

Part I

Making Developing Country Debt Manageable

The Debt Problem in Perspective

1. Until 1974, governments and public institutions were the main providers of foreign capital to the developing countries. It was generally accepted that finance was required on terms which explicitly recognised the special economic and political problems of the developing countries and that many of them would be unable to meet interest obligations, or repay principal, within a commercial time horizon. The increase in oil price in 1973–74, while obviously diminishing the creditworthiness of the oil-importing developing countries, produced an urgent need for increased finance. The commercial banks, with ample deposits from the OPEC payments surpluses, were anxious to find opportunities to deploy them profitably and responded readily. Industrial country governments approved and welcomed the banks' willingness to respond. They recognised that major political and economic interests would be endangered if finance was not made available. And they were anxious to avoid additional budgetary obligations themselves.

2. The mainstay of the lending throughout was the assumption on the part of governments, banks and borrowers that the debts could be serviced indefinitely through expanded borrowing on the capital markets. The analogy was drawn between this type of international borrowing and the domestic debt of the richest countries in the world, which in any case did not require service in foreign exchange. Although global economic and political interests of the greatest importance were at stake, the lending was not underpinned by the resources of the developed world as a whole but only by a small and vulnerable part of those resources—the capital and reserves of its principal commercial banks. The banks

were not in a position to make appropriate decisions on the aggregate amount to be lent or on its apportionment between the developing countries; nor could they stipulate appropriate controls on borrower governments, who were very ready to accept the funds being offered to them on a larger scale and on more lenient terms than were available from the international institutions.

3. In the years after 1974, the borrowing countries increased their current account deficits and the lending, for a time, continued to cover them. The period between borrowing and the servicing of debt can be bridged by further commercial borrowing—but only as long as service in real terms seems a credible prospect. Unfortunately this prospect did not grow to match the great increase in debt obligation, particularly after 1980.

4. It was inevitable that lending and its servicing could not be sustained. The second oil shock, the prolonged recession and high interest rates speeded up this recognition, and over the past two years commercial bank lending to developing countries has dried up. The debtor countries' financial and economic programmes have been badly disrupted, with consequent serious political difficulties. Their considerable contribution to the expansion of world trade, itself one of the great dynamos of world economic expansion, has been abruptly reduced by reason of shortage of funds. At the same time the leading banks of the developed world are faced with potential defaults on debts which greatly exceed their capital and reserves.

5. The experience of the last ten years has, however, led us to the conclusion that a substantial contribution from the funds of commercial banks will be required in providing finance for developing countries in the years ahead. But this in turn requires much greater involvement by governments, and particularly by the multilateral financial institutions, than has been the case since 1974.

Prospects for servicing debt

6. The view of the industrial countries and the international institutions has tended to be that the soundness of the developing countries' debts can be restored if the present industrial country economic recovery is extended and if the debtor countries continue to pursue sound adjustment policies, through IMF programmes to support rescheduling and new lending. The assumption is that in the years immediately ahead the debtor countries can generate and sustain trading surpluses to service a substantial proportion of their debts and that, while so doing, they should and would be given further bridging loans, mainly from the commercial banks.

7. If this view is correct and substantial servicing of developing country debt in real terms is manageable in the years immediately ahead, this would certainly be a fortuitous outcome to lending founded on wholly different expectations. In our view, it is neither feasible nor desirable for the debtor countries in aggregate, at their present stage of development, to generate the large and sustained trading surpluses which would be required. Such surpluses could be obtained, if at all, in this period only at the cost of frustrating economic advance. Any sustained attempt to achieve what we believe would be a premature transfer of resources from the debtors to their creditors would face continuous political difficulties.

8. Moreover, the sustained export surpluses the debtors would require, if present policies are to succeed, would raise new and formidable structural problems for the developed world. Industrial countries have not yet succeeded in reversing the growing protectionist trends which have been prompted by their existing problems of structural adjustment. The obvious connection between export earnings and debt-servicing capacity has so far received insufficient attention.

