year period 1963-1967, respectively.

Since virtually all the "other" debt matured within 3 years, the percentages indicated would have been considerably higher if this "other" debt had been included in the calculations. In the case of Latin America, it would have meant that 50 per cent of the total external debt (longer than 1 year) had to be repaid within three years and 65 per cent within five years.

TABLE V  
 PERCENTAGES OF EXTERNAL PUBLIC DEBT AT END OF 1962  
 MATURING IN 1963-65 AND IN 1963-67  
 (37 countries)

	3 years	5 years
Latin America	36	55
South Asia and Middle East	19	32
East Asia	31	52
Africa	13	50
Southern Europe	41	65

Source: *Economic Growth and External Debt*, Dragoslav Avramovic and Associates, IBRD, 1964

The conclusion to be drawn from these data is that far and away the greatest proportion of the external-debt service of the developing countries consists of amortization obligations maturing at relatively short term. This is in marked contrast to the traditional structure of external government debt, as it existed in the prewar years, when external government loans were commonly floated on the international bond markets in the form of long-term securities. Furthermore, the rate of interest was substantially higher, because the risk was borne by private individuals. Nowadays, the external debt of the developing countries is a combination of long-term, usually low-interest, inter-governmental loans, long and medium-term credits furnished by international institutions at widely divergent interest rates, government-guaranteed medium and short-term private credits, and other short-term debt. This debt structure with its associated payment obligations is little suited to the great and continued need of most of the developing countries for net long-term capital imports. If debt continues to rise further within the present structure, interest payments will become an increasingly heavy burden; even now many countries are faced with the problem of heavy amortization obligations at short term.

#### *Debt and Debt-Service Projections to 1970 and 1975*

The Agency for International Development has made a number of informative projections regarding the future financing requirements, the increase in the external debt, and the resulting interest and amortization obligations of the developing countries, by extrapolating their record of growth during the seven-year period 1956-63 (GNP plus 4.4 per cent, imports plus 4.4 per cent, and exports plus 3.8 per cent per annum), on the assumption that the amount of net loans would be

maintained at the 1963 level (cf. Table I). These projections were prepared on the basis of three alternative types of loan terms: (a) terms in line with the average conditions applicable in 1963 to all bilateral public loans made by OECD countries (amortization over 20 years, including a 7-year period of grace, and an average rate of interest of 3.5 per cent); (b) softer terms in line with those which were regarded as standard conditions in 1963 for loans furnished by the members of the India Consortium (amortization over 30 years, including a 7-year grace period, and an average interest rate of 3 per cent); and (c) harder terms, which in 1963 were regarded as standard for loans by OECD countries, excluding the United States (amortization over 16 years, including a 3-year grace period, and an average interest rate of 4.8 per cent). The results of these projections are reproduced in Table VI.

Although the assumptions underlying these projections are hypothetical, important conclusions can be drawn from them.

1. Even if the modest record of growth in their gross national product by 4.4 per cent is maintained (in point of fact this growth rate was only 4 per cent in 1963 and 1964), the current-account deficit of the developing countries will have risen by 87 per cent in 1975, unless there is an improvement in their import-export ratio.
2. If the amount of net loans is maintained at the 1963 level, "other" sources will have to play a proportionately greater part than loans in covering the deficit (in contrast to the historical trend).
3. To keep net loans at the same level, gross loans will have to increase at a rate dependent upon the average loan terms; in the case of type-1 terms by 43 per cent in 1970 and 72 per cent in 1975, in the case of type-3 terms by 88 per cent in 1970 and 150 per cent in 1975.
4. If net loans are maintained at the 1963 level, the cumulative loan debt will rise from \$22.5 billion in 1963 to more than \$60 billion in 1970 and to some \$80 to \$90 billion in 1975, depending on the terms on which loans are made available.
5. Under the conditions assumed under (4), the servicing of interest and amortization will impose increasingly heavy demands, not only in absolute terms, but also when expressed as percentages of exports; if type-3 loan terms are applicable, this debt service will claim \$7.3 billion in 1970 and no less than \$11 billion in 1975, corresponding to 17.8 per cent and 22 per cent, respectively, of assumed exports. Assuming the third type of loan conditions is applicable, of the gross loans of \$9.8 billion in 1970 and \$13.5 billion in 1975, some 75 per

cent would be repatriated to the creditor countries in the form of interest and amortization in 1970 and about 80 per cent in 1975. This may well be an overestimate, because there is always a time lag in the use of loans obtained, but still no allowance has been made for the servicing of "other" short-term indebtedness.

