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RECENT INITIATIVES ON DEVELOPING COUNTRY DEBT

Most developing countries had problems servicing their external debts in the 1980s. Over seventy countries had to delay repayments by rescheduling or incurring arrears, and many more imposed severe burdens on their economies in their efforts to meet their commitments. This paper analyses the initiatives launched since 1986 to deal with the debt difficulties of middle- and low-income debtor countries. It finds that, despite some advances, they fall well short of permitting a return to sustained economic growth.

The dimensions of the debt problem

Creditor initiatives in 1986-90 have centred on two groups, low-income Africa and highly-indebted middle-income countries. The focus is now widening: the World Bank now classifies 69 of the 111 countries reporting to it as severely or moderately indebted. These owed $913bn out of the total developing country debt of $1300bn at the end of 1989. Box 1 lists the 46 severely-indebted, which owed $675bn.

Most of the debt of a typical African or other low income country is owed to official multilateral and bilateral agencies, with aid loans and export credits the most important items. The typical middle-income debtor country, however, owes well over half its debt to commercial banks and other commercial finance houses, on considerably stiffer average terms. Relative to their exports and economic activity, the total debts of low-income debtors are larger even than those of the developing world's largest debtors, Brazil and Mexico. But because of higher interest rates and shorter maturities, the debt servicing ratios of most middle-income debtors are substantially larger than those of low-income debtors.

Graph 1 shows that since the 'debt crisis' broke in 1982, low-income groups' debt-to-export ratios have risen most rapidly. While all groups made large new borrowings, low-income groups also experienced falls (or slower increases) in exports. Graph 2 reveals that low-income debt service ratios rose by about 10 percentage points between 1982 and 1989, though they peaked in 1986. The SIMIC ratio was 5 points below 1982, but with no clear downward trend. There has also been a collapse of net debt-related financial transfers (disbursement of new loans minus repayment of principal and interest) to the SIMICs, culminating in net transfers to creditors of $25bn p.a. in 1988 and 1989. This reflects the high cost of debt service to commercial creditors and the drying up of new commercial loans. It contrasts with the SILICs, which had less initial access to such loans and have suffered only a minor fall.

Arrears and reschedulings also centred on these groups. They had growing arrears, estimated at $42bn at the end of 1988 — 81% of the developing-country total. They also accounted for almost all of the 252 multilateral reschedulings in the 1980s. Most SIMIC arrears and reschedulings were with the London Club of banks. Low-income nations' arrears were mostly to governments and multilateral institutions, and reschedulings with the Paris Club of (mainly OECD) governments.

Earlier initiatives

During 1982-7, opposition to debt servicing grew in many countries. To prevent defaults on debt service and sustain adjustment programmes, creditors launched initiatives to improve procedure and provide more relief. Before 1989, these had three main stages. *Multiyear reschedulings* (to cover service falling due in more than one year) were launched in 1984. They proved inadequate, because insufficient debt relief or new money and volatile commodity prices left programmes underfunded. Few such agreements were signed.

The *Baker Initiative* of 1985 aimed to channel extra loans to 15-17 highly-indebted countries, chiefly in Latin America, in order to raise imports and allow 'adjustment with growth'. It failed, principally because banks were reluctant to lend more (new bank loans to these countries actually fell). Net financial outflows from them totalled $55bn during 1986-88, and per capita income, investment and consumption continued to fall. Higher export earnings were absorbed by the rising cost of debt service, and import capacity remained very depressed.

Many banks saw no sign of heavily-indebted countries returning to creditworthiness, and the market value of the debt and of bank shares was falling. Entering the third stage, they reduced their exposure to debtor countries via a menu of market-based options for *voluntary debt reduction*, and by selling loans in the secondary market for debt. They increased accounting provisions against the possibility of default and by 1988 had sold about $110bn of debt, either to debtor

Box 1: Country groupings

Those assessing debt burdens of individual countries or launching initiatives to reduce them have used several classifications. The first was 15-17 *Highly-Indebted Countries.* This group, used in the Baker Initiative, lacked any formal definition. Then came 28 *Low-Income Debt-Distressed Sub-Saharan African* countries (eligible only for loans from the World Bank's soft window, IDA, and with a debt service to export ratio of at least 25%), which benefit from the Toronto agreement and Special Programme of Assistance.