9. Non-oil developing countries have sharply reduced their current account deficit—in aggregate from \$109 billion in 1981 to \$56 billion in 1983—partly because its financing became difficult. Some major debtors, under the pressure of IMF adjustment programmes, have moved from large deficits to large surpluses in their trade account. But these gains have been due mainly to reductions in their imports, abruptly brought about by a shortage of funds. They have been bought at the cost of economic setback, injury to world trade and grave risk to the political stability of the debtor countries. At present the international community is giving inadequate attention to the implications of the very large United States trade deficit. While it continues, it makes an important contribution to the export earnings of other countries, including, of course, major developing country debtors. But as it declines in future, the exports of these countries are likely to be adversely affected. We are thus in no doubt that developing country adjustment will continue to face considerable difficulties for some time ahead.

10. We do not question the need for firm adjustment programmes in the debtor countries. But these should be related to the achievement of sustainable economic growth and not to the attempt to secure early balance of payments 'gains' at the cost of inhibiting investment and growth. Such gains are too small to restore the debtors' market credit but large enough to do serious economic and social damage. The pressure for a premature reverse transfer of resources has arisen not because judgements about the economic and political conditions of the

developing countries have changed but because of the difficulties that have arisen since the assumption of readily available finance proved false. Present policies are, in our view, not policies of choice but a reflection of the failure of governments to overcome the difficulties of organising the coordinated action required for creative alternatives.

Dangerous instability in the system

11. We are not dealing with the isolated difficulties of one or two debtor countries or of one or two creditor banks. Rather we are faced with a dangerously unstable system in which the financial safety of the developing countries is involved and to which the leading banks have committed sums amounting to twice their capital and reserves. The point of greatest vulnerability for both debtors and creditors is in ensuring service of the interest on outstanding debts to the banks. If interest is not paid, the debts will be classed as non-performing and will have to be sharply written down in the balance sheets of the banks. If a substantial proportion of the debts become non-performing, we will be faced with the open insolvency of the indebted countries and of their bank creditors. The repercussions of this would be very damaging not only to the debtors and their creditors but to the world economy and to world politics. Clearly the first requirement of any sound policy must be to insure against this grave danger.

12. At present, formal default has been avoided by what appears to be payment in full of interest on almost all of these debts. These interest payments by major debtors are currently derived largely from three sources. First, the debtors have been able to borrow new funds from the IMF, roughly \$9½ billion in 1983. Secondly, in the same year, the debtors have made a substantial contribution by their aggregate trade surpluses and the drawing down of their reserves. Thirdly, the balance of interest not covered by these two sources—about \$15–16 billion in 1983—has been found by rescheduling. This means that the banks had little choice but to lend their debtors the money to make good the shortfall in their interest obligations so as to avoid open default.

13. Of these three sources of contribution to the vital task of ensuring that the debts remain performing, the most reliable is the IMF. It is by no means certain that this lending can be sustained even at present levels in the years ahead without substantial further infusions of funds. It is in the nature of the IMF that its ability to maintain its lending depends on its being repaid on time. As regards the second source, it would be very dangerous to found policy on the assumption that the current account gains of the debtors can be maintained. Thirdly, the rescheduling contribution to interest payments is rapidly losing credibility. Rescheduling is a valid and credible mechanism for granting

time to the occasional debtor in temporary difficulties. When, in conditions of vast and growing indebtedness, it is applied nearly universally and semi-permanently, it must increasingly be seen as purely cosmetic, that is to say, as a means to avoid the acknowledgement of default. For the creditors it produces balance-sheet assertions which are ever more obviously in conflict with market reality. In our opinion, we are dangerously near the time when these arrangements will no longer serve to permit the banks to treat these defaulted debts as performing assets. The debtors for their part are left with a sense of ever mounting debt.

14. The financial strength of the debtors and the bankers is now firmly interlocked. The questionable value of the banks' claims upon the developing countries represents a challenge to their solvency. Lightning rescues of the banks and emergency rescheduling, however massive, merely improve liquidity. They make neither borrower nor creditor stronger. The only way to strengthen the banks is to improve the quality of their assets. That means strengthening the economies and the finances of the debtor countries. The minimum required for safety is to ensure that the debtors are in a position to pay their interest in the years immediately ahead.