TABLE VI  
PROJECTION OF GROWTH, CURRENT-ACCOUNT DEFICIT AND  
FINANCING, FOR ALL DEVELOPING COUNTRIES  
(in billions of dollars)

	1963	1970	1975
Gross national product	200	268.2	333.4
Imports of goods and services (excl. from developing countries)	39.7	52.2	64.8
Exports of goods and services (excl. to developing countries)	31.8	41.0	50.0
Deficit on current account	7.9	11.2	14.8
<hr/>			
Loans payable in convertible currency, gross	5.4 type 1	7.7	9.3
	type 2	7.1	8.2
	type 3	9.8	13.5
Interest and amortization	2.9 type 1	5.2	6.8
	type 2	4.6	5.7
	type 3	7.3	11.0
Loans payable in convertible currency, net	2.5	2.5	2.5
Other sources (grants, "loans" to be re- paid in the currency of the recipient country, direct private investments)	5.4	8.7	12.3
Total financial resources	7.9	11.2	14.8
<hr/>			
Cumulative loan debt	22.5 type 1	61.4	86.8
	type 2	60.4	83.9
	type 3	63.5	93.1
Loan debt as percentage of GNP	11.3 type 1	22.9	26.0
	type 2	22.5	25.2
	type 3	23.7	27.9
Loan service as percentage of exports of goods and services	9.1 type 1	12.7	13.6
	type 2	11.2	11.4
	type 3	17.8	22.0

If the projected debt-service figures are broken down into interest and amortization for the various types of loan terms, the following picture is obtained.

TABLE VII  
PROJECTIONS OF INTEREST AND AMORTIZATION,  
ALL DEVELOPING COUNTRIES  
(in billions of dollars)

	1963	1970	1975
Interest and amortization	2.9	5.2	6.8
	type 1	4.6	5.7
	type 2	7.3	11.0
	type 3		
Interest	0.7	1.9	2.5
	type 1	1.6	2.1
	type 2	2.4	3.6
	type 3		
Amortization	2.2	3.3	4.3
	type 1	3.0	3.6
	type 2	4.9	7.4
	type 3		

It is evident from this breakdown that for each of the alternative loan terms the ratio of interest to amortization tends to become 1:2 or 1 to less than 2 (compared with 1:3 in 1963). In the case of the projections based on the type-3 loan terms, it is the relatively high rate of interest that influences the ratio between interest and amortization.

#### *Further Note on Structure of External Debt*

The conditions on which public loans are actually made available to the developing countries today are not confined to the three types mentioned above, but show a wide range of variation. Quite apart from the government-guaranteed private credits (predominantly medium-term supplier credits with a term of 5 to 10 years and an interest rate of 6 per cent and more), the soft end of this range includes the development credits of the International Development Association (IDA), an affiliate of the World Bank, the standard terms of which are: term 50 years, including a 10-year grace period, and a nominal interest rate of 0.75 per cent. Loans under the American bilateral AID program fall into two categories, the softer type with a term of 40 years, including a 10-year grace period, and an interest rate of 2.5 per cent (1 per cent during the grace period), and the harder type with a term of 20 years, including a 3-year grace period, and an interest rate of 3.5 per cent. The average terms of all bilateral public loans by the OECD countries

(including the United States), already indicated (term 24 years, including a 7-year grace period, and an average interest rate of 3.5 per cent), lie somewhere between these two types. Next come the average terms of the World Bank loans, namely term 20 years, including a 3-year grace period and an interest rate of 5½ per cent, followed by the average conditions of the bilateral loans by OECD countries (excluding the United States) : term 16 years, including a 3-year grace period and an interest rate of 4.8 per cent. Finally, at the hard end of the range, come the usual terms of the (U.S.) Export-Import Bank, namely term 13 years, including 3 years of grace, and an interest rate of 5½ per cent.

