All Party Parliamentary Group on Overseas Development

MANAGING THIRD WORLD DEBT

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Report of the Second Working Party established by the All Party Parliamentary Group on Overseas Development

In memory of our colleague Guy Barnett MP,
who devoted much of his life to the Third World
and helped to prepare this report.

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Summary of Findings

Many developing countries cannot service their external debt as scheduled. Piecemeal attempts to rearrange their debt profiles have not worked. New lending has not been forthcoming. Developing countries are now paying back to their creditors more in interest and principal than they receive in new loans. Countries which are already very poor are suffering, imports are being curtailed and world recovery undermined. Yet the markets have discounted much ldc debt long ago.

The largest debtors are in Latin America but the debt burden is intractable for many of the poorer African countries. Their debt is mainly owed to governments and multilateral organisations, rather than to banks as in the case of the majority of Latin American debt. As the leading creditor, the United States has hitherto determined policy on debt management, with UK assent. Developing countries have been careful to avoid outright default; very few have take unilateral action to suspend payments but in many cases it is a struggle even to pay interest.

The imposition of austerity from 1982 onwards did not resolve the ldc debt problem. The 'Baker Plan' of late 1985 marked an important change of mood: it recognised the need for growth in ldcs, but neither the time-span nor the financial concessions appear commensurate with the task.

An innovative approach is required which extends beyond narrow financial solutions and shares the burden of adjustment between the debtor countries, the banks and the creditor governments. Debt has ceased to be purely a banking problem and now requires a political solution. With firm political will, the British Government could again lead an international initiative to give debt relief. An illustrative proposal would reduce annual ldc debt service by two-thirds, giving proportionately greater relief to the poorer countries, and preserving the creditworthiness of the market borrowers. Some write-offs will be required; capital repayments could be rescheduled over a much longer period; limits put on the level of interest rates or on the amount of interest paid; and extra funding from surplus countries used to retire old debt. Debt-development swaps would become the public sector response to debt-equity swaps. With the World Bank and the IMF already heavily involved in ldc debt management (including their own arrears), the UK Government should take fresh proposals of this sort to the United Nations to establish a new international consensus.

Box 1: Terms of Reference

1. The Working Party will monitor the capacity of developing countries to service their external debt and consider their financing needs, the availability of such finance, and the appropriate conditions to be attached to such finance. It will also consider the interests of the creditors to these countries, and report its conclusions.

2. Particular attention will be paid to the availability of public flows, notably through the IMF, the IBRD/IDA and the regional development banks, and of private lending notably through the commercial banks. The Working Party will also consider evolving initiatives, such as the Baker Plan, which link both elements. The position of certain categories of developing countries, such as the poorest/middle income countries in Latin America/Africa, will be given particular scrutiny.

3. With these guidelines in mind, the Working Party will form an opinion as to whether:

a) the Baker proposals are appropriate and adequate to deal with the problems in question and whether it is in the British/European interest to fall in with this plan.
b) with the attention primarily focussed on the situations of the major debtor ldcs, adequate attention is being paid to the position of the poorer ldcs, many of which themselves have high debt-servicing ratios and in which Britain has a substantially larger interest than the US.
c) the appropriate roles and relationships in these matters of the IMF, IBRD and the regional development banks are being established, and whether the implications for their policies of Baker's apparent acceptance of the need for resumed growth in the debtor countries is realistic.
d) the likely consequences of a failure to develop more satisfactory international approaches to the debt question would affect British interests, the economic and financial stability of ldcs and our market in those countries.
e) UK banks are being properly consulted; whether their prescriptions differ; and whether there are firm prospects for a revival of lending to all or to the poorer developing countries.

Box 2: Membership of the Debt Working Party

Bowen Wells	Con (Chairman)
Alan Beith	Lib
Tom Clarke	Lab
Baroness Ewart-Biggs	Lab
Lord Greenhill of Harrow	Ind
Robert Harvey	Con
Jim Lester	Con
Oonagh McDonald	Lab
Colin Moynihan	Con
Lord Seebohm	Ind
Tim Yeo	Con

Tony Lloyd (Lab) participated in the early sessions.

Guy Barnett (Lab) was a member until his death in December 1986.

Introduction

There is serious unemployment in many developed countries and increasing poverty in the developing countries, many of which have huge debts to the countries suffering unemployment which, struggle as they may, they cannot pay. The cause of these crises and therefore our ultimate concern, is the poor performance of the world economy, but the immense burden of debt — over a trillion ('000 billion) dollars — is now itself a major obstacle to a solution. Unless the debt-ridden countries receive more investment in wealth-creating activity, their poverty will intensify to the point in some countries of near starvation. It is argued that if they do not pay their debt, many important private banks and international financial institutions will be in financial difficulty, causing greater unemployment and contraction.

These are the human and financial realities which motivated us to undertake this report. We believe that these difficulties are man-made; therefore they are capable of being solved by man, providing the issues are first understood. We can then design a programme which will permit growth in both creditor and debtor nations, and thus solve the human and financial problem. But more important than the details of any debt solution is the political will to solve the problem. Political will can only be generated if a larger number of people understand the problem, accept the necessary sacrifices and implement plans for its solution backed by popular support. This report attempts to explain the problem as clearly as possible and puts forward some suggestions towards a new initiative.

We found from the start that each country's financial problem is different and therefore there are bound to be different solutions for each situation. Many of the elements or tools of economic management to confront the differing situations, however, will be the same but applied in differing combinations. As described in chapter 6, we believe new tools and innovatory financial measures must be evolved if we are to reach the objective of growing our economies out

Box 3: Outstanding External Debt of Developing Countries[a] 1980-1987 ($bn)

	Reporting Countries[b]	*Total*
1980	573	650
1981	666	749
1982	739	825
1983	797	890
1984	833	929
1985 (preliminary)	892	992
1986 (estimated)	932	1,035
1987 (projected)	972	1,080

Notes
(a) Except high income oil exporters.
(b) Countries which report according to standard format under the World Bank's Debtor Reporting System.

Source: World Bank, *World Debt Tables, 1986-87*

Measuring the ldc debt burden: In 1985 this was the equivalent of 45% of the GNP of developing countries — or 11% of total OECD output.

of debt, including a certain amount of debt cancellation in certain circumstances.

The treatment of Third World debt has already moved some way in this direction, though, so far, only haltingly. Fifteen developing countries with major debt-servicing difficulties became the subject of a new initiative by US Treasury Secretary James Baker at the end of 1985. Most of these were in Latin America, but two — Nigeria and Ivory Coast — were in sub-Saharan Africa and we were keen in our inquiry to consider appropriate solutions, not just for the big Latin American debtors, but also for the poorer countries, especially those in Africa, whose debts were owed mainly not to banks but to governments and international institutions. After all, it was in Africa, rather than Latin America, that the first developing country fell into major arrears on its Euro-borrowing: Zaire in 1975. Subsequently several other African countries have been technically in default.

We were also aware than many Asian developing countries had pursued cautious financial policies and had shown more significant economic progress in recent years and that many of the poorest countries have lacked adequate finance throughout the 1970s and 1980s. They should not be deprived of development funds because other countries have adopted unwise financial policies. Lenders must also be reprimanded for lack of wisdom in their lending policies, and governments and international institutions for attempting to transfer the burden of solving the exceptional difficulties of the past two decades to developing countries and the commercial banks. All share responsibility for the crisis, and most have already shared the consequences. Any solution must share the costs of recovering the lost human potential, lost output, and financial losses of the recession years. We urge the British Government to seek such a solution.

Acknowledgements

In the course of our inquiries, members of the Working Party under the chairmanship of Bowen Wells MP, visited Washington DC, East Africa (Kenya, Tanzania, Uganda and Sudan) and the Caribbean. In Washington we had the opportunity of discussing these questions with, among others, the President of the World Bank, the Managing Director of the International Monetary Fund and the Chairman of the United States Federal Reserve Board. In London and in the developing countries visited, we were privileged to see ministers and central bank governors or officials, while in the course of our fortnightly sessions in the House of Commons we were able to question individuals from the banks, from the academic world, from international institutions, from the non-governmental organisations and a particularly strong contingent of debt negotiators, ambassadors and senior financial officials from a wide range of Latin American countries. Our High Commissioners in Africa offered every assistance. To all these we are grateful for the knowledge they have imparted, the arguments they have advanced, and the insights on which we have been able to draw. A full list of the persons consulted for this study is appended to the report.

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Part I

1

Origins of the Debt Crisis

1.1 Roots of the Crisis

The debt build-up began with the acceleration of transnational banking and Euro-currency lending in the 1970s as commercial banks recycled OPEC's surpluses to developing countries whose external accounts deteriorated after the rise in oil prices in 1973.

Historical precedent suggested that capital transfers were essential to development. The US and other developed countries had enjoyed large capital inflows in the nineteenth century. In 1974, many governments were in the midst of large public-sector investment programmes that required imported capital goods.

For those developing countries that had access to it, bank lending also looked like a good alternative to International Monetary Fund (IMF) conditionality to finance slower adjustment to what many considered temporary external shocks. Commercial bank loans were relatively quick to arrange and had few strings attached. In the 1970s, they offered low nominal interest rates and often negative real ones. Official development assistance (oda) was stagnating and direct foreign investment faced nationalist pressures in developing as in developed countries. Governments found commercial bank loans an attractive substitute for their traditional finance.

For the banks, the loans to developing countries were a profitable way to diversify their risks geographically. Recession damped the demand for loans in the industrial countries, deposits from OPEC increased their capacity to lend, and the developing countries proved willing borrowers. High commodity prices in 1973 had bolstered the usual measures of creditworthiness for some developing countries, and some bankers apparently believed that countries could not fail to repay.

Industrial country governments and international institutions unofficially encouraged recycling OPEC surpluses by commercial banks. They did not have their own mechanisms for absorbing the windfall surpluses and recycling to ldcs represented a 'market' solution. The World Bank estimated that net resource transfers to ldcs increased to about $110 billion ('000 million) in 1981, up from $20bn in 1970 and $60bn in 1975, an increase largely accounted for by higher bank lending.

1.2 Risks of Country Lending

The idea that lending to sovereign countries was inherently safe was based on a confusion of several ideas, and it is unlikely that the major private lenders ever deceived themselves in this way. It may, however, have helped to induce some of the smaller, less experienced lenders to join lending syndicates, and even major lenders may not have fully appreciated why it had become more risky.

Countries cannot, of course, be made bankrupt by their creditors in a legal sense, and those that issue debt in their own currencies (for example, the United States) can never find themselves unable to repay because they have the sovereign right to print money. Like any other debtor, however, they can find themselves unable (or unwilling) to repay if their income is less than their commitments. In this case they can attempt to convert their debt to another currency form (the US repudiation of the link to gold in August 1971), or repudiate the debt, formally or effectively, or negotiate with their creditors. The only reason a lender might have for considering countries in general less risky borrowers than companies might be a belief that, because they cannot cease to exist (unlike a company), their reputation for creditworthiness may be a more important constraint. The behaviour of major country debtors suggests that this is true, but it is only a constraint. If a country cannot pay, it cannot be a guarantee.

The limitations of the 'sovereign lending' argument bring into prominence two fundamental characteristics of the 1970s lending to developing countries which made it inherently more risky than other international lending. First, the loans were in the currency of the lender (or some other international currency), not that of the borrower. This is normal in international lending. Only the few countries which are themselves reserve centres, the US, Germany and Japan (increasingly), and the UK (decreasingly), can do a major part of their borrowing in their own currencies. What was abnormal was the scale of the borrowing and the size of the exchange rate fluctuations. Second, the loans were at variable interest rates. Banks were using this increasingly as a means of reducing their traditional risks from 'borrowing short and lending long' and at the same time countries were shifting to a higher share of bank, rather than bond, borrowing.

The lenders thus found their apparent security increased, but so too were the borrowers' risks. At best, they had a limited choice of currency when they arranged the loan (for official loans, there was no choice: the international institutions used the SDR and governments their own currencies). Once the loan was taken, they had neither the traditional security of fixed interest payments, nor the ultimate escape of being able to print money to repay the capital. Thus by reducing the risk that they would earn less than they expected on their lending, the lenders had increased the risk that they would not be repaid.

1.3 Unfavourable External Trends

Mexico's declaration of a temporary moratorium on debt service on 20 August 1982 created the crisis headlines, but the conditions that had eroded developing countries' debt-servicing capacity had been deteriorating since 1978. With oil prices rising and export prices falling, the terms of trade for non-oil primary product exporters fell by 31% from 1978 to 1982; for countries exporting mostly agricultural products, like much of low-income Africa, they fell by 35%.

At the same time international interest rates rose with increasing reliance on tight monetary policy in industrial countries, combined, in the US, with a relaxed fiscal policy. The World Bank has calculated that the average rate on long-term loans to public and publicly guaranteed borrowers increased from an average of 7.1% from 1974 to 1978 to an average of 10% from 1979 to 1983. Average interest on all outstanding long-term debt rose from 5.4% in 1974-78 to 8.2% from 1979 to 1983. Rates on official loans, an important source of finance for low-income countries particularly in Africa, also rose, but less steeply. On short-term loans — a large component of Latin American debt mostly linked to the US Prime Rate or the London Interbank Offer Rate (LIBOR) — rates increased even faster, from an average of 12.1 and 12.7% respectively in 1979 to 16.6 and 18.8% in 1981. As credit markets became tighter, the spreads above these rates charged to developing countries also rose.

1.4 Domestic Policies

Poor domestic policies aggravated the debt-servicing difficulties in some cases. Borrowed funds were diverted from productive use into capital flight or to delay adjustment or buy arms.