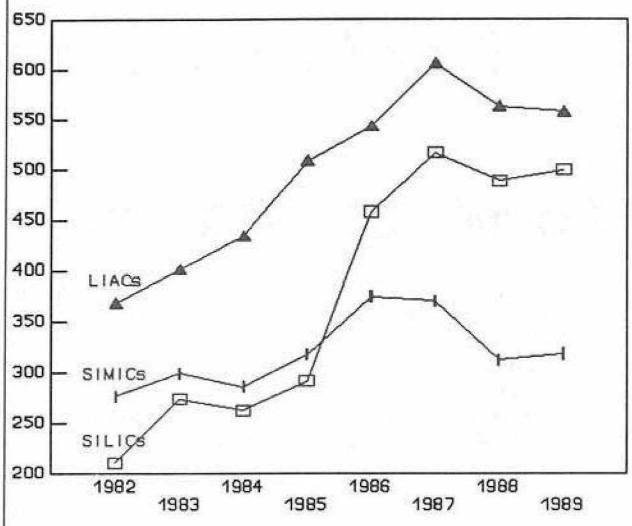
Since 1989 the World Bank has used a new classification based on ratios of debt to exports, debt to GNP, debt service to exports and interest payments to exports. It identifies two most-indebted groups, *Severely-Indebted Middle-Income Countries* (**SIMICs**) and *Severely-Indebted Low-Income Countries* (**SILICs**). Members of the groups at the beginning of 1990 were:

SILICs		**SIMICs**	
Benin*	Mauritania*	Argentina**	Peru**
Burundi*	Mozambique*	Bolivia**	Philippines**
Comoros*	Myanmar (ex-Burma)	Brazil**	Poland
Equatorial Guinea*	Niger*	Chile**	Senegal*
Ghana*	Nigeria**	Congo	Uruguay**
Guinea*	Sao Tome*	Costa Rica	Venezuela**
Guinea-Bissau*	Sierra Leone*	Cote d'Ivoire**	
Guyana	Somalia*	Ecuador**	
Kenya*	Sudan*	Egypt	
Liberia*	Tanzania*	Honduras	
Madagascar*	Togo*	Hungary	
Malawi*	Zaire*	Mexico**	
Mali*	Zambia*	Morocco**	
		Nicaragua	

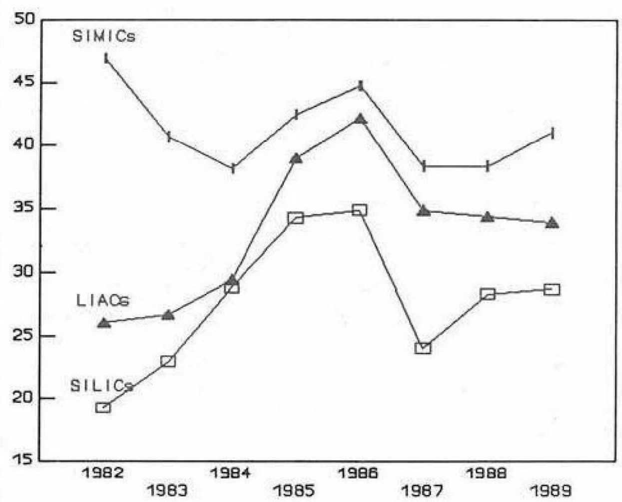
* also Low-Income Debt-Distressed.
** also Highly-Indebted Countries.

However, this classification is not immutable. Group members change due to debt or GNP changes. Several countries are 'middle-income' due only to over-valued exchange rates (for example, Côte d'Ivoire) — or the inadequacy of GNP statistics, see ODI Briefing Paper, June 1988, *The Rich and the Poor*). Countries which have large debt problems but are not World Bank members or have particularly poor data are left out (including Angola, Cuba, Iran, Iraq and Vietnam). The World Bank also classifies 15 nations as Moderately-Indebted Middle-Income (MIMICs) and 9 as Moderately-Indebted Low-Income (MILICs), see World Bank: *World Debt Tables, 1989-90.*

Graph 1: Debt to Export Ratios



Graph 2: Debt Service to Export Ratios



governments or other buyers. This reduced exposure weakened their incentives to comply with the Baker plan. In net terms, debtors' liabilities were reduced by only $13bn, however, because swaps for equity or other assets create new liabilities. Equity swaps grew rapidly in 1986-89, though good projects for swaps in the low-income countries were more limited, but risked raising money supply and inflation. This and opposition to foreign control of industry led several countries — notably Argentina and Brazil — to suspend them in 1988-89. In addition, several charities like the World Wide Fund for Nature and intergovernmental organisations such as UNICEF launched debt-for-nature and debt-for-development swap programmes. However, these were usually small-scale because commercial creditors were reluctant to donate debt and some NGOs were reluctant to accept it.