The AID study referred to earlier attempted to predict how the relationship between gross and net loan receipts would evolve for the various types of loan terms distinguished in the preceding paragraph. These projections, reproduced in Table VI, cast some light on possible future trends. The results of the calculations reveal that in order to maintain net receipts at a level of \$1 billion per year, the amount of gross lending must rise in the fifteenth year :

— on IDA terms	to \$1.2 billion
— on soft AID terms	to \$1.4 billion
— on OECD (including U.S.) terms	to \$2.5 billion
— on hard AID terms	to \$2.7 billion
— on World Bank terms	to \$3.2 billion
— on OECD (excluding U.S.) terms	to \$3.4 billion
— on Eximbank terms	to \$4.3 billion

Conversely, it is evident that if the level of gross loans is maintained at an amount of \$1 billion per year, net loan receipts must decline. By as early as the fifteenth year, the net remainder on loans furnished on OECD (including U.S.) terms will be very low indeed, while in the case of loans made on less favorable terms the servicing cost will actually exceed the gross receipts from the loans, resulting in a negative balance. The net transfers to the recipient countries will then be :

— on IDA terms	\$0.83 billion
— on soft AID terms	\$0.65 billion
— on OECD (including U.S.) terms	\$0.08 billion
— on hard AID terms	— \$0.06 billion
— on World Bank terms	— \$0.28 billion
— on OECD (excluding U.S.) terms	— \$0.40 billion
— on Eximbank terms	— \$0.48 billion

The conclusions that can be drawn from these calculations are as follows :

a. The harder the loan terms, the greater the amounts of gross loans that must be furnished from year to year in order to maintain a given net capital transfer, the more difficult it becomes to continue to find new sound loan projects (assuming that this sort of loan is tied to a specific project) and the earlier solvency is jeopardized owing to the increase in total debt and debt service.

b. The harder the loan terms, the smaller the net loan receipts become at a constant level of gross capital transfer from year to year, and the earlier the lending process loses its effectiveness, because, instead of reducing an existing financing deficit, it quite rapidly becomes a net burden on the balance of payments (in the case of loans on Exim-bank terms, this begins as early as the ninth year, for loans on average OECD—excluding U.S.—terms in the eleventh year and for loans on average World Bank terms in the twelfth year).

#### EXTERNAL-DEBT PROBLEMS OF DEVELOPING COUNTRIES

The size and structure of the external debt of the developing countries and the associated payment obligations vary from one country to another. The indebtedness of some of them has, however, already reached or approached a dangerous level.

#### *Keeping Debt Service within Limits*

The servicing of interest and amortization is already claiming a substantial proportion of the foreign capital flowing into those countries, because that capital is being supplied to an increasing extent in the form of loans repayable in the currencies of the creditor countries, instead of in the form of grants-in-aid and such like. In the past few years, direct investments have accounted for only 4 to 5 per cent of the total capital receipts of the developing countries. Dividend payments to foreign countries in respect of capital invested in the past, on the other hand, constituted a heavy burden. According to data from the World Bank, interest and amortization on loans and dividend transfers from the developing countries have claimed no less than \$6 billion per year over the last few years, which is more than half of the gross capital transfers to these countries from all sources combined. In the light of their existing payment obligations and the fact that those obligations are expected to increase still further as periods of grace expire and fresh loans are raised, there is danger of a situation arising in which the inadequacy of net financial assistance will lead to lack of continuity in the economic growth of many developing countries. Thus, far from being speeded up,

their growth will rather tend to slacken off. Symptoms of this phenomenon can already be seen in a number of countries.