The magnitude and significance of capital flight are controversial. An outflow of capital from countries where depressed economies do not offer investment opportunities or inspire confidence is not surprising. If real domestic prospects are further depressed (at least in the short run) by IMF stabilisation policies and encouragement of exchange liberalisation or if returns abroad are made artificially high, for example, because of tax exemptions for foreign bank accounts in the US, the problems are aggravated. For these reasons, some debtors argue that capital flight is not purely a domestic issue. The commercial banks are naturally unwilling to lend more money to governments that find themselves unable to repay past loans because they have been siphoned off by private citizens and sent abroad, but when credit was easier in the 1970s, their lending policies permitted this. Capital flight proved a contentious point during the Mexican rescheduling in late 1986.

Morgan Guaranty estimated that the ldc debtors most afflicted by capital flight from 1976 to 1985 were Mexico, Argentina, Venezuela, Malaysia and Nigeria. Overall it was estimated to be half the size of the increase in gross external debt, with $53bn from Mexico alone. The Mexican Government and the Inter-American Development Bank (IDB) have challenged this figure as too high. The IDB estimates $44bn has left Mexico since 1976, and it shows that the bulk of capital left Argentina before 1982, Mexico before 1983 and Venezuela before 1980, a fact largely confirmed by the Morgan Guaranty figures.

Funds that remained were not always invested in projects that would generate enough foreign exchange to service the loans. In Argentina and Chile, for example, the military governments invested in arms, and sub-Saharan Africa (SSA) countries have also increased military spending.

Governments also borrowed to finance the adjustment to higher oil prices after 1979, as they had done in 1974-5. In some cases, they contracted short-term loans at variable interest rates to pay for current expenditures or low-return, public investment projects, which then became very expensive to service as interest rates increased and export prices fell. The banks contributed to the problem by failing to ensure that the funds lent would generate foreign exchange or be used productively. They went beyond their traditional role of trade and project finance, but created no new safeguards other than to shift as much risk as possible to the borrowers. On balance, however, the funds were used productively. A recent IMF study of 20 middle- and high-income countries found that all but two invested their loans in additional physical capital; low-income countries did less well, but some of the difference was accounted for by war or drought. Although developing countries did not accomplish structural adjustment in the early years, the Fund's 1983 annual report argues they made a good start.

The number of ldcs that ran into debt-servicing difficulty simultaneously thus argues strongly that common external shocks played a central role. The number of formal reschedulings climbed from an average of four per year in the late 1970s to 13 in 1981, 31 in 1983, 21 in 1984 and 31 in 1985.

1.5 Erosion of Debt-servicing Capacity since 1982

Developing countries' ability to service their debts has continued to decrease since 1982 as external finance grew scarcer and real interest rates continued high and commodity prices low. In consequence, imports and investment collapsed, and more recently, governments have found it increasingly difficult to impose further rounds of austerity.

Since 1984, the net capital flow has been from developing countries to developed countries, reversing the normal flow. These net flows cover new loans less interest and amortisation on old ones; they do not include private investment or grants.* The United Nations Conference on Trade and Development (UNCTAD) estimated the net outflow from ldcs on official debt totalled $16bn in 1985. Even if short-term credits are included, about $10bn was paid by all (non-OPEC) developing countries in 1985. Although by areas this was concentrated in Latin America ($17bn) with inflows to Africa ($1.5bn) and Asia ($4.5bn), countries like Zimbabwe and Grenada were among the net exporters of capital as well as middle-income debtors like Argentina and Mexico. While nominal interest rates have fallen since 1982, real rates remain high especially if measured against developing countries' export prices. The World Bank calculated that real adjusted rates were 10% for oil importers in 1985, down from 12.7% in 1984 and 19% in 1981-82, but still high historically.

And commodity prices have continued to slide. After a brief and partial recovery in 1983 and 1984, they fell by about 10% in each of

*For coverage of all elements see Table 2.3

1985 and 1986 (after allowing for the fall in the dollar). The oil price decline will benefit developing countries only if it is used by developed countries as an opportunity to stimulate their own growth. The Organisation for Economic Cooperation and Development (OECD) estimated that, in direct effects, ldcs would gain only $2bn annually if oil prices stay at about $15 per barrel. Developing country oil producers stand to lose $32bn and consumers to gain $34bn. So far, the hoped-for acceleration in world growth has remained elusive.

Developing countries adjusted to these unfavourable external shocks with stabilisation policies — with and without IMF prompting. A common result has been sharp reductions in imports, through controls and fall in demand, and in public and private investment as governments cut back spending and channelled foreign exchange into debt service. Both reduce their long-term ability to service their debts. Lower imports of intermediate products and inputs prevent them from using their existing production capacity fully, and, in particular , from shifting to commodities with better export prospects or goods that substitute for imports. In many countries in sub-Saharan Africa this has restricted the supply of agricultural inputs and transport that would boost exports. According to the IDB, gross domestic investment in Latin America has fallen by 30% since 1980, reversing the trend of the preceding 20 years. In SSA it has fallen from 22.5% of GDP in 1980 to 14.5% in 1985, with some governments giving priority to emergency food imports as well as to interest payments.

At the same time, debtors are becoming less and less willing to postpone the recovery of their living standards. As Mexico's former Finance Minister, Jesus Silva Herzog, told an IDB meeting in London in January 1986, 'The limit of the responsibility to our creditors is the responsibility to our people'. This was echoed in the Vatican's 1987 Pontifical Commission on Justice and Peace Report, which called for a resolution to the debt problem which did not impose unbearable demands on developing countries, noting that 'no government can morally demand of its people privations incompatible with human dignity'. The shift in debtors' impatience became evident in mid-1985 when Fidel Castro urged Latin America's leaders not to pay the close to $400bn due and Peru's President Garcia announced a ceiling for debt service of 10% of exports (see case studies, Part II).

1.6 Conclusions

The four principal factors precipitating the debt crisis were the further rise in oil prices, the lower volume and prices for exports, high interest rates, and a sharp reduction in external loan finance. Domestic policies in some debtor countries reduced their ability to repay, but the widespread nature of the crisis, and evidence that many countries did use borrowing wisely, are strong indicators that systemic causes were the major explanation. Since 1982, the continuing fall in imports, investment, and growth and the increasing political resistance to austerity have further undermined developing countries' debt-servicing capacity in a dangerous cycle.

2

Developing Country Debt

2.1 Debt Distribution by Source and Area

The World Bank reported that the developing countries together owed $992bn in 1985 and estimated total external liabilities to increase by 4.3% in 1986 to $1,035bn.

Debt problems are concentrated in Latin America and sub-Saharan Africa although there are problem debtors, often oil exporters, scattered throughout other regions. Latin American debt was the most serious threat to the stability of the international financial system, but the burden of servicing debt relative to domestic income is greater in some SSA countries.

In Latin America, the main lenders were banks: they have held more than half of the external public debt since 1978, an unusually large proportion measured against an average of about 16% in the 1960s and 20% in the 1970s. Commercial bank rescheduling packages, with IMF sanction, have been the primary 'solution' to debt-servicing problems.

Low-income SSA countries tend to owe the bulk of their debt to official creditors. Although some are now in serious arrears, these forms of debt have not traditionally been eligible for rescheduling. As a result, African 'solutions' have focussed on increasing concessional bilateral and multilateral aid flows, except for the handful of countries that borrowed heavily from the banks.

Asia is home to the main 'success' stories. China and India have very little external debt and continue to receive net capital inflows. Among the fast-growing exporters, a few, notably South Korea and Malaysia, have large and manageable debts and are still considered creditworthy by commercial lenders; they are now limited more by their own fears of the consequences if their debt-servicing capacity deteriorates.

As Table 2.1 shows, the share of official versus private creditors is the most important difference between the Latin American and

Table 2.1 Debt by types and area, 1985

	Reporting Countries	*Low-income Africa*	*Latin America Caribbean*
Total ($ bn)	892	46	384
Public ($ bn)[a]	632	37	272
Shares in total (%)			
Public	71	80	71
Official creditors	30	67	16
Multilateral	12	25	8
Shares in public			
Variable interest	44	5	67
Concessional terms	22	53	5

a. Public and publicly guaranteed debt.

Source: World Bank, *World Debt Tables 1986-7*

African debt cases. Low-income Africa owes 67% of its debt to bilateral and multilateral lenders, and this is reflected in a much higher level of concessionality in the terms of the loans. Low-income Africa's strength is that over 50% of public and publicly guaranteed loans, the bulk of total debt, are on concessional terms. On the other hand, over half of Latin America's medium- and long-term disbursed debt by 1985 had been lent by private financial markets, a figure that would be much higher if short-term debt were included. Four middle-income African states — Gabon, Ivory Coast, Congo and Nigeria — also borrowed heavily from the banks.

A significant indicator of risk is the share of variable interest rate debt as a proportion of public and publicly guaranteed, long-term debt.

Latin America has a lower share than Africa of public and publicly guaranteed debt in total debt, which means private borrowers were considered creditworthy by international lenders. But since 1981 the share of public debt has risen from only half to 70% in Latin America as governments have shouldered retroactively the responsibility for many private debts. Private borrowers in low-income Africa were never considered good risks by international lenders.

Debt burden can be measured by two indicators: as a proportion of exports or of GDP. Both can be poor indicators of long-term ability to service debt as repayments are determined also by the duration of the loan, and, if credit conditions are normal, the debt may be rolled over, so that interest payments are most important. For ability to repay, the GDP ratios are most significant in the long term, when resources can be switched to productive and foreign-exchange earnings use, but exports measure immediate access to foreign exchange. Export earnings, however, especially in SSA, can fluctuate widely.

Despite these limitations, Table 2.2 shows that the debt burden has been steadily increasing for all regions since 1980, with an especially acute deterioration in low-income countries including SSA. In 1985, debt-to-exports ratios within SSA ranged from over 1,000% in Mozambique, Sudan and Guinea-Bissau to less than 50% in Gabon, Botswana and Lesotho. Scheduled interest payments and charges for use of IMF credit ranged from 69% of exports in Mozambique and Sudan to less than 4% in Guinea, Gabon, Botswana, Chad and Lesotho.

Table 2.2 Debt ratios (%)

	Debt/exports		*Debt/GDP*	
	1980	1985	1980	1985
All countries	134	194	28	45
Latin America, Caribbean	193	311	35	62
Low-income Africa	218	425	47	80

Source: World Bank, *World Debt Tables*, 1986-7.

2.2 Future Needs: New Financial Flows

The main sources of external finance to developing countries are official development finance (bilateral and multilateral), and private finance, bank loans, direct foreign investment and bonds. Table 2.3 shows that the total net resource flow to developing countries has fallen since 1981 to below 1975 levels, as measured at 1984 prices and exchange rates, and this has been a contributing factor to widespread debt-servicing difficulties since 1982.

The proportions of **private finance** have changed dramatically since 1975 because of the unprecedented volume of bank lending; by 1981, odf had shrunk to only a third. Since then, however, **bank lending** has decreased faster than other types of external finance. Table 2.4 shows

*Table 2.3 Total net resource flows to developing countries**

	$ bn			%		
	1975	1981	1985	1975	1981	1985
1 Official Development Finance (odf)	37.3	44.3	47.8	45	34	61
Official Development Assistance	30.9	35.5	36.0	37	27	46
Bilateral	25.4	28.0	27.7	31	21	35
OECD countries	12.0	17.6	21.7	14	13	28
OPEC countries	8.3	7.2	2.3	10	5	3
CMEA countries	2.2	3.0	3.5	3	2	4
Other countries	0.6	0.2	0.2	1	—	—
Multilateral	5.5	7.5	8.3	7	6	11
Other odf	6.4	8.8	11.8	8	7	15
2 Total Export Credits	8.2	17.2	1.2	10	13	2
3 Private Flows**	37.8	70.9	29.7	45	54	38
Direct Investment	16.6	16.4	7.7	20	12	10
International Bank Sector	17.5	49.6	13.5	21	38	17
Total Bond Lending	0.6	1.2	4.5	1	1	6
Other Private***	3.1	3.6	4.0	4	3	5
4 Total Resource Flows (1+2+3)	83.3	132.4	78.7	100	100	100

Source: OECD. Development Assistance Committee, *Development Co-operation*, 1986 Report. *in US$ bn at 1984 prices and exchange rates and percent. **Private flows exclude export credits. ***includes grants from non-governmental organisations.

that the drop has been most precipitous in Latin America. In Africa, it has also fallen, but it is a much smaller portion of the total debt. Lending recovered somewhat in 1985, but only to Asia and the Middle East, and even this appears to have been reversed in 1986.

This suggests that the Baker Initiative, launched in October 1985 (see chapter 4), has not restored bank lending to promised levels. As Table 2.4 shows, net new lending was negative in the first three quarters of 1986, to all regions, but with the largest outflow from Latin America.

The decline is linked to three trends. First, the flow of surplus Japanese and West German capital into the US, attracted by high interest rates. Second, lenders increasingly use securities markets where creditworthiness depends more on widespread familiarity with a borrower, a condition most developing countries cannot meet. Third, and most importantly, bankers as a group have become more cautious

Table 2.4 Net international bank credit 1980-86 ($bn)

	1980	*1981*	*1982*	*1983*	*1984*	*1985*
Latin America	27.4	30.5	12.1	7.8	5.4	1.6
Africa	2.0	2.0	1.7	0.6	0.2	0.7
Asia, Middle East	9.5	7.4	6.0	3.8	4.4	8.5
Total	38.9	39.9	19.8	12.2	10.0	10.8

Quarterly flows

	1985.I-III	*1986.I-III*	*1986.I*	*1986.II*	*1986.III*
Latin America	0.2	−3.1	−2.2	−0.1	−0.8
Africa	0.2	−0.2	−0.2	−0.3	0.3
Asia, Middle East	5.1	−1.3	−2.3	0.3	0.7
Total	5.5	−4.6	−4.7	−0.1	0.2

Source: Bank for International Settlements (BIS), *Annual Report 1986, International Banking Developments,* October 1986, January 1987. Flows at constant end-of-quarter exchange rates.

and more aware of their exposure, partly as a result of experience, but also because of tighter standards from the supervisory authorities.