15. In short, at this crucial point of vulnerability, present policies provide only a most precarious protection. The world's financial safety is balanced on a knife-edge.

The Need for a More Systematic Approach: Public Purpose and Private Finance

16. Our analysis underlines the following conclusions:

- The debt crisis threatens not only development in developing countries but also the stability of the banking system of industrial countries.
- Debtor nations are being required by their debt-servicing obligations to engineer a net flow of resources to industrial countries for the foreseeable future.
- The bank debt crisis has been allowed to obscure another crisis in which indebtedness has been superimposed on other serious problems: namely, that of many low-income developing countries, especially in Sub-Saharan Africa, whose situation arouses the deepest anxieties. For many countries the position is very grave and calls for urgent responses to alleviate the situation.

17. Although the origins of the developing country debt problem in its present form can be traced to a particular set of historical circum-

stances, the problem has now become so intertwined with world economic relations that it has to be attacked simultaneously on a number of different fronts. We have therefore ranged widely in our discussion of policy measures, the remedial effect of which, on the debt problem, may in some cases be indirect rather than direct. But our prime concern is not with the detail of these various measures, important as they are individually. What really matters is that the aggregate impact of the measures taken should be on a scale which matches the size of the problem. We recognise the difficulties in mobilising the degree of intergovernmental cooperation required to frame and execute the necessary policies. But the issues at stake call for no less.

Recommendations

A. *Commercial indebtedness*

18. Any satisfactory solution to the present situation must in our view respect the following criteria:

- (a) There should be an equitable distribution of responsibility and costs between debtor countries, creditor country governments and the private banks, having regard to the history of the lending and the contribution it has made to the growth of the world economy whatever its defects may have been.
- (b) It is a matter of urgency to put an end to the premature outflows of resources from developing countries. Austerity which produces growth is acceptable. But austerity which attempts to secure premature balance of payments adjustments at the expense of investment and growth is not.
- (c) Policies to bring about a positive transfer of resources to developing countries must be soundly based—that is, both regulated and designed to produce growth—and of mutual advantage to industrial and developing countries.
- (d) Creditor countries must cooperate to assist the debtors, by guarantees or other means, to raise the funds to meet the interest on existing debt obligations and to ensure the flow of new funds referred to in (c) above.
- (e) The efficient functioning of the banking system both domestically and internationally must be preserved and insolvencies avoided. The banks must not, however, be bailed out. They must bear an equitable share of the burdens involved and must be given adequate time to make this manageable.

19. Proper arrangements must therefore be made to keep loans performing and to permit higher levels of growth, and imports, in the

debtor countries. This requires a level of additional financing sufficient to enable the debtors to pay the interest on their outstanding debt, while removing the pressures for achieving premature trade surpluses. Since the market will not provide this additional amount without guarantee, the industrial countries will have to take steps to ensure the availability of this additional financing. This would come from a combination of:

- commercial bank lending underpinned by a scheme of insurance;
- bilateral official lending, including export credits; and
- multilateral lending via the IMF, the World Bank and the regional development banks.

20. In parallel with the additional financing, rescheduling arrangements should be enlarged in scope along the following lines to give greater stability to the 'overhang' of debt and to reduce the debt-servicing burden:

- longer maturities and grace periods will be necessary in most cases;
- mechanisms should be established to provide at least temporary relief in respect of interest when it is at exceptionally high levels;
- multi-year rescheduling should be the norm rather than the exception; and
- the possibility should be considered of granting temporary relief by arrangements which would permit debt service in local currency to cover periods of foreign exchange difficulty.

21. In this way the debtors would be enabled to pay the interest and the banks would be in a position to make realistic write-downs of the debts to sustainable levels over a long period of years. This would bring about that combination of public purpose and private finance that ought always to have been in place. The exposure of governments in respect of the guarantee would be reduced in size over time as the banks write down their debts. Debtor countries would be able to end negative transfers and to finance balance of payments deficits on a basis compatible with the resumption of growth—the only way in which a satisfactory long-term solution of these problems can be achieved.