There were complaints in creditor countries that these approaches, and the resulting depression of trade with debtor countries, were favouring the banking system over exporters. In many debtor countries, political pressure against adjustment and debt service continued to grow, and relations between creditors and debtors deteriorated. At various times, Peru limited debt service payments to 10% of export earnings; Brazil suspended interest payments to banks; Venezuela suffered severe food riots; and several low-income countries abandoned adjustment programmes and fell into arrears with the IMF and World Bank. As a result, creditors realised the need for further initiatives (Box 2). These have distinguished between middle- and low-income countries, because of their different debt structures.

Current initiatives for middle-income countries

The Brady Initiative (Box 2) addresses SIMIC debt problems. For the first time, it enables *concerted* debt reduction, on terms negotiated by a debtor and commercial banks and supported by IMF, World Bank and OECD government funds. This strategy offers debtor governments genuine debt service relief but leaves major questions unanswered.

One, predictably, is whether the initiative has enough supporting finance. Although substantial amounts have been pledged, the net annual debt service savings will be under $4bn, equal to only 2% of SIMIC imports, against a 34% fall in import volume since 1980. It is difficult to make precise connections between imports and economic performance but the World Bank postulates that a 1% rise in import volumes will produce 1% GDP growth. On this basis, funds fall $4bn short of imports regarded by the Bank as necessary for per capita growth. Even if all the debt service savings are devoted to investment, GDP is expected to rise by only an extra 0.7% after three years. Existing debt is intended to fall by approximately $65bn but new debt of $50bn will be incurred to the IMF, World Bank, Japan and commercial banks. Overall, only a $15bn net reduction in the stock of debt is expected — a tiny fraction of the total.

Indirect effects may fill part of the remaining gap. In Mexico, for instance, domestic interest rates fell by 20 percentage points when preliminary agreement was reached, cutting the domestic debt service burden on the budget by 6% of GDP, and allowing government and private sector to borrow more for investment. It is also possible that 'Brady agreements' may reverse capital flight, or stimulate additional foreign investment or loans from OECD export credit agencies. But such effects are uncertain and the most optimistic projections put their value at only $1-2bn pa.

The World Bank reckons that, in addition to reduction, SIMICs will require $4bn of net new commercial loans during 1990-93 to increase imports by amounts needed for per capita growth but only 10% of banks agreed to lend new money to Mexico. Banks have strong commercial reasons for reluctance. They are continuing to increase provisions and to reduce exposure, to make themselves less vulnerable to default and boost their share prices. Most banks have raised provisions to 55-75% during 1989. Behind these actions lie long-term business strategies. Some, notably US banks outside New York, intend to abandon developing-country lending. Most others will confine loans to individual projects, trade finance or the private sector, and will require creditor government guarantees or other security.

The regulatory, tax and accounting framework in some creditor countries is an additional deterrent. Some regulators (for example in Canada) require extra provisions and capital increases on new loans, providing powerful disincentives. Adequate new money will be increasingly difficult, especially for countries with small bank exposure (Costa Rica, Jamaica) or of less strategic interest for creditor governments (Congo, Nigeria), unless disincentives are removed.

In contrast, many regulators, notably in the US, encourage reduction by refusing tax benefits for provisions without reduction; by not requiring provisions or capital increases for reduced debt (or allowing them over several years rather than immediately); or by spreading the tax on gains accruing to banks from reduction over 20-30 years. Coordination of regulation to remove barriers to reduction is improving: the Group of 7 has set up a committee to standardise it, and capital adequacy rules will be broadly uniform under a Bank for International Settlements (BIS) agreement by 1992. Different business practices and regulations have led to wide divergences in bank preferences, but these are now narrowing. Overall, banks are favouring debt reduction over new lending, and debt or debt service reduction options about equally. Which option is of most benefit to the debtor? For most countries, bonds are likely to save more than buybacks per dollar of supporting funds but if a buyback clears almost all debt, it may be preferable. Debt service reduction is likely to be more cost-effective in providing immediate cash flow relief, but debt reduction will help more in the medium-term.