The share of **direct investment** has halved since 1975, and looks unlikely to increase without higher growth in developing and industrial countries. Furthermore, the share in Latin America and the Caribbean and Africa has remained fairly constant since the late 1960s, although Asia and the Middle East have drawn some investment away from these countries. The World Bank has estimated that Latin America received an average of half the total investment in ldcs between 1980 and 1983, Africa 10%, and Asia and the Middle East about 40%.

The volume of ldc **bond issues** more than doubled in 1985 to just under $8bn, but most of the issuers were countries in the Middle East and Asia. However, this rise is small relative to the drop in private bank loans since 1981.

Official development finance (odf) has not offset the large drop in private finance since 1981, but has been steadily increasing. Odf includes bilateral official development assistance (oda) (ie official flows to developing countries administered with development as the prime objective and containing a grant element of at least 25%), multilateral oda, and other bilateral and multilateral finance that does not meet the grant terms of oda.

As Table 2.3 shows, bilateral flows, chiefly from the OECD, accounted for three-quarters of odf flows. The overall level of bilateral flows remained fairly constant in the decade 1975-85, with increases in OECD aid being offset by decreases in OPEC funds. Multilateral oda lending increased steadily, and non-concessional bilateral and multilateral finance has doubled.

Export credits, a small share of total resource flows, fell drastically and low-income countries have felt the loss most keenly. Some of the decline is probably accounted for by a lack of demand, as trade flows have themselves contracted, but the policy of withdrawal or reduction in new credits when past debt is rescheduled is difficult to understand in normal financial terms as rescheduling is intended to improve a country's immediate creditworthiness.

Finally, developing countries supplement external financial flows with borrowing from the IMF, drawing down of reserves, and arrears.

Use of **IMF credit** peaked in 1983 at $11.3bn and has since fallen to $0.4bn in 1984 and a net repayment of $1.5bn in the first half of 1986, in line with IMF estimates that developing countries will repay $3bn more in 1986 than they receive in new loans. The 10 major Latin American debtors are scheduled to make gross repayments of $6bn between 1986 and 1988.

Reserves have played an important financing role, especially in Africa, and have dwindled in some cases to levels worth only weeks of imports. Between 1982 and 1985, developing countries drew down their reserves by $31bn.

2.3 Net Transfers

Table 2.5 shows World Bank estimates for net transfers — disbursements of medium- and long-term debt less payments of principal and interest. The figures distinguish between debt borrowed by governments or guaranteed by them (public and publicly guaranteed debt) and loans taken by the private sector (private); the public debt is further divided by official and private lender.

In 1985, the developing countries made a net repayment of about $26bn, mainly to private creditors. The World Bank does not include short-term debt in its calculations, which seriously understates the outflow from regions that borrowed heavily from private creditors, like Latin America. For instance, on World Bank estimates, Latin America repaid $47bn between 1982 and 1985; ECLA estimates, which include short-term debt and payments of profits, suggest the outflow may have been nearer to $76bn.

Table 2.5 Net transfers ($ bn)

	1975	*1980*	*1985*
All countries	21.3	28.7	−26.3
Publicly guaranteed	19.0	24.6	−16.1
to official creditors	9.8	14.9	4.7
to private creditors	9.1	9.7	−20.8
Private sector	2.4	4.1	−10.2
Major areas:			
Sub-Saharan Africa	2.5	5.7	−2.2
Publicly guaranteed	2.4	5.2	−1.9
to official creditors	1.5	3.2	1.3
to private creditors	.8	2.1	−3.2
Private sector	.1	.5	−.3
Latin America, Caribbean	6.5	5.5	−22.0
Publicly guaranteed	5.5	3.8	−14.1
to official creditors	1.5	2.3	1.5
to private creditors	4.0	1.5	−15.6
Private sector	1.0	1.6	−7.9
South Asia	2.3	3.3	2.4
Publicly guaranteed	2.2	3.1	2.2
to official creditors	2.3	2.7	2.2
to private creditors	.0	.4	.0
Private sector	.0	.2	.3
East Asia, Pacific	4.2	5.4	.7
Publicly guaranteed	3.5	4.7	1.0
to official creditors	1.2	2.0	.7
to private creditors	2.3	2.7	.3
Private sector	.7	.7	−.2

Figures may not add because of rounding.

Source: World Bank, *World Debt Tables 1986-7.*

2.4 Conclusions

Debt problems are concentrated in Latin America and SSA, although other problem cases, often oil exporters, are scattered throughout other regions. Asia is home to many 'success' stories.

Latin America owes its debt to the banks, and with few exceptions, SSA owes more to official sources — multilateral and bilateral. As a result, more of SSA debt is on concessional terms, but less is eligible for rescheduling.

The debt burden has grown steadily in all regions since 1978, with an especially severe deterioration in low-income countries. The flow of finance has dropped sharply since 1981, to below 1975 levels in real terms. A small increase in odf has been offset by large contractions in private finance — principally bank lending and direct investment.

The developing countries paid their creditors $26bn more in interest and principal than they received in 1985, a trend that continues.

3

International Institutional Arrangements

International financial institutions (IFIs) have a dual role in the management of Third World debt. As creditors, they have an interest in the security and performance of their loans; they are also important suppliers of future credit. But they also exist as supervisory organs, charged to ensure smooth functioning of the world's financial and payments systems, and hence monitor and advise on the policies of their member countries whether creditors or debtors.

It is this surveillance role which has enhanced the importance of the **International Monetary Fund**, even as its net lending has diminished. Conversely, the **World Bank** has always had a longer-term horizon and, whether through IDA credits or its IBRD loans, has had as its major objective the promotion of sustainable development through its investments and their catalytic effect on private initiative. However, at a time when it is turning more and more to policy-based lending for adjustment and recovery programmes rather than to new project investments, it finds itself increasingly cast in the role of a debt management institution rather than a development agency — though this is being resisted. **The Regional Development Banks** tend to operate on the more traditional basis of project lending and are only now, through amendments to their charters, beginning to offer programme loans for restructuring.

Since IFIs are owned and controlled by governments and their lending (say, in the case of IBRD loans) is dependent on raising finance on capital markets, they do, however, straddle the public-private divide. Furthermore, just as creditor governments normally insist on an IMF standby programme being in place before agreeing to a rescheduling of their official loans, the same sort of IMF (and by extension with adjustment lending, World Bank) guarantees are now sought by the commercial banks before they will grant a rescheduling of bank debt. Rescheduling in the absence of an IMF programme (such as the case of Brazil in March 1986 — see Part II) is the exception rather than the rule. In exceptional cases a World Bank medium-term restructuring programme may be acceptable in lieu of an IMF short-term standby, but often the granting of a rescheduling depends on prior IMF and World Bank programmes being in place. The interlinkages of policy conditions between the two (and increasingly also between World Bank credits and bilateral donors' programme lending) can also mean that new development finance has to be suspended when short-term performance criteria, say after the first IMF review, cannot be met. The fragility of the system is thus apparent.

Neither creditors nor debtors are satisfied with the present **Paris Club** arrangements for rescheduling government loans. Officials from creditor governments simply meet — there is no formal institutional status and no secretariat — as and when requests are made for rescheduling of official (not bank) debt. This is often later than is desirable for adequate rescheduling to be arranged in time. Moreover, since the governments represented in the Paris Club have traditionally been reluctant to grant multi-year reschedulings (and until recently were very resistant to rescheduling interest) debtors face repeated short-term negotiations. From 1956 (when a meeting was first called to deal with Argentina's official debt) until 1978 only eight countries sought such rescheduling. In the 1980s this rose to over thirty countries in some years, with many of the poorer African countries returning almost annually.

The merit of the Paris Club is that it permits a debtor government to deal with all its official creditors at once. A similar arrangement for rescheduling debt owed to the commercial banks exists through the **bank advisory committees**, known as the **London Club**. However, a meeting of the Paris Club or London Club is far from the end of the story. Thereafter, the debtor government has to seek and implement bilateral arrangements with its creditors, and it has no guarantee of impartial and equal treatment between debtors, or of a satisfactory balance in burden-sharing between creditor and debtor. It also has to attempt to secure new concessional finance from the same countries as donors. Although the Paris Club has shown greater flexibility recently in some areas — grace periods have lengthened, interest rescheduling is now being considered — its short-term, purely financial objectives no longer seem appropriate.

Standing behind the commercial banks and their national supervisory agencies, the central banks, is the **Bank for International**

Settlements (BIS). Though far from being a world 'lender of last resort' (there is none), the BIS has been in a position to raise some emergency finance. More importantly, it monitors debt levels and debt service flows, co-ordinates the banking practices of its members (through the meetings of the Group of 10 major central bank governors) and warns. It has promoted common supervisory standards among all the G-10 creditor nations: currently there is more progress in harmonising bank regulations between the USA and the UK than within the EEC. But, significantly for a major financial institution, it has taken the view that purely financial solutions to Third World debt problems cannot now be expected to work.

The commercial banks themselves now have their own monitoring and co-ordinating institution, the **International Institute for Finance** (IIF), based in Washington. This was established in 1983 following the bankers' recognition that they had been caught out by the rapidity with which Mexico's financial crisis had developed (and others subsequently). It aims to monitor much more closely and project forward with greater accuracy comprehensive information of interest to its members on sovereign borrowers (mainly the lower-to-middle-income developing countries, not the poorest which have very little bank debt).

The Working Party's Washington visit centred around the IFIs themselves, notably the World Bank, the IMF and the Inter-American Development Bank (IDB), plus a session with the IIF. In all cases, the progress with and outlook for the 'Baker initiative' dominated discussions, though we also considered a range of alternative approaches. The current creditor strategy, broadly encapsulated in the Baker Plan, is outlined in chapter 4, with a range of innovations considered in chapter 5. Three significant findings, however, emerged from the Washington visit:

1. There was no feeling of complacency. The Baker Plan notwithstanding, the developing country debtors' position was seen as generally much worse at the end of 1986 than had been anticipated when the first remedial actions were taken in 1982. There was a feeling that four years had been lost in laying too much emphasis on short-run financial solutions, while ldc living standards had deteriorated and the world economy had failed to revive. The 1986 Mexico settlement (see Part II) — the most innovative so far — appeared fragile, with co-operation from the commercial banks far from assured. Overall, the institutional impact on the IMF and the

World Bank was itself severe. IMF arrears were now a pressing problem. Africa was by now showing a net repayment of funds to the IMF, but it was persuasively argued to us that the IMF's recent deep involvement in Africa was only occasioned by the lack of (more appropriate) concessional finance. The World Bank, in contrast, had non-performing loans in only two countries (Nicaragua and Liberia) but this position was only sustainable by offering larger new credits.

2. The commercial banks were in a much stronger position now than in 1982. They had taken the opportunity to strengthen their capital base, and in the main to reduce their ldc exposure. American banks were now more vulnerable to domestic energy, farming and housing loans than to ldc debt. This means that it is now less easy for the IFIs (and the debtor governments themselves) to cajole the commercial banks into rescheduling. For most of the major banks, only a simultaneous default (collective or coincidental) by a number of large Latin American debtors would shake them; a single default would be absorbed. Without firm government intervention (and increased official funding, including stronger and prompter export credit cover) they would therefore be less inclined to seek innovative solutions. It was also apparent that an imbalance not only of resources but of information and negotiating power existed. The debtor governments had no effective forum (Cartagena Group*, UNCTAD, etc. notwithstanding). They were simultaneously assisted and punished by the IMF and World Bank. Advice and negotiating expertise could be bought in at cost from the merchant banks, and technical assistance was offered to improve debt reporting systems. But debtor-creditor consultations such as those organised by the Commonwealth Secretariat were rare and, though promising, were available only on a modest scale.

3. All those we met in Washington but particularly Mr Conable, the World Bank President, stressed that financial solutions alone would not suffice; crucial to a recovery from debt-service difficulties was an expansion in world trade, improved commodity prospects and a roll-back of protectionism.

* The Cartagena Group of 11 Latin American countries — Argentina, Bolivia, Brazil, Colombia, Chile, Dominican Republic, Ecuador, Mexico, Peru, Uruguay, Venezuela — came into being in June 1984 more as a political response to the experience of dealing with creditors en bloc in Paris and London club negotiations, than as an overt attempt to form a debtors' cartel.

4

What Is Being Done?

4.1 Before the Baker Initiatives

The severity of the debt crisis of 1982 was quickly recognised and during the following three years Western banks were able to reduce their overall ldc exposure and build up their capital base. The international financial system did not collapse (though it continued to creak); nor were the debtor countries tempted to form an effective cartel withholding all service payments. But a set of policy responses which left the developing countries with *higher* debt-service burdens in 1985 than in 1982 can hardly be judged a success. Moreover, whereas they had been in receipt of a modest net flow of resources ($16bn) in 1982, the debtor developing countries were by 1985 *paying back* a net transfer of $26bn to their creditors (see Table 2.5), so sharp was the contraction in new lending. It was on the developing countries that nearly all the burden of adjustment was placed. This ignored the fact that they were only one part of the problem of world economic instability.

The chief instrument was a short-term rescheduling of debt accompanied by stabilisation programmes supported by an IMF stand-by credit, usually of one year or eighteen months' duration. A typical IMF package would require a major devaluation, a cut in the budget deficit and strict government targets towards a balanced budget, restrictions on the extension of domestic credit and as a result a substantial cutback in imports, the overall aim being to achieve a viable balance of payments in a very short time by encouraging the output of tradeables, earning more foreign exchange to permit continuing levels of debt service, and consuming less — but also indirectly investing less from the public purse — at home. Not all IMF programmes employed an identical mix of elements — nor would a policy which sets great store by the 'case-by-case' approach be expected to lack adaptability — but it is by now agreed that the post-

1982 programmes were homogeneous in their aim of imposing a deflation of demand in the expectation that foreign capital (both direct investment and bank lending) would flow in once the immediate debt-service problems had been addressed.