22. In addition to the combination of commercial bank lending, bilateral official lending and multilateral lending from the international financial institutions, there is need for action on other fronts. Steps should be taken to create a larger role for direct foreign investment in developing countries, many of which are now actively seeking such investment. The necessary encouragement must be provided by both

developing and industrial countries in a mutually acceptable framework. An expansionary economic environment for developing countries is an important element in this scenario and it can scarcely be fostered by the current deflationary approach to solving balance of payments problems. The principle of guarantees or insurance can be applied not only to bank lending as advocated above but also to expand private foreign investment, and to encourage new types of commercial flows such as bond financing.

23. By giving the necessary help to prevent the insolvency of the debtors the developed world will in the best and most economical way protect the banking system. Though the sums involved are large in relation to the resources of the banks and of the borrowing countries, they are small in relation to the world economy. The OECD annual income is around \$8,000 billion; by contrast the whole of developing country debt to the banks is some \$400 billion—little more than one year's potential growth of the world economy. And a great deal more than one year's growth of the world economy is at stake.

B. Special measures to assist low-income countries

24. A distinction needs to be made between middle-income developing countries, mainly in Latin America, whose external debt is primarily owed to the commercial banks, and low-income developing countries, mainly in Africa and South Asia, which have relatively little bank debt, but where debt arises from export credits and past official development assistance (ODA).

25. The serious debt-servicing problems facing many low-income countries have not received adequate recognition from the international community. The combination of declining ODA in real terms and rising debt-service obligations has sharply reduced net transfers to low-income countries, particularly in Sub-Saharan Africa. This contraction occurred during a period in which the prices of primary commodities collapsed to the lowest levels since the 1930s and market access has been reduced. The drought in Africa has aggravated the difficulties of a decade of declining living standards. Even countries pursuing appropriate adjustment policies have been forced, in these circumstances, to renegotiate their debt.

26. The terms of official finance—IMF and World Bank loans and officially guaranteed export credits—have hardened in response to increases in interest rates.

27. We are greatly concerned at the danger that emergency solutions for the big debtors could result in a crowding out of the poorest

countries from official financing when in fact their problems are the most difficult and urgently in need of attention.

28. Priority must be given to a special set of measures for assisting low-income developing countries, especially in Africa:

- reactivation of the IMF Trust Fund and interest subsidy account to promote medium-term, low-interest balance of payments finance for low-income countries which have great difficulty in using high-conditionality short-term IMF finance at normal interest rates;
- recognition that while IMF lending of an appropriate kind is desirable, the essentially long-term, structural nature of adjustment required in most low-income countries calls for the central role in external financing for adjustment to be played by the World Bank, in conjunction with regional banks;
- substantial real increases in ODA with a larger proportion going to poorer countries, and a greater role for programme lending. In this connection, attention must urgently be given to providing supplementary resources to IDA, to avert a significant reduction in multilateral flows to low-income countries;
- full implementation of the commitment to ODA debt write-offs for the poorest countries and substantial relief for other low-income developing countries;
- substantial relief, through longer maturities and grace periods, lower interest and multi-year rescheduling in Paris Club restructuring of the official debt of low-income countries;
- a reform of the official debt rescheduling procedures to give greater attention to new financial flows; in particular a coordinated approach to support rescheduling with new concessional flows and to ensure that insurance cover for export credit is promptly restored;
- improvement of domestic management and in particular debt management; international agencies can play a useful role by providing technical assistance to develop debt management systems in low-income countries.

C. *International financial institutions*

29. The international financial institutions need to play a much more active role in resolving the debt problem and in meeting the financing needs of developing countries. To carry out this role they need substantially revised terms of reference to deal with economic adjustment in a long-term framework, and adequate resources to carry out this mandate.

The IMF

- adjustment programmes should be designed with an emphasis on investment and growth;
- longer periods should be granted for adjustment, particularly in the case of low-income countries. This would entail a consistent joint approach by the Fund, the World Bank and the debtor countries' governments to financing structural adjustment, along the lines envisaged by the Report of the Commonwealth Study Group, *Towards a New Bretton Woods*;¹
- the present facilities with regard to compensatory financing should be enlarged; and
- the IMF should have substantial increases in its resources mainly through an increase in quotas. A substantial further allocation of SDRs is also necessary.