The value to debtor governments of debt reduction depends on the degree to which they 'capture' secondary market discounts. The announcement of the Brady initiative increased prices by 10-20% of face value for countries thought likely to benefit, raising the cost for debtors. Actual prices were then negotiated between banks and debtors. In spite of intervention by the IMF, World Bank and OECD governments to maximise the discount, prices in the Costa Rican, Mexican, and Philippine draft agreements were a further 5-10% above then-existing market levels. Mexico received only a 35% discount, compared to its initial request for 50%. Many banks insisted that using market prices would give debtors an incentive to drive prices down by withholding payments, but there is no evidence that governments have followed this tactic.

Securing draft agreement with a committee of banks has been less time-consuming than expected. The first three draft agreements took 'only' six months. On the other hand, final approval from non-committee banks has taken a long time (though less than in previous reschedulings), in spite of heavy penalties for banks that refused, and this bodes ill for other debtors.

If banks choose reduction, payments on the bonds or other debt they acquire in exchange for existing debt will be guaranteed by IMF, World Bank and Japanese funds, and they will be exempted from providing new money. This higher status increases the attractions for banks, but also the inflexibility of debt. Should debtors default on guarantees, future debt reduction negotiations will be much more difficult. This may lead debtors to cut service to creditor governments or multilateral institutions, or to use more official funds to meet guarantees or enable further reduction. The internal logic of the initiative requires that enough reduction or new money is provided in the first agreements to avoid such complications.

Agreements will also need enough contingency finance to prevent negative balance of payments trends from derailing them. The CCFF ought to represent an important advance on the CFF, because it compensates for foreign exchange shortfalls which occur during programmes, does so immediately, and covers a wider range of shortfalls. However, it remains seriously unsatisfactory. By the end of 1989 no country had drawn on its contingency element, and only three had drawn on the compensatory part, largely because of the policy conditions to which it is linked and because it has harsher repayment terms than other IMF credits.

Current initiatives for low-income countries

The IMF Structural Adjustment Facility (SAF) and Enhanced Structural Adjustment Facility (ESAF) (Box 2) have provided additional new money on softer terms, and reduced the net flow of funds to the IMF from low-income countries. However, they have suffered several problems.

They are based on short-term programmes and have included both rigorous short-term IMF policy conditions and additional medium-term strings. Given that credits have been smaller than previous IMF loans, governments have not queued up to borrow. Only 24 took SAF loans and 10 ESAF loans in 1986-89, far fewer than expected. Though the IMF raised the size of SAF loans by almost half, the SAF had committed only SDR1.2bn and disbursed only SDR560m by June 1989; the ESAF had committed only SDR1.8bn and disbursed only SDR342m. Delay in disbursement was exacerbated by implementation problems. By April 1989, disbursement was so far behind schedule that the IMF Board extended the period for agreeing ESAFs by 12 months to November 1990.

In consequence, they have not prevented net transfers by low-income nations to the Fund. These are estimated at SDR2.1bn during March 1986-June 1989, even though arrears rose by more than SDR2bn. The Fund is still reducing its exposure to low-income countries. Moreover, several governments' contributions to ESAF came from existing aid budgets, reducing the additionality of ESAF lending.

In contrast, the World Bank's refinancing of interest payments on IBRD loans is based on the amount due from each country. This has reduced payments by 60-90%, depending on the size of matching contributions from Nordic governments. However, loans are tied to adjustment policy conditions, exerting a similar disincentive to that which has constrained the ESAF. Consequently, only 8 of 13 potential

Box 2. Summary of recent initiatives

Heavily-indebted middle-income countries

In March 1989, US Treasury Secretary Brady endorsed commercial debt or debt service reduction for middle-income countries, in what became known as the **Brady Initiative**. Countries with IMF or World Bank programmes and large debt burdens will be eligible for $30-35bn to support reduction in 1989-92. About $12bn will come from existing resources of the IMF and Bank. Their major shareholders also agreed to provide $12bn through a General Capital Increase of $75bn for the Bank and a quota increase for the IMF. The IMF can lend up to 25% of a standby or Extended Fund Facility credit for debt reduction and 40% of a nation's quota for service reduction. The Bank can lend up to 25% of its adjustment credits to reduce debt, and 15 per cent to reduce service. Japan will provide an additional $10bn to cofinance these loans.