The reality was different. New capital flowed in only as 'forced lending'. Aid flows stagnated. The IDA-7 replenishment as negotiated in 1983 emerged, owing to US pressure, at barely two-thirds of its required level (a Special Africa Facility had later to be arranged to supplement it). Most donor governments were prepared to reschedule in the Paris Club but not to convert all their loans to grants. The import cuts applied in the debtor countries not only reduced consumption but were so severe as to diminish capacity utilisation of their existing stock of investment. In many countries, real wages were cut (in Mexico by 18% over 2 years) and jobs shed. But jobs were lost in the industrialised countries too, largely as a result of the import cutback. The ldc export expansion also failed to operate in the prescribed fashion. Although certain debtors showed brief signs of 'success' — Brazil in 1985 had the third largest trade surplus in the world — the absence of a strong recovery in demand in the West and growing protectionist measures against developing countries prevented a solution to debt-service problems from this course. Those countries dependent on commodity exports experienced the greatest difficulties as, with only one or two exceptions, commodity prices continued to fall in real terms: the real prices of agricultural raw materials and minerals were by 1985 not merely well below their 1974-5 and 1977 peaks, but some 30% below their long-term average (calculated over thirty years). UNCTAD estimates that in the period 1980-85, the developing countries of sub-Saharan Africa lost $11bn in terms-of-trade losses alone.

This was a period of adjustment-without-growth. Latin American countries experienced a recession worse than that of the 1930s. Per capita incomes in Africa fell to below the levels of 1970, and in some cases were lower than in the early 1960s, just after independence. The bargain that the deprivations of short-term stabilisation would lead to a rapid revival of net lending and export earnings expansion was not kept, for world demand failed to revive adequately or to be transmitted to the developing countries. Despite the formation of the Cartagena Group, a more concerted trend towards debtor default did not emerge, perhaps surprisingly. The Peruvian example of a debt-service ceiling of 10% of exports (see Part II, 7.3) was scarcely followed (Nigeria and Zaire later adopted similar, but still conciliatory, approaches to their creditors). The beginnings of a reduction in world interest rates offered some hope, as did the oil price decline (much accelerated in December 1985) for the non-oil exporting debtor countries, but by mid 1985 the strategy of IMF-led contraction and ldc demand deflation had to be put into reverse. The IMF itself was beginning to accumulate arrears in a number of countries: as a preferred creditor it could not permit rescheduling, nor did it have adequate resources to lend more. So even the IMF programmes which were the keystone of the early 1980s approach became inadequate to the task of assisting short-term balance, and the commercial banks saw themselves as obliged to lend to ldcs to permit repayment to the IMF.

4.2 The Baker Initiatives of 1985

A number of initiatives to improve world financial stability were launched in late 1985 by US Treasury Secretary James Baker, with the support of the Western industrialised countries. They do not, of course, amount to a comprehensive 'solution' to the debt problem: indeed, the Baker approach stresses case-by-case treatment and aims at gradual, longer-term remedial action. Significantly, however, it does mark a political shift in the way North-South debt problems are addressed. It assumes that growth and expansion consistent with balance of payments viability are an essential part of the solution, and that continuing retrenchment will create a downward spiral in global economic activity, which will affect the creditor nations themselves. Just as the time-frame for a solution is shifted, so is the relative responsibility between international institutions: Baker posits a much stronger role for the World Bank and the regional development banks, whose policy-based lending is intended to operate effectively over the medium term, compared with the IMF which concentrated on short-term balance of payments remedies.

The Baker initiatives can be divided into three parts:

1. **Exchange-rate adjustment**. The Group of Five (the US, the UK, Germany, France and Japan) Finance Ministers met in the Plaza Hotel, New York on 22 September 1985 and agreed to reduce the over-valuation of the US dollar. This would have the incidental effect of reducing the value of the ldc debt (mostly dollar-denominated) and also of helping to stem the rising tide of protectionism in the United States occasioned by the relative

cheapening of imports. It was also hoped that expanding ldc exports could be diverted to other non-US markets, notably Japan and Germany. Above all, the move represented an, at that time, unaccustomed faith in government intervention in the market. For the previous decade, exchange-rate imbalance had been largely left for the market to resolve.

A year after the Plaza agreement, the US dollar was worth 22% less in terms of the standard trade-weighted index, proving that a currency adjustment could be managed by governments which agreed to co-ordinate their policies. On other scores, however, success is still awaited. The US trade deficit has not narrowed and in November 1986 a Democrat-dominated Congress looked no less protectionist than its predecessor: the preparatory stages of the new GATT round in Punta del Este, however, put further tariff reductions (in addition to agricultural trade and services) on the agenda, although the potential benefits of these to developing countries already receiving preferences is open to question. And the benefits of a lower dollar:yen or dollar:DM rate to developing countries holding dollar debt, serviceable in dollars, are negligible as long as their export prices follow the dollar down. Far greater benefits were expected from the halving of the oil price, though this acted as a further external shock to some of the leading debtors, notably Mexico and Nigeria, which are net oil exporters.

2. The programme to tackle the problems of the **fifteen largest ldc debtors** through growth-oriented policies. Under the proposals put forward in October 1985 at the World Bank/IMF meeting in Seoul which became known as the Baker Plan itself, these fifteen major debtors were to be the beneficiaries of $29bn of extra financing in 1986-8 — $9bn from the IFIs (with the World Bank now at centre-stage) plus $20bn of new commercial lending. In return, they would agree to restructure their economies, placing more emphasis on market disciplines and private-sector initiatives. Although the direct association of multilateral and private bank lending was new, and the time scale more generous, the conditions applied to the loans were familiar, amounting to a programme promoting renewed private foreign investment, trade liberalisation and public spending cuts to raise domestic savings.

The considerable exposure of the commercial banks to these major debtors can be judged from Table 4.1. The exposure of UK banks to Latin American countries is highest in the case of Brazil ($13.3bn of claims outstanding) and Mexico ($12.6bn). UK bank exposure is also quite large on lending to Argentina ($4.4bn), Venezuela ($3.5bn) and Chile ($2.5bn).

Table 4.1 'Baker Fifteen': disbursed debt outstanding as at end 1984 (US$ bn)

	Total Debt	*Bank Debt*
Argentina	47.8	32.0
Bolivia	4.1	1.1
Brazil	102.0	73.7
Chile	20.4	15.6
Colombia	12.6	7.5
Ecuador	7.6	4.7
Ivory Coast	6.2	2.6
Mexico	96.6	72.5
Morocco	13.2	3.4
Nigeria	19.2	5.7
Peru	13.4	5.0
Philippines	26.2	13.4
Uruguay	4.7	2.5
Venezuela	34.8	27.6
Yugoslavia	18.5	7.9
Total	427.3	275.2

When we visited the IIF in September 1986, it appeared that less than $2bn of the annual $7bn of new lending from the commercial banks had been forthcoming. However, a deal was finally struck with Mexico, for which by the end of 1986 $6bn of new bank loans had been agreed (though not disbursed, since some banks were still taking an uncompromising stance) at 13/16ths above LIBOR (see Part II, 7.1). Certain novel features (failure to achieve a prescribed growth rate or further significant oil price falls triggering extra multilateral and private loans) were incorporated into the arrangement. This led some observers to believe it represented a new generation of debt settlements; the other ldc debtors were keen to take any financial innovation as a possible precedent. The fundamental similarities with previous debt and adjustment programmes are, however, quite marked (*relatively* little new money compared with the scale of the debt-service problem; harsh policy conditionality rendering the government vulnerable to popular dissent; and no writing-off of outstanding debt), and as a result it is more than likely that Mexico will within a year or so again move into arrears necessitating a renewed round of debt negotiations.

Treasury Secretary Baker reported on progress to the US Congress in December 1986. Nine of the fifteen had agreed formal IMF programmes or signed Letters of Intent. Only Peru and Brazil had opted to avoid IMF involvement, though in some cases (e.g. Nigeria) the government insisted that the IMF's presence be kept discreet (See Part II, 7.3). On the World Bank side, $3.7bn worth of new structural adjustment and sectoral loans (i.e. policy-based loans rather than project finance), had been shared among ten countries, with a further $5bn of lending under negotiation. Some $75bn of debt had also been rescheduled with the commercial banks, indicating a significant postponement of current service obligations. This represents over one-quarter of all bank debt owed by the 'fifteen' — itself a laudable performance, but one which will be worth little if the debtor economies fail to grow (a) to be able to meet the bunched debt-service burden in the later 1980s and (b) to cope with the rescheduled debt which falls due in the 1990s.

3. Excluded from the fifteen were a large number of **poorer developing countries** covering the whole of sub-Saharan Africa apart from Nigeria and Ivory Coast, for whom a continuation of IMF/World Bank policy-based lending as a prerequisite to Paris Club single-year reschedulings was envisaged. The main concession to them under the Baker initiative was an agreement that the IMF Trust Fund would be reactivated for the exclusive use of the poorest developing countries (the only IMF facility so constrained). This provides under the so-called Structural Adjustment Facility (SAF) a total of nearly $3bn over three years on soft financial terms to governments agreeing to take IMF programmes. It is recognised, however, as providing little more than the wherewithal for African and other poorer debtor countries to continue paying interest, rather than enhancing their foreign-exchange earnings capacity. Some countries have resisted the apparent cross-conditionality between short-term IMF and longer-term World Bank programmes which SAF drawings now imply, and are concerned that bilateral programme aid too may be withdrawn if IMF targets are not met.

Maybe the greatest value of the Baker initiatives will prove to be as a demonstration of political will to reflate the economies of debtor countries, rather than condemning them to further retrenchment. The ambition to associate private bank and investment finance with official contributions was a brave one, but seems to be encountering difficulties. (In Baker's early presentation, he assured his audiences that his proposal would not cost the taxpayers a cent.) As we saw in chapter 2, banks have been reluctant to lend on the scale envisaged, much of the new lending has been forced rather than voluntary, and the banks' restored capital base and reduced ldc exposure strengthen their position if they want to resist public pressure to lend in the future. Public flows too have not responded to the challenge. The eighth replenishment of IDA in December 1986 was initially a poor compromise at \$11.5bn (though the offer of supplementary funding mainly from Japan and Italy will take it to \$12.4bn); the OECD's Development Assistance Committee expected only a 2% growth in oda (instead of the 4% in recent years) and warned of the threat of collapse in policy-based lending to Africa in the absence of significant increases; and government export credit guarantee agencies are still slow to restore cover to debtor countries after they reach agreement on rescheduling.

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5
Alternative Proposals

Until recently the Western governments assumed that the ldc debt problem was manageable and that a modest revival in world growth, together with an expansion in trade, would be enough to permit most ldc debtor nations to keep up their debt service. Those few which failed to do so would be dealt with as special cases. A 3% GDP growth in the OECD countries was estimated as enough to pull most ldcs out of recession and overcome their current debt-service problems, on the assumption that the recovery in demand would be transmitted to them in the form of a rise in commodity prices, that barriers to ldc manufactures exports would be removed, and that there would be substantial new voluntary bank lending. Unfortunately none of these assumptions holds. The Western creditors' case against the eventuality of a formal default is the threat that any ldc which took this step would lose its creditworthiness, and that a collective default would damage the international financial system and disrupt world payments arrangements, thus forcing defaulting countries to descend into countertrade and barter for their external transactions.

5.1 Ldc Positions

The ldc governments themselves are not keen to go down the road of default, though they point out that with the collapse of new (other than forced) lending the threatened loss of creditworthiness would hardly be worse than their current situation, where many have negative net resource transfers. Nor, despite the formation of the Cartagena Group, have developing countries generally attempted to exercise debtor power collectively (see Part II). Instead, the majority (including most of the Baker '15') prefer much more favourable longer-term rescheduling operations, ie rescheduling over at least 20 years as in the recent Mexican deal. They see the advantages of debt write-offs, but not if that were genuinely to affect their capacity to attract future lending; however, if voluntary write-offs were agreed, as a contrast to de facto default or suspension of payments causing arrears, this could have the effect of strengthening the country's balance of payments and so make it more creditworthy. A familiar feature among debtors' attitudes is the attempt to establish precedents wherever new concessions are made or particular positions taken (see case studies in Part II). The creditor banks and their government regulators, on the other hand, are equally intent on emphasising that each case is unique.

Above all, our discussions with African and Latin American officials revealed much common ground — despite the obvious differences in debt profiles. There was a common frustration with a world payments system which did not reward countries which struggled to service their external debt, and which had seen the net transfer on loan operations from North to South go into reverse. With goodwill from the creditor nations, the ldc debtors would respond positively to a package of measures which dislodged their debt overhang and limited their current debt service (an acceptable range would be 15-20% of export earnings for many ldcs). For the poorer countries with much bilateral debt, this would mean some write-offs or loan conversion into grants. The major debtors would need to have their debt burden reduced by measures which cut (or cap, or compensate for) high interest payments and which reschedule the principal over such a period as permits a domestic economic recovery programme to take root. All countries wanted to see an end to the piecemeal approaches which resulted in finance ministries being constantly preoccupied with the next round of negotiations with their creditors: development was too serious a task to permit such diversions.

5.2 Western Alternatives

From Western sources there have also been a number of alternative proposals for managing the debt crisis. The World Bank has appraised more than 50 prescriptions for solving the problems of Latin American debtors alone. The Bank of England has undertaken a similar exercise. Here we outline only a selection of proposals arising directly in the course of our enquiry.