At the present moment, the gross national product of all developed countries combined amounts to an estimated \$1,000 billion and is rising at the rate of approximately \$40 billion a year, that is by 4 per cent (equal to the increase in the GNP of the developing countries over the last 2 years). In terms of this figure of \$40 billion, the gross and the net capital transfers to the developing countries of about \$12 and \$6 billion, respectively, already account for 30 per cent and 15 per cent, respectively, of the present annual growth in the GNP of the developed countries. There is little reason to suppose that these percentages will increase much in the future. Of the gross capital transfers of \$12 billion, \$5.4 billion, that is 45 per cent, was in the form of loans. Now let us assume that this percentage remains the same (in contrast to the historical trend, which shows a powerful increase), and let us further assume that in the coming years the amount of gross loans furnished will rise in proportion to the anticipated growth in the GNP of the developed countries, that is by 4 per cent per annum, or at twice that rate, that is by 8 per cent per year, allowing for the possibility that the developed countries will be prepared to relend for development purposes a large proportion of the amortizations which they receive. Even in the latter case, average loan terms closer to those of the soft AID type than to the OECD (including U.S.) type will be required to maintain the annual amount of net loans at its present level of approximately \$2.5 billion. The harder the loan terms are, the greater the need for fresh financing becomes in each succeeding year.

The burden of external-debt service does not owe its significance merely to the fact that the developing countries have to find the funds with which to meet their payment obligations or that the developed countries have to provide the funds required for continued financing. It is also connected with the degree to which the developed countries are prepared to continue their financing of developing countries in the light of the existing indebtedness of their borrowers and the margin those borrowers still have for contracting additional debt. An important consideration when providing new loans is the schedule of the combined interest and amortization obligations of the borrowing country during the period in which new loans have to be repaid. In many cases, the next few years are already heavily burdened by the service of "other" debts and/or medium-term supplier credits (commonly guaranteed by the government) and it is only after 5 to 7 years that any significant margin is found. The further the repayment obligations are extended into the

future and the lower the interest rate, the greater that margin becomes—and the better the chances that the economic development of the debtor countries will in the meantime have enhanced their debt-bearing capacity.

As far as the economic growth of developing countries is concerned, an increase in their external indebtedness cannot be regarded as a wholly adverse factor. Normally speaking, it means that foreign capital is being brought in to supplement the investment resources available in those countries and is thereby helping to enlarge and accelerate the capital formation required for development. The influx of foreign capital therefore has the effect of strengthening the economy of the borrowing countries. This advantage is offset by the disadvantage of growing external-payment obligations, and the degree to which the developing countries increase their capacity to pay interest and amortization depends on the effect which foreign capital has on their economic growth.

The utilization of foreign capital and its productivity in terms of increasing the national revenue and raising the level of savings and investments are of strategic importance in this connection. Account must also be taken of the fact that the capacity to absorb into the growth process additional capital that becomes available varies from one developing country to another. Finally, it is important to remember that interest on and repayments of external debt have to be remitted, and that it is therefore not simply a question of ensuring that a large enough revenue surplus is created to pay interest and redemption, but also that a wide enough margin is created in the balance of payments on current account, by stepping up exports or by import substitution, to make the transfers required.

#### *Utilizing Foreign Capital Efficiently*

Since the purpose of foreign capital imports into developing countries is to help speed up the process of economic growth by raising the level of investment, the rate at which useful investments can be made is of crucial importance. In almost every country there are limits beyond which, in any given period of, say, five years, investment activity on worth-while projects cannot be stepped up, without resulting in the waste of any additional capital used because of a rapid decline in marginal productivity.

In the investment process three phases can be distinguished. In the first phase, the possibilities of development are investigated, certain programs and projects are formulated, their technical feasibility is studied, and their economic and financial value assessed. One of the

cardinal objectives in preparing national-development plans ought to be to work out an efficient procedure for identifying and preparing an increasing number of well coordinated investment projects. In practice, however, this has often been precisely what was missing. Many developing countries have made (or have had made) impressive and ambitious plans based upon econometrically tested models and a complex set of interwoven assumptions, but their feasibility content is not very high and their translation into carefully prepared projects is frequently neglected. The reasons for this are sometimes inadequate knowledge of natural conditions, which first have to be explored, often a shortage of technicians trained in project appraisal, and not infrequently a hesitant, slow-moving bureaucracy that is unaccustomed to taking radical economic and financial decisions. Political considerations, too, sometimes have a habit of intruding.