The World Bank and regional development banks

- a significantly higher fraction of World Bank loans should be in the form of programme lending to countries with balance of payments financing difficulties; in particular, the proportion of programme lending should be raised to over 30 per cent;
- the World Bank's lending resources should be increased by a further substantial general capital increase and by relaxing the gearing ratio;
- lending by IDA, which under present policies would decline even in nominal terms, should at least be maintained;
- the World Bank and regional banks should undertake a larger role in supporting private lending (for example, via co-financing) and equity investment;
- the World Bank and regional banks should play a more central role in drawing up adjustment programmes, especially for low-income countries;
- the regional banks have a useful role in development financing in addition to that played by the World Bank; to perform this they need greater resources and more flexibility to respond to the need for programme loans.

D. Industrial country policies

30. Our recommendations have been framed in the context of uncertain and uneven economic recovery in industrial countries, high interest

1. Commonwealth Secretariat, *Towards a New Bretton Woods: Challenges for the World Financial and Trading System*, Report by a Commonwealth Study Group, July 1983.

rates and protectionist resistance to increased imports from developing countries. The scenario for the future, sketched out in Chapter 5 of Part II, highlights the dangers in the debt situation if any, let alone all, of these problems continue. Although the improved economic climate in industrial countries is not in itself enough to avert the recurrence of serious debt problems, the dangers and difficulties would be lessened considerably by:

- the resumption of sustained economic growth at higher rates than in the past decade;
- a significantly lower level of real and nominal interest rates; and
- a ‘roll back’ of protectionist measures, particularly those affecting developing countries in such sectors as agriculture, textiles and clothing, and steel.

Conclusions

31. We observed at the outset that we saw our basic task as one of drawing attention to the central features of a fast-moving and deteriorating situation.

32. The message is clear. The present situation is not sustainable. The world’s financial safety is balanced on a knife-edge. The greatest immediate danger of disruption is posed by the risk that interest will not be paid on the existing debts of the major developing country borrowers. The erosion in the living standards of developing countries has pushed their peoples to the margin of tolerance. There is thus an urgent need to organise an adequate and collective response to the situation. There must be an end to premature negative transfers of resources and the quest for developing country trading surpluses. The needs of the poorest and most seriously disadvantaged developing countries must receive greater collective attention. The international community must find again the balance between public purpose and private finance which was at the heart of the Bretton Woods arrangements and which is indispensable to the sustained growth and stability of an interdependent world.

33. There is no room for complacency. We sense rather that a recognition of the gravity of the issues and of the dangers posed by the debt crisis in an interdependent world is growing. Full expression is not always given to this recognition, perhaps because of fear of seeming to aggravate matters. But the situation has now been reached where collective determination to take action is imperative. The knowledge that such determination has been mustered will itself be a factor for greater stability.

The Scope of the Developing Country Debt Problem

- * Total debt of developing countries at the end of 1983 was about \$800 billion, long- and short-term, and was of the order of one and a half times their export earnings.
- * Half of all developing country long-term debt is owed to private markets, compared to one-quarter a decade ago.
- * The annual debt service payments of the non-oil developing countries increased from less than \$20 billion in 1973 to more than \$100 billion by 1983.
- * Interest payments on external debt by the non-oil developing countries reached a level of \$60 billion by 1982-83, absorbing 13-14 per cent of their export earnings. Between 1980 and 1983, these countries' export earnings did no more than keep pace with the increase in their interest payments.
- * In respect of some acutely indebted countries, interest payments absorbed between one-third and half their export earnings.
- * The debt-service payments of low-income countries (i.e. countries with per capita incomes of not more than \$350 at 1978 prices), absorbed more than a fifth of their export earnings in 1983.
- * 40 per cent of all non-oil developing country debt, as against 5 per cent a decade ago, is at variable interest rates.
- * Each one percentage point rise in the rate of interest is estimated to cost the developing countries at least \$3 billion per year in increased interest payments.
- * During 1983, developing countries experienced a negative net inflow of funds (i.e. gross borrowing minus debt-service payments) of \$11 billion.
- * Developing countries reduced their imports by \$60 billion between 1981 and 1983, \$40 billion of which was in respect of imports from industrial countries.