We discussed in Washington with **Senator Bill Bradley** an illustrative programme of yearly concessions which would involve:

- a three percentage point interest rate reduction for one year;
- a three per cent write-down of principal outstanding;
- and an additional $3bn in multilateral loans.

A similar plan extending to a one-third write-off (specifically applied to Mexico's debt) has been advanced by **Congressman Schumer**. Like Senator Bradley, he is confident that the main lending banks can afford these measures. The US Federal Reserve Board has, however, riposted that losses for 24 major US banks under the Bradley proposals would exceed $12bn, entailing major damage to the banks while affording relatively little relief to the debtors. Its Chairman, Paul Volcker, has also claimed that write-offs of principal are now largely irrelevant, such is the current preoccupation in meeting interest payments. In early 1987, however, the US authorities were moving cautiously towards a recognition that some formal debt cancellation might be a desirable form of relief, in recognition of the reality that ldc debt was not worth its face value. This would, however, require a political initiative.

Lord Lever, who chaired a Commonwealth Experts' Group inquiry in 1984 proposed a package involving
- new foreign investment;
- longer-term rescheduling;
- some writing-off of commercial and government debt;
- worldwide interest rate reductions and special measures for the poorest countries.

The later **Lever-Huhne** proposals hinge on a similar set of conditions, focusing on economic expansion through a further shift in IMF conditionality towards growth promotion, $30bn of new resources for investment in production and a gradual write-down of commercial debt, with changes in the banks' regulatory structures to permit this.

The banks, of course, do not regard themselves as concessional lenders, though they are prepared to accept some discounting of their outstanding claims. They thus see scope for further **debt-equity swaps**, in which foreign debt is sold at a discount in order to realise local currency for multinational investors already interested in investing in the debtor country. Such measures have been tried with some success in Chile, Brazil, Argentina, Mexico and the Philippines. Two dangers of such an approach are that it can effectively sell off national capital stock to foreign interests cheaply, and that it may reduce net new inflows.

Debt-equity swaps are unlikely to be used much in Africa or for the poorest debtor countries. For these cases **S.G. Warburg and Co** have developed a proposal (see box) whereby African governments could avoid the costly and inefficient annual debt rescheduling negotiations by the issuing of long-dated bonds with a maturity of between 15 and 20 years. These would be marketable, offering an immediate cash repayment to the creditors, but the countries would make provision for the eventual maturity of the bond through regular payments to a sinking fund.

Box 4: Warburg Proposal for African Bank Debt

The commercial banks would agree to transform the present loans, with amortisation spread over the life of the debt, into longer (15-20 year) term debts, with the repayment entirely at the end. They would then market the new long-term securities, giving their own guarantee of the interest payments to buyers of the securities. This would lower the interest to the rate appropriate to a bank security. The capital sum would have to be guaranteed by an international agency. The amount of the loans to be transformed in this way would be decided on the basis of how much a debtor could afford to pay annually in debt servicing. On Warburg's present estimates of ability to pay and interest rates, African countries on average could cover interest plus the sinking fund. If an individual country could not service its debt on these conditions, the proposal implies that the remainder might be written off.

It is difficult to estimate even present ability to pay: actual payments may be too high (if they imply negative transfers or a severe adjustment programme) or too low (creditors may think a debtor could pay more). Even an accurate present assessment would not hold for 20 years. Without a Mexico-style clause on changes in the export price of the major commodity and a switch to fixed interest rates (both of which would increase the costs of the interest and capital guarantees) the debtors would still be liable to changes in external circumstances which could make them unable to repay, and therefore require renegotiation.

The non-government organisations are now understandably much exercised about Third World debt. **Oxfam** has focused on the direction of flows, regretting that Africa's debt payments exceed its receipts of famine aid. We recognise, however, that aid flows overall make a substantial addition to Africa's net resources; we too would like to see them grow. The Oxfam report, *For Richer for Poorer*, favours a package of rescheduling, debt cancellation and interest relief, in addition to higher concessional flows. **War on Want**, while stressing that the poor in Latin America bear a disproportionate part of the debt burden, levels its main criticisms at the Western commercial banks, which it sees as drawing profits from the misfortunes of debtor countries. Since we acknowledge that the banks must be part of the solution to the ldc debt crisis, a campaign which alienates them does not attract our support. It is noteworthy that the banks are currently resisting government/IFI exhortations to 'lend voluntarily' to debtor nations more robustly than they did a decade ago. War on Want urges closer government control over the banks, but advocates a major reduction in world interest rates, reform of the IMF and greater concessional flows, in addition to debt forgiveness, as elements in its overall prescription for recovery.

Lastly, British NGOs have also supported a proposal emerging from Europe for the sale of a proportion of the $150bn **European Community gold stocks** held by EC central banks — the proceeds to be used to help debtor countries in Africa, the Caribbean and the Pacific with a special relationship with the EC. There are some problems with this proposal. Gold sales (even in the form of coins) could be inflationary. The restriction to the ACP countries would duplicate the existing operations of the EDF but would still exclude the major debtors, mostly in Latin America, where UK, German and Iberian interests are particularly strong. The combined efforts of the European commercial and central banks could, however, be applied constructively to a fresh debt proposal at European Community level.

Yet another approach has been floated by **UNCTAD**, in its 1986 *Trade and Development Report*. It suggests that ldcs could make a new start if they were allowed, like firms, to file for bankruptcy in the manner permitted in Chapter 11 of the US Bankruptcy Reform Act. This could provide creditors with a greater proportion of their claim as payments, while allowing the debtor country a once-and-for-all reorganisation of its financial affairs.

There is also the **massive transfer of funds** approach, an idea floated in the Brandt Report and regularly revived since. Under the 'Third World Marshall Plan' idea suggested in late 1986 by **President Mitterrand**, official loans and grants equivalent to between 0.5 and 1% of the GNP of the Western industrialised countries would need to be raised (ie between $35bn and $70bn). As this is well in excess of the present oda effort of the OECD DAC donors (0.35%), while, as we saw in chapter 4 the DAC expect only a 2% annual expansion in oda compared with a projected 3% growth of donor GNP, this does not seem a realistic option for the present. Nor would it be favoured in principle by some Western governments who would see in it a 'crowding out' of the private incentive structure. More progress seems possible along the path involving multi-year rescheduling and some limited debt write-offs, with conversion of bilateral official loans into grants. Creditors are reluctant to commit themselves to write-offs because of the risk of creating a precedent, but many are prepared to recognise that in particular cases a partial debt write-off is the only sensible course, permitting both economic recovery and a stronger chance of political stability in the debtor country.

6

A Framework of Recommendations

6.1 The Necessity of Political Will

As an all-party group concerned primarily with development issues, we have taken the view that the existing procedures adopted to handle the ldc debt problem have been excessively focused on financial solutions. These have involved the imposition of austerity on nations which are already very poor. Moreover, the financial imperative has inclined policy-makers to the adoption of very short time horizons for adjustment measures, which usually fail and then have to be repeated with consequent loss of efficiency for all concerned.

The time has therefore come for **new political initiatives** and we base our case on three interrelated propositions:

- First, that in 1987, the Third World's debt problem seems no closer to resolution than it did in 1982 (when the crisis broke) or in 1984 (when the major international institutions predicted an upturn). Since 1983, in fact, developing countries' net capital transfers have turned negative. They are, moreover, now paying more interest than principal repayments. Net bank lending to most ldcs has stopped, the expected spontaneous revival of lending has not materialised, and the 'Baker Plan' and the innovations of the late-1986 Mexico deal have not altered that overall pattern. Adjustment and retrenchment have not of themselves brought a return to creditworthiness.
- Second, that so long as the debt burden cripples the performance of so many developing countries, it stifles the growth potential of the world economy — in particular world trade growth, but also the market for credit. Thus, economic and social costs are borne by us all in an apparent endeavour to satisfy some creditors' financial requirements. Senator Bradley told us how US exports to Latin America had fallen by 25% between 1981 and 1985; over the same period, the World Bank calculates Latin American and Caribbean imports from all countries have fallen by 40%. Africa — already

facing economic stagnation in 1981 — saw its import levels further decline by one-fifth to 1985. Those lost imports represent jobs and new investment in improved technology in the North. At the same time, debtor countries are obliged to expand their exports — whether of commodities (effectively depressing world prices) or of manufactures and semi-processed goods (raising further protectionist opposition in the West) — instead of investing in their own economic development.

- And third, that Third World debt is already being discounted. A secondary market for ldc sovereign debt already exists where obligations can be traded for a fraction of their face value — proof, if any is needed, that private financial institutions do not seriously expect to recover all their outstanding loans. Many donor governments have also written off oda debt for the poorer countries by converting outstanding loans into grants. In contrast, however, new multilateral facilities such as the IMF's SAF are conceived largely to enable interest payments to be maintained.

The least we could do in our recommendations, then, would be to develop a framework which takes these realities into account. This leads us to our initial recommendation: **the political will should be generated for a far more innovative approach, and since a certain amount of debt is already being written off informally, a way should be opened for making this official, thus allowing new credits to be established with improved underlying guarantees.**

6.2 Need for Government Action

During our inquiry it was put to us from several official sources that the debt problem, though requiring constant attention, remained manageable. The Baker initiative itself represented a note of confidence in the existing institutions — notably the World Bank and the IMF — and a belief that slight modifications to the traditional adjustment formula would be adequate to restore creditworthiness in due course. Even the IIF believed that adequate finance would emerge voluntarily from the commercial banks if debtor countries which had 'adjusted up' to an unsustainable standard of living in the 1970s were prepared now to retrench. The British Government's view was expressed in similar vein by the Economic Secretary to the Treasury, Mr Ian Stewart, who saw it as natural that any period of 'overborrowing' should be followed by an unravelling, with inevitable social and economic costs for the debtor nations.

Not even the largest debtors have favoured policies threatening or moving towards outright default. Most see their interest in working jointly with creditors to devise more generous schedules of debt service which will avoid damaging the solvency both of the debtors and of the banks, enabling a market for lending to resume. This is in stark contrast to the 1930s, when a number of Latin American countries defaulted first, and then sought solutions to their access to credit later. Today, we recognise that there is a strong desire for jointly workable solutions which, however, do not leave the debtors with the whole burden of adjustment.

Although the bulk of ldc debt (notably excluding that owed by low-income Africa) represents as much a banking as a debt crisis, we recognise that new government initiatives are now required to address the problem. After five years of 'crisis', incapacity to service debt is no longer a temporary problem, but an issue hampering the efficient management of the world economy. The mechanism which keeps ldc debt service just about current — IMF stabilisation programmes, a dose of involuntary lending and a requirement to generate export surpluses — has been shown to be unsustainable. **We believe therefore that once development interests (not just the interests of developing countries) are adequately taken into account, the need for public sector initiatives becomes imperative.**

We justify government action on three counts:

- interest payments are now a major part of the ldcs' debt problem (particularly as a result of the shift to variable interest rate loans): the overall level of interest rates is determined by the policies of governments, notably of the Group of Five;
- it is governments through their central banks which regulate their private banks' lending and rescheduling practices. The same governments are also ultimately responsible for the policies of the IMF and World Bank;
- while a high share of private lending to ldcs was a feature of the decade after 1973, the normal pattern is for official or officially controlled and guaranteed flows to dominate (as in Africa today). Already the relative failure of post-Baker voluntary lending indicates a need for a stronger role for publicly-backed financial flows (and also for alternatives to loans, such as direct investment and equity capital).

6.3 Focus on the Real Economy

The concentration on purely financial solutions to the ldc debt problem has led to a gross imbalance in the system of international financial management. Such an approach has required the IMF to impose conditionality on ldc debtors but not on the United States (the world's major debtor and with an enormous budget deficit), nor on member countries like West Germany and Japan in chronic balance of payments surplus. It has given Western banks the 'breathing space' to strengthen their capital bases but not the developing countries the required breathing space to restructure their economies. It has overlooked the need to sustain the momentum of development in Third World economies. Negotiators and international institutions have too lightly assumed that their task is to protect the international financial system rather than to safeguard the living conditions of people in developing countries, at a time when even the appropriate international supervisory organisation, the Bank for International Settlements, questions this narrow approach. The new emphasis on growth since the Baker initiative may seem to have partially redressed this imbalance, but it is not evident that sacrifices of ldc growth have ceased, or that development based on export expansion and domestic austerity is politically or socially sustainable.

Nor does the financial solution make sense in terms of economics. At prevailing world interest rates it involves a continuing leakage of capital from the Third World to the First. All economic logic would indicate that this is perverse. Over any reasonable time-scale, the marginal efficiency of capital will always be greater in developing countries where it is scarce than in industrial societies.

Our case for a wider focus does not simply rest on this premise, however. By forcing developing countries to carry the whole burden of adjustment, other highly important sectors of our own economy have suffered from the second-round effects of contraction. We have already referred to the loss of exports, and hence of employment, following ldc import cutbacks and declines in GDP. Furthermore, the continuing debt problem has restricted the market for direct foreign investment and this represents another area where our own economic agents are being denied their normal scope for expansion.

We thus conclude that **debt management has in the past been too preoccupied with narrow financial settlements. The interests of world economic growth, and employment in our own countries, require a much broader approach.**

6.4 Equitable Treatment and the 'Risks' of Precedent

The distribution of debt relief between developing countries is a delicate question. The arguments about international fairness in according more generous debt relief fall into three parts:

- First, that any financial concessions to heavily indebted countries would be unfair to 'prudent' borrowers, like the South Asian countries.
- Second, that the most generous terms offered to the most grievously indebted states would be taken by others as a precedent on which their own case would be negotiated. This is also an issue of equity, between borrowers who can and cannot or who try and do not try to repay.
- Third, that sovereign debt is contracted by governments but is used and consumed by particular interest groups who may not be the most deserving.