Debt reduction can occur in two ways. The debtor government may buy back its debt from creditors at a discount using Brady money. Alternatively, it may swap debt for other obligations, such as bonds, either at a discount on face value of the principal (debt reduction) or with lower interest rates (debt service reduction). Brady money would be collateral to ensure that principal or interest on these new obligations was paid, giving creditors more security.

The IMF Board also modified two lending facilities in April 1988. It widened the Compensatory Financing Facility (CFF) into a Contingency and Compensatory Financing Facility (CCFF), by adding an 'External Contingency Mechanism' to compensate for foreign exchange shortfalls during IMF programmes, and for unexpected interest rate and import price rises. It also agreed to use Extended Fund Facility (EFF) loans for countries with a record of sustained adjustment. These have longer adjustment and repayment periods, and the Board agreed to further extend repayment and cut interest rates depending on country needs.

Low-income sub-Saharan Africa

Multilateral actions: While maintaining the rule that their loans cannot be rescheduled, the Fund and Bank refinanced some service due to them. In 1986 the IMF created the Structural Adjustment Facility (SAF), to relend $2.7bn of low-income nations' repayments on softer terms (0.5% interest, 5.5-year grace, 10-year maturity). In December 1987, the SAF was tripled to create an Enhanced Structural Adjustment Facility (ESAF), with potential loans 3.5 times larger. OECD governments (except the United States) and Saudi Arabia provided capital and interest rate subsidies. The World Bank will refinance $650m of $700m interest payments due to it from 13 low-income African nations in 1988-90, using repayments to IDA augmented by Norwegian and Swedish aid. Under the Bank's Special Program of Assistance (SPA), $400m a year of additional credits and $950m of government aid is targeted to go to low-income 'debt-distressed' Africa in 1987-90.

Finally, as part of the Brady initiative, low-income countries with heavy debt burdens can use 25% of an IMF ESAF credit for commercial debt reduction and 40% of quota for debt service reduction. The World Bank has allocated $100m of income on past IBRD loans to be used as grants for debt or service reduction, with a ceiling of $10m for each country.

Bilateral initiatives: Creditor governments have accelerated debt cancellation, writing off over $3.5bn in 1986-89 (twice as much as in 1979-85) and have promised $3.5bn more for countries which adopt adjustment programmes. These actions cover most OECD aid (but not export finance) debt. The Soviet Union has granted write-offs or 100-year moratoria on aid debt.

In September 1988, the 10 major OECD governments concluded the **Toronto agreement** — a menu of options for Paris Club governments to soften rescheduling terms on nonconcessional debt, mostly owed to export credit agencies. Creditors can choose among, or combine, three options:

Option A: cancel 33% of debt service covered by the agreement;

Option B: reduce interest rates by 3.5 percentage points or 50%, whichever is the less; or

Option C: extend grace periods to 14 years and maturity to 25 years (8 and 14 years in the other two options).

They will also extend grace periods and maturity on aid loans to 14 and 25 years.

countries have received relief, and only 60% of available funds are likely to be used.

The Toronto principles (Box 2) of below-market terms on non-concessional debt and a menu of options to suit creditor governments' interests, are seen as important advances. The various options have different implications. Option A (debt cancellation) and B (interest reduction) imply an immediate cost to creditors and relief for debtors. Option C (longer repayment), on the other hand will raise future debt and debt service, and eventually reduce the immediate and overall benefits of options A and B.

Fewer debtor nations than expected have so far taken advantage of the Toronto terms, because of difficulties in agreeing adjustment programmes. Of the 12 which did so by September 1989, 2 creditor governments (owed 37% of debt) had chosen option A; 11 (owed 34%) chose B; and 6 (owed 27%) chose C. Actual service saved was only $50m in 1989 (2% of service due). These savings will rise if debt is repeatedly rescheduled, but the rise of debt stock will only be slowed, not reversed. Based on governments thought likely to secure Toronto terms, the total savings will be around $700m in 1989-2000, less than 1% of 1989 debt for low-income debt-distressed African countries.

In contrast with Toronto terms, almost all recent debt write-offs (except those by Belgium, the Netherlands and the US) are not conditional on adjustment programmes. Sweden has even cancelled export credits for a few countries. However, actual cancellations in 1986-9 saved low-income Africa less than $250m in debt service.

The World Bank's Special Program of Assistance for Africa was designed to improve the position of African debtors both by improving aid negotiation practices and by providing additional money. For the first time it empowers the Bank to monitor aid flows for Africa as a whole and to assess national aid requirements semi-annually. It also aims to reduce the demands of multiple donors on debtor aid-processing staff, and the amount tied to exports from one donor country.