In the second phase of investment activity, programs and projects are executed, construction (which usually absorbs about two-thirds of the capital) is undertaken, and equipment is installed. The ability to implement an investment program within a given period does not depend only on its size, but also on the existence of and the possibility of mobilizing local resources, competent contractors and laborers, transport facilities, sources of water and power, and the domestic financial resources that are normally required to supplement foreign capital. Shortages of local factors of production and time spent in remedying them frequently lead to serious delays (and cost increases) during the execution phase of investment programs. The possibilities of preventing or eliminating this through foreign-aid channels are limited not only by restraints imposed at the giving end but also by resistance encountered at the receiving end.

The third phase is where the new investments begin to participate in the production process. The capacity to make full and efficient use of invested capital is a highly important aspect of a country's absorptive capacity. The quality of the management, the skill and productivity of the personnel employed, the regularity with which raw materials, auxiliaries and parts requiring replacement are procured and the finished products sold in receptive markets, all have a decisive effect on the contribution of invested capital to increasing the national product. Low productivity, defective quality, underutilization of capacity, inadequate level of replacement and renovation are frequent phenomena in developing countries, which point up the limitations of their absorptive capacity or the rapid deterioration of the capital-return ratio that sets in once a certain level of investments has been passed. One of the main

factors here is the chronic shortage of foreign currency for imported raw materials, auxiliaries and parts requiring replacement, because these requirements are either neglected or underestimated when new projects are taken in hand, or because these requirements are not given proper priority by the authorities of the developing country when they draw up their foreign-exchange appropriations. Another factor responsible for this state of affairs, however, is that many capital-exporting countries tend to tie their official financial assistance, except for that in the form of guaranties, to new investment projects, while current import requirements are for the most part financed by short-term commercial credits or medium-term supplier credits, which are subject to normal business considerations.

### *Generating Domestic Savings and Capital Formation*

In most developing countries per capita income is low (even though individual incomes may vary widely) and the increase in population considerable. Consequently, there is a shortfall in savings and capital formation in relation to the investments required for accelerated economic growth. By raising the volume of the investments which developing countries are capable of making from their own resources, foreign capital imports make it possible to speed up the increase in incomes. The degree to which this is achieved depends on the volume of capital imported, the productivity of the capital (that is, on the capital-return ratio), and on how much of its increased income the population is prepared to save.

It is obvious that the primary issue is the volume of net capital imports—after deducting interest and amortization on loan capital, dividends and amortizations on direct investments, insofar as the latter are repatriated to the countries that provided the capital, and flight of capital (which is by no means exceptional in the case of developing countries). These net capital imports must be sufficient, in terms of both volume and term, to help bring about a continued and noticeable increase in the per capita GNP. To meet this condition successfully, they must attain a reasonable level, according to the absorptive capacity of the country in question, and be continued until the increase in incomes creates a permanent and growing margin of savings that will itself generate enough capital to support the investment process. Otherwise the growth process will be prematurely retarded and the country will be in danger of relapsing into a state of economic stagnation.

In the second place, the increase in incomes depends on the productivity of the added capital. This can be gauged by the increase in

wages and profits, including interest, depreciation, and cost-price-raising taxes, which results from a rise in investments. The better the ratio between the amount of additional capital invested and these proceeds (the gross added value), the greater the rise in incomes brought about by the imported capital. As stated earlier, the productivity of the added capital also varies with a country's absorptive capacity; the factors which influence that capacity determine to a large extent the capital-return ratio. Given a certain absorptive capacity, the choice of investment projects is of cardinal importance. Extravagant and capital-consuming new projects with long construction periods often have relatively less economically useful effect than modest investments which remove bottlenecks preventing rapid increases in the productivity of existing economic activities. In addition, the burden of the first type of projects mentioned on the external-debt service is frequently disproportionately heavy.