Our riposte is, first, that there is a legitimate world interest in restoring sustained growth in major parts of Latin America and Africa; this can only be to the benefit of the world economy as a whole. In any case, those countries which have maintained a prudent record of creditworthiness would not lose it just because other countries' credit ratings are restored, say, through partial write-offs. Donor governments have the capacity to increase public concessional flows to South Asia if they wish — though the IDA cutbacks indicate that their main preoccupations are elsewhere.

Second, the issue of establishing precedents in debt negotiations is not new. Other debtors would like to adopt features of the 1986 Mexico deal — compensatory facilities linked to an export commodity price or to growth rates, extended rescheduling periods, etc — and may in time succeed in establishing these as a precedent. Providing generalised debt relief would still require a procedure whereby debtors' sustained capacity to pay is studied on a case-by-case basis. The issue of precedent arises hardly more than under the existing Paris Club rules, where the conventional wisdom is that debtors (as well as creditors) must be ensured equality of treatment. The ultimate restraint on 'good debtors' demanding the same concessions as 'the profligate' will remain the fear of losing creditworthiness. Sensible management of case-by-case treatment of debtors would remain the safeguard against unwelcome precedents.

Lastly, debt relief is too blunt an instrument with which to address the problem of income inequality within developing countries. Experience has demonstrated that not having a generous debt settlement leads to more domestic inequality than having one. Many studies, notably those sponsored and conducted by UNICEF, have shown that the poor bear an unfair share of the burden of adjustment.

They should accordingly benefit disproportionately from the relief. Safeguards as to the distributional consequences of government policies could be made a condition of debt relief. They have yet to become a feature of IMF adjustment packages; the position of the poor need be no worse therefore, and could be potentially better, than under the present ad hoc debt management procedures where growth of the whole economy is forgone.

We conclude, therefore that **measures to resolve the debt problem which are based more firmly on the expansion of developing countries and on a revival of demand in the world economy would represent an advance on excessively narrow financial measures.**

6.5 Specific Proposals

We start by acknowledging that not all developing countries need

Box 5: Debt-Development Swaps

A country whose commercial debt is already heavily discounted can negotiate with a donor agency to swap debt relief for an agreed development programme. An example would be Bolivia, whose outstanding debt of $2.5 bn (of which $800m. is owed to commercial banks) is trading on the London secondary market at about 8% of its nominal value. The banks holding that debt (who have already made provision for substantial losses) could be persuaded to sell the $800m. debt for around $80m. (ie already at a premium to the market rate), if there were a willing government purchaser. A donor government (or several) which already wanted to spend $80m. on an aid programme inside Bolivia could thus purchase the debt at a deep discount, while to implement the domestic aid spending (in this case, a drug eradication programme) the Bolivian Government would simply have to raise $80m. worth of local currency through taxation or other means. The commercial creditors receive hard currency in redemption of the debts they hold, at or above the market rate; the donor governments have to raise no new money to fund the development programme, since this was planned in advance; the debtor government is relieved of its bank debt obligation and so saves foreign exchange on amortisation; its only obligation is to raise real resources locally and adjust according to a programme agreed with creditor governments. In other circumstances, part or all of a country's commercial debt could be bought back in this way. An agreed poverty alleviation programme could be the target of the counterpart spending. Innovations of this sort are necessary to address particular countries' debt problems. *(Further details in Colin Moynihan's adjournment debate, House of Commons Debates, 18 December 1986.)*

special debt relief measures. The poorest countries in Africa are in such a difficult plight that we would work towards a **writing-down of most of their external debt**, which in any case is mainly owed to governments and institutions rather than banks. Elsewhere in the developing world, where the restoration of lending for trade credit and of investment flows is crucial to economic recovery, and where debts are mainly owed to commercial banks, relief measures should involve a package of much **longer-term rescheduling of principal, together with interest-rate capping** to reduce the total service payments to manageable proportions.

Advantage should be taken of the fact that in many cases bank debt is already heavily discounted in these countries and is sometimes traded at rates of a fraction of its face value. Making debt relief (on principal) official would in these circumstances simply amount to regularising the debtor's status. One such solution is outlined in the box **Debt-Development Swaps**, an imaginative variant on the debt-equity swaps suggestion in chapter 5. In Table 6.1 we estimate the approximate 'cost', in terms of nominally forgone creditor revenue, of a **general government-led debt relief initiative**. If ultimately it revives growth in the world economy, it will not have been a real 'cost' at all.

The $29bn shown in the table would represent the maximum amount of debt service payable annually by developing countries, a reduction of about two-thirds from their present burden of $87bn. Not only would this return their net transfer on loan transactions into surplus; the total debt service on long- and medium-term loans would be less than their annual aid receipts ($30 bn from the OECD countries, or a total of $36 bn from all sources). Most developing countries would then be well primed for recovery, with the most disadvantaged having been accorded the highest level of relief.

We justify these debt relief measures as follows. We take first the case of **the poorest countries**, which could be defined as all countries eligible for IDA credits. A bilateral precedent for debt write-offs already exists for this group with the Retrospective Terms Adjustment, a procedure started in 1978, with the UK in the lead, by which oda loans were converted into grants, ie the loan element was 'adjusted', relieved or ultimately written off (see Table 6.2). Only $6bn of debt relief has been accorded in this way, however, and major donors like the United States and Japan have barely begun to convert their official loans to grants: Much more could be encouraged by the force of example. Relief could also be extended on the same principle to official loans other than aid; the World Bank already recognises that

Table 6.1 Debt relief measures: illustrative costing ($ bn))

Present ldc debt repayments	Principal	43
	Interest	44
	Total	87
Stage I.	Relief of poorest African countries interest ($1bn) and principal ($1bn)	2
Stage II.	Roll over remainder of principal outstanding —reschedule over 20 years +	42
Stage III.	Reduce $43 bn interest payments by one-third	14
Remains for debt service: interest of		29

(Figures based on 1985 flows in World Bank, *World Debt Tables 1986/87*)

at least a dozen of the poorest countries will never be able to service their debts.

Whether the international financial institutions should concede their status as preferred creditors by also converting their loans (even IDA soft credits) into grants is a contentious problem. We recognise this could undermine their capacity to raise future capital for market-rate lending, but it need not affect the facilities which are totally funded by governments. Where World Bank/IMF/regional development bank loans are a substantial part of a country's debt problem, it makes little sense to exclude them from debt relief measures, unless new credits from those same institutions were to be sufficiently increased effectively to refinance the debt. Much larger flows will be required to fund this; the projected DAC increase of 2% per annum to 1990 would be quite inadequate.

Given that new lending to problem debtors currently tends to be policy- rather than project-based, we would favour an audit of the stock of individual project loans in the case of the World Bank/IDA. Where poor funding and implementation decisions are identified under the audit procedure, then the IFI in question should offer debt relief. Where the loan generates an adequate return, no relief may be necessary.

Table 6.2 Nominal value of RTA measures taken with respect to oda debt ($m)

DAC members	*Total*	*Nature of measures taken*			
		Debt cancellation	*Waiving of interest payments*	*Refinancing/ rescheduling*	*Conversion to local cost aid or local currency payments*
Australia	0.2	0.2	—	—	—
Austria	5.7	4.4	1.3	—	—
Belgium	15.1	—	2.2	12.9	—
Canada	220.5	188.1	30.0	2.4	—
Denmark	94.5	94.5	—	—	—
Finland	70.3	70.3	—	—	—
France	125.1	100.2	—	—	
Germany, Fed. Republic of	2,072.6	1,772.6	300.0	—	—
Italy	71.4	71.4a	—	—	—
Japan	147.3	56.3a	91.0	—	—
Netherlands	349.3	159.0	190.3	—	—
New Zealand	3.5	3.5	—	—	—
Sweden	285.4	247.3	38.1	—	—
Switzerland	69.2	69.2	—	—	—
UK	1,941.5	692.2	52.2	—	1,196.8
USA	691.0	—	—	—	691.0
Total DAC	6,162.6	3,529.2	730.3	15.3	1,887.8

Note: (a) including interest payments

Source: Unctad TD/B (XXX) CRP.3, 25 March 1985.

Inevitably, governments and IFIs which offer debt relief on their public loans will expect to exercise more leverage over the policies adopted and applied in the debtor country. It is a fact of life that debtor countries wishing to start afresh with greater dependence on concessional finance during the recovery stage will have to accept more external guidance and supervision over their financial and economic decisions. Donor governments which engage in debt-development swaps will also find themselves in a position where their advice on domestic policies will be more closely heeded.

For the **major ldc debtors**, a three-pronged solution seems necessary. Principal repayments, largely owed to commercial banks, have to be reduced substantially through **rescheduling, debt-equity swaps** or other means. Interest payments should be maintained but not in excess of the rates which the lenders themselves expected: so **interest-rate relief** makes economic as well as political sense. And thirdly, the catalytic power of IFI lending has to be enhanced through **greater World Bank/RDB funding and a more rapid restoration of government-guaranteed export credits.**

Twenty-year rescheduling on a sinking fund basis, as outlined in chapter 5, could also apply to the major debtors; negotiations on bank debt have already moved towards multi-year rescheduling programmes with built-in policy adjustment measures in the medium term. An alternative discount procedure would be the debt-development swaps outlined above. Of course, the rates of discount vary greatly — at end 1986 Bolivian debt could be bought for 8% of face value, but Philippine debt stood at 75% — and might be very different for large purchases rather than the present marginal trading. The scope for this proposal is limited by other factors, notably the volume of current demand for investment in some debtors: it is not suggested that Brazil could find foreign government purchasers for all its stock of debt ($105bn) discounted at 75% to $80bn. Such sums are much too large, but a limited amount of debt-development swaps, together with the more conventional debt-equity swaps which could be attractive to new private investors, foreign or domestic, should help to reduce the principal outstanding. Even a measure involving no formal writing-down of principal, such as the introduction of a five-year grace period on repayments of existing loans, followed by an assessment of the debtor's position, would give a much needed breathing space.

As for interest payments, various ways of 'capping' the interest rate have been suggested. Instead of unilateral disruptive action on the part of the debtors, we see the attraction of a co-ordinated international policy of reducing interest through a **centralised interest equalisation fund**. Such a scheme has been attributed to the German banker, Alfred Herrenhausen. A central fund, possibly to be administered by the IMF on similar terms to the Compensatory Financing Facility for merchandise trade, would be established with government, IFI, and private bank contributions, to compensate lenders for interest rate payments in excess of an agreed norm of, say, 6% on dollar loans. Developing countries would be spared the obligation of paying interest at beyond its long-term market cost, but would be obliged to repay the fund when interest rates fall again. Exception could be made for the poorest countries. Commercial banks would need such international supervision and guarantees if they were to be re-allocating funds set aside as provision against non-payment into a compensation scheme.

The third leg of an enduring solution to the ldc debt problem would use the available surplus of a major creditor nation to establish a new **international debt facility** which could buy up sovereign debt at its secondary-market value and assist in new development financing. The obvious source of such a surplus is Japan, whose currency has become so strong on account of its trade position, similar to that of the United States after World War II: an economy in search of new markets and benefitting from world economic growth with stability. As with the US, a Marshall Plan-type response, initially involving public generosity, could be used to redound to the benefit of the world economy, by creating new non-inflationary demand. Japan has shown with its voluntary additional contribution to the IDA-8 replenishment that it might be willing to fund a major debt relief effort, possibly with the involvement of the World Bank. One variant on this would be to establish an international 'Solidarity Bank' to lend on softer terms as well as retiring old debt.

6.6 Conclusions

All our proposals demand a generous response on the part of the creditors. All demand the involvement of governments, sometimes with some direct commitment to additional funding and guarantees but mainly as intermediaries. What is required is a politically-initiated formal debt relief arrangement among debtors, creditors and governments which grants the debtors a major breathing space and brings an end to the uncertainty which inhibits new investment. To achieve this requires burden-sharing among the three parties. Obviously, a counterpart to any such arrangement would be increased external influence over ldc economic policies in future. Even under a growth programme, however, it is important that the interests of the poorest sections of the population are protected as general policy conditions are applied, with funding drawn from the local currency counterpart to the debts written-off.

Inevitably there is a connection between rolling over or writing down the stock of debt arising from past decisions and securing larger and more stable flows of finance in future. Certain creditors — notably the IFIs — stress this. But the alternative of allowing the debt problem to drag on is in no one's interest. Not only do our own economies lose output and employment, but also the ever-present threat of a major default threatens the security of the financial system in which our country has a major stake. With leadership from government, we believe that the banks, which frankly admit to the existence of a secondary market for ldc debt already, would be willing to offer realistic and lasting solutions. This would improve stability in the world market for credit and allow those developing countries which can attract direct and portfolio investment to benefit from a recovery of confidence, which in turn would stimulate local finance and savings.

The Third World debt problem is complex and far from homogeneous; the problems of Sudan are very different from those of Brazil, and so the solutions to be applied must also differ. We have outlined a framework of multiple solutions, applicable still to a case-by-case treatment of individual debtors. Its common features are:

a) a greater involvement of creditor governments in initiating debt relief and adjusting their regulations to enable banks to respond;
b) recognition that readiness to write off at least a portion of the principal outstanding would not only give debtor nations a breathing space to restore their domestic savings and investment but would also reflect the view of the markets, which have already discounted many Third World debts; and
c) co-ordinated action by the creditor nations, possibly using surplus funds, to reduce the burden of current debt service by returning interest rates to the sort of real levels originally expected by the lenders.

What has been our UK response? Apart from according generous aid-debt relief to the poorest countries, the Government have not launched any innovations. Treasury caution has determined the agenda at the expense of our interests in developing countries. The Government have preferred a reactive response, closely attuned to the US position. We note, however, that the US itself is now showing a greater sense of urgency. Our banks show realism about the problem, but are awaiting a signal from government. The UK places great trust in the IMF and the World Bank. These are excellent and valuable institutions. But their close involvement in lending and policy prescriptions in ldcs over the past five years means they are also part of the problem. They must be part of the solution, but the political will to innovate must start elsewhere.