However, the SPA has increased financial flows by less than expected. The additional World Bank loans will barely maintain its real disbursements to low-income Africa, though they are being disbursed approximately on schedule. Against this, bilateral aid disbursement was 20% behind schedule at the end of 1989, and the Bank has extended the period for disbursement to the end of 1991. Moreover, the list of *potentially* eligible countries has expanded rapidly, from 19 to 28, with 22 *actually* eligible (ie with an IMF programme) by August 1989. The SPA fund is due for a three-year replenishment in June 1990.

This raises the issue of how far all the initiatives for low-income Africa will increase import capacity. They were initially intended by the World Bank to permit 1% annual additional import growth (and, as explained above, 1% GDP growth) for 19 nations — a modest target. However, there is an estimated annual shortfall below the Bank's target of $700m for actually eligible nations, and of almost $2bn for potentially eligible nations. Fourteen of 22 individual SPA national programmes have received enough assistance to meet the targets. This is partly because the Bank has filled gaps with its own resources but also reflects larger debt cancellations and disbursements of non-SPA bilateral aid, due to better coordination between the Bank and bilateral donors.

Gaps and other weaknesses

In addition to the difficulties already mentioned, the initiatives currently on offer suffer from a number of weaknesses:

(a) They do not adequately cover a number of important debtor countries. Thus, the Brady initiative may not cover SIMICS such as Egypt and Honduras, while others with large non-commercial debts will receive limited benefits (e.g. Jamaica, Morocco, Nigeria). Some countries with substantial debts simply fall outside the 'severely indebted' categories listed in Box 1, such as Angola, Cameroon and Colombia. There are difficulties too for the SILICS from outside sub-Saharan Africa: Myanmar (Burma) and Guyana. There is a further group of countries which will remain outside the current initiatives because of unwillingness or inability to conclude agreements with the Fund and/or the Bank, such as Ethiopia and Zimbabwe.

(b) The requirement that debtor governments must first agree an adjustment programme with the IMF and/or World Bank presumes that these programmes, and the policy conditions laid down by the Fund and Bank, will improve economic performance. In practice, such improvements have proved rather elusive. Doubts persist about whether Fund and Bank programmes are either appropriate or effective, particularly in low income countries, as do tensions between what the separate programmes of the Fund and Bank seek to do.

(c) There is a danger that agreed programmes will be under-funded. Despite the trappings of objectivity, estimates of amounts of new finance and debt relief needed in support of a country programme are commonly tailored not to go far beyond what is 'realistically' expected to be available, rather than to meet programme objectives.

(d) Decisions on aid, debt relief, export credit cover and policy conditionality remain weakly coordinated within and among creditor countries. They are made by different agencies at different meetings (Paris Club, London Club, Consultative Groups, etc). On some occasions adjustment programmes have broken down even before the terms of debt relief have been agreed. The many sets of negotiations and monitoring procedures place enormous demands on already over-stretched administrations.

(e) It is unclear how much of the funding of recent initiatives is 'new' money. There has been a major diversion of aid from such countries as India which still have the largest numbers living in extreme poverty. Some of the resources of the Fund and Bank have also been diverted to meet debt relief claims.

(f) Many negotiations remain short-term, notably in Fund adjustment programmes and the annual Paris Club reschedulings. Some with a longer-term outlook, e.g. under the Brady initiative, look fragile in the face of global economic instability.

Conclusion

Policy responses to the debt problem have come some distance since the debt crisis broke in 1982. Creditors have gradually moved from short-term damage limitation and insistence on maximum service payments to a longer-term approach which shares the burden more equally among creditors and debtors. By introducing the principles of reducing debt to banks and governments, the Brady initiative (for SIMICs) and the Toronto agreement (for low-income Africa) are important moves. Yet they still fall far short of providing support adequate to restore sustained economic growth in indebted countries (and benefiting world trade).

Moreover, implementation of these initiatives is being delayed; they leave out many countries with debt problems; they do not necessarily provide appropriate or adequate funding; they are often too short-term; and they are dependent on controversial adjustment programmes. Furthermore, recent initiatives should be seen in the context of wider global economic developments and creditor country policies. For example, the 2-3% rise in world interest rates during 1988-89 has cancelled out much of the relief the initiatives were intended to provide — and the trend is still upwards.

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