In the third place, decisive importance attaches to the inclination to save, that is to say the ratio in which the increase in incomes is allocated to consumption and investment. The higher the level of saving, the greater the extent to which available productive resources are exploited with a view to accumulating additional capital, and hence the greater the increase in incomes. This cumulative process, in which an initial increase in incomes can, by saving and investment, lead to a greater increase in incomes, is the pivot (and the spiral) about which the process of economic growth revolves, and, other conditions being equal, it is the percentage of the increase in incomes which is saved that indicates the rate of growth.

In many developing countries this process can only be initiated or accelerated with the aid of foreign capital. The higher the rate of growth, the easier it will be to meet external-debt obligations and at the same time reduce the investment deficit. Conversely, the greater the proportion of the rise in incomes that is absorbed by external-debt servicing, the more difficult saving becomes. In the past, however, developing countries have not infrequently spent too much of the increase in their incomes on consumption, both in the public sector and, owing to an inadequate tax system, in the private sector. Not infrequently, too, savings are invested in unproductive or in low-productivity projects. Both phenomena have the effect of curbing their rate of growth and reducing their debt-bearing capacity.

#### *Avoiding Too Heavy External Debt*

If continued for long enough, imports of foreign capital enable the

developing countries to maintain a deficit on their goods-and-services account, which is covered by a surplus on their capital account. Where the foreign capital is loan capital, it is subject to fixed interest and amortization obligations, and where it consists of direct investments, there is frequently an agreement providing for the remittance of reasonable amounts by way of dividends and amortization. Depending on the volume of imported capital and the conditions on which it is furnished, the burden of the external-payment obligations rises, as discussed earlier, and leads to a corresponding increase in the financing deficit on the balance of payments. There is, however, also a secondary effect which capital imports have on the balance of payments. Basically, investments in the developing countries are stepped up with the aid of foreign capital and the increase generates a rise in incomes. This rise in incomes, however, generally has a large foreign-exchange component, which leads to additional imports of both consumer and capital goods, especially in the early stages of development. Since it is often some time before export capacity can be strengthened enough to match growing import requirements (for which there are domestic but no external financial resources available), the current-account deficit rises accordingly. Apart from grants and similar aid, there is no other cover for this deficit but additional loans, which will normally take the form of short and medium-term credits. In this way the danger arises that in the course of the growth process stimulated by the import of foreign capital, external debt will continue to rise and at the same time acquire an unfavorable structure, until it finally reaches its upper limit, which is commonly set far too high, at which point additional credit becomes a serious problem and a balance-of-payments crisis sets in. Examples of this are not hard to find.

To head off this danger and limit the external-debt burden on the balance of payments to an extent that will enable them to continue to meet their financial-transfer obligations without having to cut back their imports drastically—which would have a detrimental effect on their growth process—the developing countries are faced with the task of bringing about a fundamental improvement in their import-export ratio as soon as their internal and external circumstances permit. The greater the financial-transfer obligations, especially in relation to the overall balance-of-payments figures, the more imperative this need becomes. As noted earlier, however, the process of growth in developing countries is inevitably accompanied by an increase in import requirements. Improvements must therefore be sought in an increase in exports, which must first catch up with the increase in imports and subsequently