The issue must be treated at the level of governments. All interested parties, debtors as well as creditors, developed and developing countries, must be heard. All the issues, economic and social as well as financial, must be covered. That is why we believe the United Nations to be the most appropriate forum. **We propose therefore that the UK Government now take the debt issue to the United Nations General Assembly**. We believe that support should be urgently sought for the spirit of our recommendations from the Commonwealth, our European partners, the United States and Japan. Governments could then take a stronger consensus view to the annual meeting of the World Bank/IMF in September.

Part II

7

Case Studies

7.1 Mexico

In August 1982, Mexico announced that it would not be able to service its debts normally, and requested that its principal payments on public-sector loans held by commercial banks be stopped for three months, a period later extended.

A rescue package was hammered out that was to become something of a blueprint for many developing countries as the debt crisis escalated. It took its basic shape from procedures long used at the Paris Club, but added two new twists: bank advisory committees and two-edged conditionality from the IMF. Thirteen banks — seven from the US and six from the other major lending countries — would co-ordinate the more than 500 banks that had lent to Mexico and negotiate a medium-term rescheduling of its public debt. And for the first time the IMF stated that it would not sign a Standby Agreement (SBA) with Mexico until the banks had contributed enough fresh support to make a Fund programme workable.

In the emergency days of 1982 Mexico was reluctant to take unilateral positions that could have made it an international pariah. Its representatives took care to act responsibly, to contact creditors beforehand and to confine bargaining to technical points — spreads, maturity and grace periods — thereby implicitly accepting the negotiating framework patched together that August weekend. In practical terms, Mexico negotiated a rescheduling agreement, an IMF SBA and two 'new money' deals in 1983 and 1984. The banks agreed to reschedule about $23 bn in principal payments on public-sector loans falling due between August 1982 and the end of 1984; Mexico continued to meet interest payments. The agreement simply postponed the problem by not addressing severe 'bunching' of payments in 1985 and 1987. The SBA, which required the public-sector deficit to be cut from 18% of GDP in 1982 to 3.5% in 1985 and the current account deficit from $13 bn in 1981 to $3.5 bn in 1983, paved the way for $8 bn in fresh loans from commercial banks to cover expected current account deficits in 1983 and 1984.

The recovery programme appeared to work well. The trade balance moved from a deficit of 6.9% of GDP in 1981 to a surplus of about 5.8% in 1984 and 1985. The public sector deficit was halved. In 1983 and 1984, Mexico's GDP shrank, but growth recovered in 1985. The main casualty was investment, which fell despite a high savings rate, as domestic resources were transferred abroad to service the debt.

Mexico's progress earned it a good reputation amongst its international creditors; *Euromoney* named Mexico's Silva Herzog 'Finance Minister of the Year'. Trying to capitalise on the strength of its recovery, its reputation, and its importance to the US and also to guard its creditworthiness, Mexico has shied away from the more radical Cartagena proposals at critical moments. For instance, in mid-1984 Argentina sought support from other debtors for a debt-service freeze. The Mexican Goverment felt that the worst was probably behind it and that too close an association with a radical debtor would damage its creditworthiness and/or hurt future rescheduling negotiations. Mexico joined other Latin American debtors in a bridging loan to help Argentina pay its interest arrears, and to dissuade it from taking more drastic unilateral action.

In 1985, Mexico negotiated its second rescheduling agreement, again sticking to the rules of the game and bargaining hard over technical points. Its $48 bn public-sector debt falling due between 1985 and 1990 was restructured over 14 years on a schedule designed to avoid bunching. The principal payments were to be about $2 bn a year, giving time to restore Mexican creditworthiness and to obtain voluntary loans from international markets. In this second round, Mexico bargained successfully for the first multi-year rescheduling agreement (MYRA), which linked finance needs to medium-term projections of the current and capital accounts and debt growth. The IMF and other creditors came to see debt management as integrated macroeconomic planning and set aside the 'short-leash' approach that had traditionally focussed on annual current account results and finance requirements; Mexico in turn agreed to more frequent IMF monitoring.

Mexico continued to service its debts, thereby ensuring that the banks were not forced to take losses on non-performing loans, but at the expense of investment that could have improved future current account performance and debt-servicing capacity. Mexico's debt has continued to increase and its debt-to-export ratio, a measure of creditworthiness, to erode.

The MYRA was a technical advance towards a solution, but one that was later swamped by changing external trends. In theory, the longer-term MYRA framework lessens the pressure for new money when it is not appropriate or available, thereby decreasing uncertainty with lenders and investors. A MYRA can also decrease the interest burden if new margins are negotiated. In Mexico's case, the fall in oil prices in early 1986, which caused a loss of about $8bn in foreign-exchange earnings, dramatically increased the need for external finance, scuttling the 1985 MYRA.

In February 1986, the Government decided that the international financial community would have to share the cost of the new adjustments; Silva Herzog delivered the message. The economy would have to be isolated somewhat from further unexpected international economic trends, the IMF and other creditors should monitor Mexico's adjustment efforts with an operational, rather than financial, measure of the public sector deficit and sufficient new money would have to be brought in to restore modest growth.

The Government toughened its negotiating stance. Officials began to talk of interest capping if an agreement could not be reached, a clear departure from earlier 'good behaviour'. Silva Herzog, the man most closely identified with Mexico's responsible reputation, was replaced by Gustavo Petricioli, a move widely interpreted as an attempt to bolster the credibility of the interest-capping threat. Mexico took a more active role in the Cartagena process, pushing with Venezuela for a monitoring committee to assess the effects of the collapse of oil prices on debt-servicing and establishing the principle that the Consensus would support individual policy actions.

In August, Mexico agreed in principle to a new SBA with the IMF which explicitly incorporated all of its demands, and fundamentally changed the 'blueprint' first put together in 1982. Moreover, Mexico's new demands were not confined to technical points, but comprised a new sharing of the costs of adjustment. The agreement included $12 bn in new money to meet the likely current account deficits in 1986 and 1987, of which $6 bn was expected to come from commercial banks, an increase in their exposure to Mexico of 13%. It also included Mexico's third debt rescheduling since 1982 on principal payments of public-sector debt worth $52.8 bn.

The main new feature was the linkage of the amount of total lending to the price of oil and to GDP growth. If the oil price falls below $9 per barrel, Mexico will receive additional new loans; if the oil price rises above $14 per barrel, it will receive less. If Mexico's economy does not begin to grow by 2-3% in 1987 and 3-4% in 1988, it will again receive more funds. The contingency funds together would provide $2.4bn. The deal signed in September had not been implemented by February 1987, as only 60% of the more than 500 banks had agreed to put up the money. Those banks accounted for 95% of the expected $6 bn, but all banks must sign before the money can be disbursed.

As before, the success of the package hinges on hard-to-predict external trends, which makes it precarious in the absence of measures to improve debt-servicing capacity fundamentally. If the package survives long enough to allow a restoration of growth and investment, then Mexico's debt-servicing ability could improve, the first step towards a solution. The new package could also falter if the promised funds are not disbursed, either because the committed banks cannot persuade the others to join the agreement, or because Mexico cannot live up to all the cross-conditions in its contracts with the World Bank, IMF, IDB, USAID and the banks. Also, some of the multilateral loans are contingent upon new legislation, which can defy deadlines.

Mexico's tough bargaining position has followed close on the heels of its worsening financial situation, a trend repeated in other countries. If the deal breaks down in 1987 or 1988 and external trends have not improved, the Mexican Government is likely to take an even tougher line with its creditors, again arguing that the international financial system must take a bigger share of the costs of the imprudent lending of the 1970s.

7.2 Brazil

After the first oil shock, Brazil pursued a policy of long-run structural adjustment financed by external borrowing, investing in its export capacity and infrastructure. Three unfavourable circumstances threatened that adjustment policy after 1979. First, the trade balance deteriorated sharply following the second oil shock and because of rising imports. Second, recession slowed world trade growth, and with it Brazilian exports. Third, interest payments rose from $700m. in 1974 to $4.2 bn in 1979 as both interest rates and the amount of debt increased.

In late 1980, the Government curtailed demand to curb the trade deficit, to reassure its bankers, and to control public-sector borrowing enough to finish priority projects that would then generate foreign exchange. It did not go to the IMF, although its package was fairly orthodox, for fear of a loss of domestic political control and that the long-run adjustment strategy would be challenged. Bankers kept lending, but on more costly terms.

By 1982, the trends that had prompted the 1980 stabilisation attempt had worsened. Although imports were falling, exports fell more and interest payments increased to $11.4 bn. After the Mexican moratorium in August, bankers were not prepared to lend enough voluntarily to bridge Brazil's $16.3 bn current account deficit. The military Government argued that since the IMF did not have enough money to help Brazil on its own, Brazil should not submit to Fund conditionality; at the same time, it prepared its first mission to the Fund for just after the November elections. In the meantime, emergency funding of $6.5 bn was obtained from the US, plus $500m. from the BIS.

After the elections Brazil agreed with the IMF to a stabilisation package that included $4.4 bn in new funding from the banks, rescheduling of medium- and long-term repayments due in 1983 worth $4.4 bn, and roll-over of $15.7 bn of short-term debt.

In January 1983 the Government submitted the first of seven Letters of Intent to the IMF asking for money under the extended facility and promising to reduce the economy's domestic and external imbalances. The IMF proposed its standard package including decreases in public investment, mini-devaluations, a change in relative prices to increase exports, and limits on domestic credit expansion. Although the Fund considered these measures a structural adjustment package, the Brazilians deemed them excessively deflationary and damaging to the long-run structural adjustment programme they had followed since the mid-1970s. In particular, they argued that exports were falling because of international recession, not wrong domestic prices. Also that inflation would not be cured by demand deflation and credit restraint because of thorough indexation of the economy, especially given the Fund's mini-devaluations. Finally, the IMF had difficulties adapting its usual borrowing requirements to Brazil's public financial sector. Each of these factors contributed to the on-going negotiations over successive Letters of Intent.

Brazil's financing needs eased considerably in 1983 and 1984. Exports started to grow slowly in 1983, with the US recovery, and increased dramatically in 1984. The current account deficit shrank to about $7 bn in 1983 and showed a slight surplus in 1984; growth revived in 1984.

In 1984, Brazil entered its second round of negotiations with its bank advisory committee, the Paris Club and the multilateral agencies. The package agreed included $6.5 bn in new money from about 800 private banks rescheduling of about $5 bn of medium- and long-term loans, and roll-over of the $15 bn of short-term finance.

Throughout this second round of negotiations, Brazil played by the rules, fearing, like Mexico, that unilateral action could damage the international financial system and make it an outcast. Within the Cartagena Consensus, Brazil also guarded its creditworthiness and tried to capitalise on its native bargaining advantages — the size of its debt and its trade surplus. It therefore joined Mexico and others in nudging Argentina away from unilateral default. Nevertheless, the Brazilian Government did not live up to the letter, and in some cases, the substance of its agreements. By continually missing deadlines but signing new letters of intent, it kept the game in motion and safeguarded its political autonomy.

In March 1985, the civilian Government of President Jose Sarney, the first in 21 years, came to power and washed its hands of the IMF. It proceeded to generate an estimated $13 bn trade surplus, which allowed it to service the $104 bn debt without external finance and the economy to grow an estimated 8.2%. Since new money was not needed because of the exceptionally strong export performance, the Government had more freedom to make independent choices without risking behaviour unacceptable to the international financial community, and it took a more active role within the Cartagena Consensus.

With the IMF on the sidelines, the Sarney Government launched its own adjustment programme, the Cruzado Plan, in February 1986. This froze prices and created a new fixed-rate currency, the cruzado. Inflation fell from about 300-400% per year to about 2-3% a month. Wages were allowed to rise by 8% to sweeten the plan and workers were promised that when accumulated monthly inflation reached 20%, wages would automatically increase by the same amount. Real wages rose sharply. The plan unleashed a consumer spending and stock market boom, as well as shortages. Savings and investment, both domestic and foreign, suffered.

In March 1986, a restructuring of $30 bn of medium- and long-term debt was negotiated, without an IMF agreement in place. The deal only became effective in September, however. The Government's refusal to take responsibility for three banks that failed in 1985, with foreign debts of $450m., was cited as the main impediment. The agreement rescheduled $6 bn of debt due in 1985 over seven years and rolled over $8 bn due in 1986 and $15.5 bn in short-term credits until March 1987. The deal included no fresh loans.

In June, Finance Minister Dilson Funaro announced that Brazil would try to limit its debt-service payments to 2.5% of GDP in 1987 and to 2% in 1988, compared to 4.6% in 1986 and 5.1% in 1985, an argument the Government had already pursued within the Cartagena Consensus. The announcement was seen as an attempt to obtain new money to finance debt payments above 2.5%, rather than as a unilateral default.

On 21 January 1987, the Paris Club agreed to reschedule $4 bn of debt due in 1985 and 1986, again without an IMF agreement in place. The agreement breaks new ground as creditor governments demanded only continuation of the greater information contacts with the IMF established in 1986. The deal involved brinkmanship, however; Brazil threatened to break off the talks, the first step towards a moratorium, if the Paris Club insisted on IMF involvement. The Government was also negotiating with the commercial banks for new money to service its debts. In December 1986 the private sector creditors agreed to roll over interest and principal on $67 bn of debt as a precursor to the bank negotiations.

By early 1987, only weeks after the November elections, won on the popularity of President Sarney and the Cruzado Plan, the plan was in trouble. Interest rates had hit record high levels. The Government had lifted the price freeze on industry for a limited period, which triggered a 20% pay increase for 6 million workers. Inflation had returned to an annual rate of 200%.