surpass it. To achieve this, enough of the investment funds that become available must be applied to strengthening and broadening the export sector. Here, however, opposing forces come into play. In many developing countries a large, and not infrequently a disproportionately large, part of the capital imported and saved is invested in the infrastructure (roads, means of transport, utilities, etc.), which does not add to export capacity or does so indirectly only at a later stage. Moreover, there is a common tendency in these countries to give priority to investments aimed at supplying the domestic market more liberally. The growth in the population is partly responsible for this; expectations of prosperity have risen and there is a growing demand for means of providing more of the basic necessities of life (food, clothing, housing, education, health services, etc.). It is also easier for the business community to orient its expansion towards the domestic market, where the quality demands are lower and, thanks to widespread protection, prices are usually higher than in the international market, while additional costs are involved in winning foreign markets. As a result, the export component of the rise in production due to the increase in investments is relatively small in many developing countries and a considerable period usually elapses before the process of economic growth reaches the stage where domestic circumstances become conducive to an increase in this component. The time it takes adequately to adapt a developing nation's production structure, originally created to satisfy largely domestic needs, to the international market and to invest it with the competitive power to find the necessary sales outlets in that market, depends on a number of factors, natural, human, and administrative, which will not be developed further here. But if, sooner or later, this change in the structure of the economy takes place, it will be accompanied by a change in the structure of the balance of payments due to increased exports and to import substitution. There are many developing countries which are now in this transitional stage; some are already approaching equilibrium in their goods and services balance; the majority, however, have many years of growth ahead of them before their import-export ratio is likely to take a turn for the better.

The success of developing countries in increasing their export revenue is dependent to a large extent upon external circumstances, which for the most part are beyond their control. One way of expanding exports is to increase the supply of primary products (raw materials) or of industrial goods and of services. For most of the primary products the growth in world demand is only moderate, or, put another way, total demand is insufficient to provide the resources needed to cover rising

import requirements in the developing countries. Moreover, the prices of these products are subject to serious fluctuations. Consequently, the developing countries must also concentrate their efforts on exporting industrial goods and services (such as tourism), for which international demand shows a relatively steep upward trend. The range of industrial goods which these countries, on reaching a certain level of development, can start producing for export with any chance of success is limited, however, chiefly to the products of light industry. Some developing countries have succeeded in considerably expanding their exports of these products. Repeatedly, however, they come up against import restrictions imposed on such goods by the industrialized countries and this slows down the rate at which their export revenue can rise. For countries with strong tourist appeal the prospects of raising their revenue from the exchange of services appear promising. Though many developing countries would like to enjoy such a position, only few are favored in this way.

The capacity of developing countries substantially to lighten their external-debt burden within a relatively short space of time by creating an export surplus should certainly not be overestimated. There is a close correlation between the successive stages of economic growth in these countries and the pattern of their external-debt position. Against the background of the foregoing considerations, the broad outlines of this correlation can be presented as follows:

During the initial stage of (accelerated) economic growth, national revenue is insufficient to produce the savings required to step up investments. To enable it to finance a greater volume of investment, the young emerging nation begins to attract capital—for the sake of argument we shall assume that it does so in the form of loans. Since it has during this stage a growing need for net capital imports, it will continue to borrow up to amounts that are sufficient not only to cover part of its investments, but also to cover interest and amortization on its previous foreign loans. In this way, interest and amortization are financed by foreign countries and place no burden on domestic savings, but its external debt rises at an accelerated rate (the interest being subject to the law of compound interest). The longer this situation continues, the greater the external debt becomes. The rise in national revenue should, however, make it possible by degrees to finance a relatively greater proportion of investments from domestic savings.

In the second stage of development, domestic savings have reached a level where the country can meet its investment needs itself, but its savings are still not large enough to pay simultaneously the interest and

amortization on the external debt which it has in the meantime accumulated. It must therefore continue to raise fresh loans, even if only for the amount of its debt service. In a later phase, the country will be able, as it develops further, to take interest payments for its own account, too. At this point the increase in debt ceases and the amount of fresh loans raised may be limited to the country's amortization obligations, that is, its refinancing needs. There is no further need for net capital imports.

During the third stage, the country is in a position to use its own savings not only to finance its investments and its external-interest obligations, but also to start repaying the principal of its loans. This results in a corresponding decrease in the amount of interest payable. When the external debt has been paid off, the wheel has come full circle. How long this cycle takes to complete depends primarily on the total amount to which external debt rose during the first stage and the earlier phase of the second stage; secondly, on the extent to which and the rate at which the country is able to build up a surplus of domestic savings over investments; and thirdly, on the country's ability to earn, or convert, this surplus—which must be reflected in a surplus on its balance of payments—in the foreign currencies that it needs in order to pay its foreign creditors.