The trade surplus that permitted Brazil's independent strategy deteriorated sharply at the end of 1986, falling from a projected $12.5 bn to an estimated $9 bn; in the fourth quarter of the year, it was only $497m. The trade accounts have suffered in a year when external trends — lower interest rates, and lower dollar and oil prices — should have greatly benefitted Brazil. Foreign exchange reserves have shrunk by $3 bn. Growth was estimated at about 8%, a good performance even by the standards of Brazil's 'miracle economy', but down from the expected rate of 11%.

Brazil had capitalised on its bargaining strengths — the size of its debt and its trade surplus — and won historic concessions from its creditors, as measured against the negotiating 'blue print' first agreed on in 1982. But the Brazilian case illustrates again how fast favoured debtors can fall from grace. At the end of February 1987, Brazil announced it would suspend interest payments indefinitely on its $68bn medium- and long-term bank debt. If no interest is received after three months there will be severe repercussions on the most seriously exposed US and UK banks. These are Citicorp (owed $4.6 bn), Chase Manhattan ($2.8 bn), Bank of America ($2.7 bn) and Manufacturers Hanover ($2.2 bn). Lloyds and Midland each have $2 bn of loans outstanding, Barclays $700m.

This is the strongest movement towards default in the whole story. Brazil's Finance Minister explained his frustration after years of accepting short-term rescue packages by recalling that the country had paid $44 bn in debt service over the previous four years in return for only $11 bn of new loans. Saddled with debts now totalling $105 bn, Brazil now wants a long-term solution and believes it must be found in the actions of governments rather than the defensive reactions of the banks.

7.3 Other Unilateral Actions

Peru's President Garcia announced in his inauguration speech in July 1985 that debt-service payments would be limited to 10% of exports, the first major public debt-service cap by a debtor, but an improvement on what the country had been paying. The cap was later extended to private-sector debt and the profits and royalties of foreign companies. In August 1986 the IMF declared Peru ineligible for new loans. It continues to receive trade credits, largely from European banks, and the World Bank and IDB have disbursed previously agreed loans; no new loans are likely from any official source. Negotiations were sought with commercial bankers in September 1986 on rescheduling $6 bn of the $14 bn debt, but an agreement is unlikely without an IMF package, which President Garcia continues to resist. An estimated growth rate of 8.5% was achieved in 1986, more than any other country in Latin America except perhaps Brazil, and 6% is expected in 1987.

Bolivia halted interest payments to creditor banks in 1984 and in late 1986 was over $200m. in arrears. In 1986, the Government entered into negotiations with the Paris Club to reschedule about half its external debt, after a dramatic domestic adjustment programme, but announced in January 1987 that it would ask creditor governments to write off their loans, or else buy them back using aid.

Costa Rica quietly stopped servicing its debt in the autumn of 1986 when its creditors refused to reschedule $1.4 bn over 25 years at below-market rates. It argued that it should never pay more than 1.5% of its GDP in debt service and that interest charges should be fixed at 4% until 1988, rising in stages to 6% by 1993. To service the external debt in full would, the Government felt, jeopardise the social programmes that are the foundations of its democracy.

African countries have also taken unilateral action, often quietly by letting arrears pile up, but occasionally by publicly limiting debt-servicing. **Sudan**, like Peru, was declared ineligible for further IMF loans in February 1986 because of long-standing interest arrears on its IMF borrowing. The country owes an estimated $13 bn and is still suffering the after-effects of famine and civil war. The Government has discussed requesting writedowns and limiting debt service. Loans from other nations, principally those of the Middle East, are continuing but there are no multilateral or commercial loans.

The **Nigerian Government** announced in January 1986 that it would pay no more than 30% of its export earnings to service its debts. In March, it requested a 90-day moratorium on principal repayments on medium- and long-term debt, following the collapse of oil prices. The Government continues to limit debt-servicing to 30% of exports, but has negotiated rescheduling agreements with bank and government creditors on much of its $22 bn debt. It has agreed to policies supported by the IMF, including a controversial exchange-rate auction, in order to reschedule about $4 bn. For domestic political reasons, however, it is reluctant to draw on the IMF loan.

Zaire, which had earlier followed a more or less orthodox path under IMF supervision, also decided in late 1986 to adopt a Peruvian-style 10% cap on debt-service payments, stop the floating of its currency and thus break its IMF agreement. Zaire's external payment difficulties are, however, so long-standing that it now gets more debt relief on previously rescheduled debt than on original maturities. Debt outstanding is now $5.6 bn, compared with $2.9 bn in 1975.

7.4 Low-income African Countries

The total stock of debt of sub-Saharan Africa (42 countries) in 1985 is estimated by the World Bank to be $85.6 bn, of which $65 bn is public or publicly guaranteed. Many observers think these figures are greatly underestimated, but even on a high estimate of $138 bn (including short-term debt), Africa's external debt obligations are less than one-third of those of Latin America. The twenty-five low-income (IDA-eligible) countries in Africa of particular interest to the Working Party had total debts of $45 bn at the end of 1984, of which $28 bn was long-term. The stock of debt was, however, a considerable burden, representing on average 74% of GNP and 349% of annual exports, in both cases higher than for developing countries as a whole.

Together with IMF obligations, this stock required outward debt service equivalent to 35% of exports. For some countries, the burden was impossibly high: 146% of exports in the case of Somalia (1984) and 96.4% for Sudan, projected to rise to 151% for 1986-7. A series of short-term reschedulings and the build-up of arrears have reduced the *actual* debt-service ratio to about 22%. However, in the absence of economic growth, even this figure represents a significant loss, with imports at the end of 1985 already well below their 1980 levels. Several countries, like Sudan, effectively defaulted long ago.

So African debt — especially that of the low-income countries — has a number of features which we believe require special treatment:

- Not only are official creditors dominant, but often over 50% of long-term debt is owed to the IMF and the World Bank alone. World Bank IDA credits are of course made on soft terms, but they cannot at present be rescheduled. IMF drawings (which no longer include extended facilities in Africa) are neither reschedulable nor cheap: 7.4% interest on stand-by loans for 1985 (variable at six-monthly intervals), and usually repayable within 5-7 years.
- Thus African debtors have less flexibility than their Latin American counterparts. By 1985, they were suffering not only a virtual suspension of new bank lending, but also a collapse of IMF net flows (from over $1 bn in 1981-3 to $118m. in 1985), with several countries in arrears. As a result, governments often have to raise private bank loans at high rates of interest to pay off the IMF arrears in order to start new reform programmes and gain access to fresh development finance. Similarly, though less seriously, the World Bank's financial contribution to development programmes is considerably diminished by unreschedulable servicing obligations.
- However, even the Paris Club public debt reschedulings which have occurred have been far from the ideal solution. Short-term reschedulings which have to be repeated year after year (65 by 18 countries up to 1986), or which collapse as a result of the tying to IMF performance criteria, indicate a need for a new approach if fresh 'bunching' is not to occur in the late 1980s.
- Many African governments, including those faced in 1984/5 with famine, have responded to international pressures to embark on reforms even in politically sensitive areas of economic management

such as privatisation, the introduction of incentive schemes, devaluation and the abolition of subsidies. They have done more than simply pursue policies of budgetary restraint, though this has also been necessary. Already most African exchange rates have moved to more realistic levels and producer prices to farmers have been raised to stimulate export crops and domestic food output (to the extent that many countries are now having to manage food surpluses). In return, however, Africa has not enjoyed the promised upturn in prices and world demand for the commodities on which it remains dependent. Nor have tighter fiscal and monetary policies ushered in the return of voluntary bank lending and foreign investment.

Even with such reforms in place, the World Bank calculates that African countries will still experience a $2.5 bn annual resource gap over the period 1986-90 if import levels are to be returned simply to 1980-82 levels but assuming no debt write-offs. New finance on the scale of the IMF Trust Fund and the 40% of the IDA -8 replenishment promised will assist, but will make little impression while the stock of outstanding debt remains rescheduled only on a 'short-leash' basis. Indeed, the World Bank's own general rule that 'no donor country should be a net recipient of resource flows from an African country which is undertaking credible reform programs'* is already close to being violated, and the quick-disbursing aid that was intended to provide import support is all too often being used simply to pay the interest of official creditors. New flows on concessional terms have not been adequate to fill the financing gap (itself hardly calculated to restore rapid economic growth: the World Bank's economic scenarios for Africa are all bleak, even the optimistic projections).

It is too easily assumed that all Africa's problems, including debt, stem from domestic mismanagement. This belies the reality of nearly every country on the continent facing severe debt-servicing difficulties. Resistance to IMF programmes as a prerequisite for debt rescheduling was not the sole preserve of Tanzania: important debtors such as Zaire and Nigeria have done likewise, to the extent of adopting ceilings for their debt-service ratios (see 7.3). Moreover, because so much of the debt is owed to governments and official bodies, government action — on trade and commodity policy as well as on finance — is an essential part of the solution.

* *Financing Adjustment with Growth in sub-Saharan Africa 1986-90*, World Bank, 1986, p.42.

Government innovatory interventions are particularly necessary for the poorer countries. Clearly new funds from the commercial banks are not likely at present, so national creditworthiness is unlikely to suffer significantly from official debt write-offs. In many cases — Sudan being the most extreme — there is some frank admission that the debt outstanding can never be paid off, and that continued attempts to service it are undermining recovery. Solutions to the low-income countries' problems will necessarily differ from those of stronger debtors such as Nigeria and Ivory Coast. To that extent, we endorse the case-by-case approach which the main creditors have adopted.

But some problems are continent-wide, and do not discriminate in favour of oil producers or wealthier countries. African governments are already implementing the programme of action for economic recovery agreed for 1986-90 in the UN General Assembly. Failure to respond to their financial needs now would put the reform process in jeopardy.

Appendix

List of Persons Consulted

London

(i) *Main sessions April — December 1986*

Ian Stewart MP
Economic Secretary to the Treasury

Chris Patten MP
Minister for Overseas Development

Peter Mountfield
H.M. Treasury

Harry Walsh
H.M. Treasury

Christopher Johnson
Economic Adviser, Lloyds Bank

Dr Stephany Griffith-Jones
Fellow of the Institute of Development Studies, Sussex

Dr Vincent Cable
Special Adviser, Economic Affairs Division, Commonwealth Secretariat

H.E. Dr Jorge Eduardo Navarrete
Ambassador Extraordinary and Plenipotentiary of Mexico

George Galloway
General Secretary, War on Want

John Denham
War on Want

(ii) *Symposium with Latin American Participants in Dr Griffith-Jones's 'Debt Crisis Management' Project, 26 November 1986*

Luis Foncerrada
Ministry of Finance, Mexico

Dr René Villareal
Former Under-Secretary, Ministry of Trade and Industrial Planning, Mexico

Dr Ennio Rodríguez
Former Minister of Debt and Foreign Finance, Costa Rica

Professor D. Dias Carneiro
Head of Economics, Catholic University, Rio de Janeiro, Brazil

Dr Diana Tussie
Ministry of Planning, Argentina

Washington DC visit 14-19 September 1986*

(i) *International Organisations*

World Bank

Barber Conable
President

Ernest Stern
Senior Vice-President, Operations

Moeen Qureshi
Senior Vice-President, Finance

David Hopper
Vice-President for Asia

David Knox
Vice-President for Latin America

Nicholas Hope
Chief, External Debt Division

Charles Larkum
Economist, External Debt Division

Ramgopal Agarwala
Special Office for Africa

Philip Birnbaum
Special Office for Africa

International Monetary Fund

Jacques de Larosière
(Then) Managing Director

Manuel Guitián
Deputy-Director, Exchange and Trade Relations

Maxwell Watson
Economist Exchange and Trade Relations

Tim Lankester
UK Executive Director of both World Bank and IMF

Inter-American Development Bank

Miguel Urrutia
Manager, Economic and Social Department

Henry Constanzo
Manager, Finance Department

International Institute for Finance

André de Lattre
(Then) Managing Director

Gregory Fager
Economist

(ii) *US interests*

Senator Bill Bradley (Democrat)
Congressman Jack Kemp (Republican)
Congressman Charles Schumer (Democrat)

Paul Volcker
Chairman, Federal Reserve Board

Charles Siegman
Senior Associate Director, Federal Reserve Board

J. Conrow
Deputy Assistant Secretary, US Treasury

Raymond Albright
Vice-President, Eximbank

(iii) *Symposium at Overseas Development Council, Washington*

Richard Feinberg
Vice-President, ODC

Stanley Please
Henry Nau
Norman Bailey
Carole Lancaster
Robert Berg

Africa** and Caribbean***

Professor George Saitoti
Minister of Finance, Kenya

Harris Mule
Permanent Secretary, Ministry of Finance, Kenya

Philip Ndegwa
Governor of the Central Bank of Kenya

Ben Kipkorir
Chairman, Kenya Commercial Bank

Cleopas Msuya
Minister of Finance, Economic Affairs and Planning, Tanzania

Professor Kigoma Malima
Minister of State, President's Office, Tanzania

Mr Mkila
Head of External Debt Management, Bank of Tanzania

Hon. Ali Kirunda Kivenjinja
Acting Minister of Foreign Affairs, Uganda

Emmanuel Tumusiime-Mutebile
Permanent Secretary, Ministry of Planning and Economic Development, Uganda

L. Kibirango
Governor of Bank of Uganda

Haji Moses Kigongo
Vice-Chairman, Natural Resistance Council, Uganda

Hon. Edward Seaga
Prime Minister of Jamaica

Research Support

Adrian Hewitt, ODI
Research Adviser to the All Party Group

Sheila Page, ODI
Specialist Adviser

Lucy Nichols, IDS

* Comprising Bowen Wells, Oonagh McDonald, Guy Barnett, Robert Harvey, Tim Yeo and Colin Moynihan, accompanied by Adrian Hewitt.
** Jim Lester.
*** Bowen Wells.

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