When it comes to repaying external indebtedness, there is the added complication that creditor countries require to be paid in their own currency or in a currency acceptable to them. Naturally, this also applies to payment obligations arising out of trade, but in commercial traffic there is usually a greater freedom of choice regarding the countries with which payment obligations are entered into, because to a certain degree imports (and exports) can be oriented towards certain countries. When they seek to raise loans abroad, developing countries usually have a very limited choice of lenders and once they have become debtors vis-à-vis one or more specific countries, this has the effect of adding an element of inflexibility to their transfer problem. This is intimately connected with the limited convertibility of currencies in the world today, which is likely to continue into the foreseeable future. In many cases, the element of inflexibility referred to adds yet another burden to the foregoing obligations and tasks already placed on the shoulders of the developing countries as their external indebtedness increases. For it is often easier for them to find markets for a growing supply of export goods in other countries with weak (inconvertible) currencies, than it is in the capital-providing countries. Frequently, too, they conclude bilateral-trade agreements with certain countries, because this bolsters their exports, although such countries are seldom their creditors. This

means that the developing countries do not simply have to step up their exports, but that they must expand their exports to the industrialized countries with convertible currencies, that is, to those markets in which it is most difficult for them to compete and in which they often meet with considerable resistance to imports.

### *Actions of Developing Countries to Increase Creditworthiness*

Here, as in the following (and final) paragraph, the suggested actions will simply be summarized in the form of several short points, most of which contain only the conclusions that follow from the foregoing analysis.

1. Maintain the greatest possible degree of internal monetary equilibrium. Inflation distorts investment decisions, lessens the inclination to save, and undermines competitive capacity.
2. Carefully draw up a development plan for the public sector and in support of the private sector, aimed at balanced economic growth with optimum utilization of the country's natural comparative advantages.
3. Increase its capacity to absorb foreign capital for investment in projects of high economic priority and in projects that yield a relatively high direct or indirect return in the shortest possible time.
4. Create a favorable climate for attracting direct foreign investment (including foreign entrepreneurial experience) and encouraging the reinvestment of interest, amortizations, and part of the profits on those investments.
5. Make a conscious effort to narrow and eliminate the gap between domestic savings and investments, among other things through the system of taxation and by developing a capital market.
6. Make a determined effort to improve the import-export ratio with respect to goods and services, by stimulating exports and by efficient import substitution.
7. Stimulate to the fullest possible extent the mobility of the nation's productive resources and the capacity of the economy to adapt to new technological advances and changing foreign-market conditions.
8. Impose severe restrictions, especially during the initial development stage, on the raising of short and medium-term foreign loans.

#### ACTIONS OF LENDING COUNTRIES TO EASE EXTERNAL DEBT

- I. Make as large a proportion as possible of their development aid

available in the form of grants-in-aid, quasi-grants, and direct investments, and, when lending, scale the amounts and terms of its loans to take account of the debt-bearing capacity of the developing country concerned.

2. Confine their loans to a large extent to projects of high economic priority which, directly or indirectly, rapidly yield a high return.

3. Continue to provide sufficient capital to enable the developing countries to pass through the first stage of their development, as described on pp. 21-22; during the second stage the accent may be shifted from grants and soft loans to loans on conventional terms.

4. Wherever possible, provide loans whose proceeds are not tied to the purchase of goods and services in the creditor country itself, but may be used to make purchases in the cheapest market.

5. Make maximum use of the channel of international development-financing institutions, such as the World Bank and IDA (as well as of Consultative Groups sponsored by the World Bank) which are well experienced in the selection of projects, insist on good economic management and performance, and assess the debt-bearing capacity of developing countries.

6. Pursue a liberal import policy with respect to the products of developing countries and support any measures that may prevent excessive fluctuations in the prices of those products (without providing incentives for overproduction).

7. Exercise great discretion when extending short and medium-term credits to developing countries that are still in the initial stage of economic growth.

8. Be prepared, where circumstances so require, to convert short and medium-term loans into longer-term loans on reasonable conditions.

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