

Chapter 3

The Debt Crisis and the Low-Income Developing Countries

Features of Low-income Country Debt

3.1 According to the IMF, over 40 low-income developing countries have a combined debt of \$88 billion, just over one-eighth of all developing country debt. Eighty per cent of it is official, owed to the governments of industrial countries and multilateral institutions, and arising from past official development assistance (ODA) and guaranteed export credits. As can be seen from Table 3.1, there is a strong correlation between the share of official debt, and per capita income. While the debt of low-income countries is small in global terms, it is large in relation to the capacity of many of them to service it. The 'least developed' group of countries are particularly badly affected: their debt-service payments on long-term debt increased from 16 per cent in 1975 to 26 per cent in 1982.

3.2 Among the low-income countries there has been a somewhat different experience in Asia and Africa. Some low-income Asian countries have had worsening debt-service ratios, for example, Burma and Pakistan. However, for low-income Asia as a whole, the situation is not critical, since most debt is in the form of highly concessional long-term credits, such as IDA loans. By contrast, low-income African countries have seen their total external debt increase as a proportion of export earnings from about 90 per cent in 1970-73 to almost 250 per cent in 1983. Debt-service payments on the long-term debt of low-income Africa, which stood at around 7 per cent of their export of goods and services during 1970-73, are estimated to have reached a quarter of their export earnings by 1983. The wider African picture can be seen from Table 3.2, which shows a five-fold increase in total debt over the last decade and a trebling in overall debt-service ratios.

Table 3.1: Classification of Developing Countries by Per Capita Income and Importance of Official Creditors (1982)

	Value of Medium- term Official Debt	Share of Official Disbursed Debt in Total Debt	Per Capita Income
	\$ billion	%	\$
<i>I. Countries with under \$400 per capita income and over 60% Official Debt</i>			
Bangladesh	4.21	93	140
India	18.37	91	260
Uganda	0.55	91	230
Tanzania	1.55	89	280
Malawi	0.49	69	210
Ghana	0.95	69	360
Sri Lanka	1.42	66	320
Sierra Leone	0.23	65	390
Kenya	1.57	60	390
<i>II. 'Hybrid' Cases</i>			
Guyana	0.48	69	720
Jamaica	1.05	67	1180
Mauritius	0.22	55	1270
Indonesia	8.33	52	530
Zambia	1.73	36	600
<i>III. Countries with over \$750 per capita income and over 60% Commercial Debt</i>			
Costa Rica	1.10	37	1430
Colombia	2.99	33	1460
Ivory Coast	1.34	27	950
Korea	8.33	27	1910
Philippines	3.85	23	820
Algeria	2.90	20	2350
Malaysia	1.77	20	1860
Nigeria	1.14	15	860
Chile	1.31	15	2210
Brazil	8.18	13	2240
Mexico	7.10	10	2270
Argentina	1.99	8	2320
Venezuela	0.30	2	4140

Note: Total debt used to calculate ratios excludes private unguaranteed debt.

Source: World Bank Tables and BIS.

Table 3.2: Features of Low-income Developing Country, and African, External Public Debt^a

	1973	1980	1981	1982	1983
1. Total Outstanding Debt (\$bn)					
Low-income countries	25.4	71.4	75.2	81.8	87.8
Africa	14.2	50.9	55.5	62.5	66.3
2. Ratio of External Debt to Exports					
Low-income countries	227.9	134.8	133.3	146.5	148.9
Africa	71.5	143.2	168.6	204.5	223.5
3. Share of Official Creditors in Long-term Total Debt					
Low-income countries	84.5	76.0	79.0	81.1	82.3
Africa	47.8	45.2	46.5	46.8	48.7
4. Share of Short-term Debt in Total Debt					
Low-income countries	2.3	5.9	4.3	3.3	2.6
Africa	2.7	8.4	11.1	12.6	11.0
5. Debt Service Ratio^b					
Low-income countries	14.6	10.3	12.6	14.6	13.3
Africa	8.8	17.4	19.7	23.7	25.1
6. Interest Payments Ratio					
Low-income countries	6.1	4.4	5.1	5.4	5.4
Africa	5.9	8.1	9.2	11.0	10.8

Source: Derived from IMF, *World Economic Outlook*, 1983 and 1984.

Notes: ^a Low-income countries exclude China for 1973. Africa includes some middle-income countries and excludes South Africa for years 1980 onwards. All ratios are given in percentages.

^b Payments (interest, amortisation or both) as percentages of exports of goods and services.

3.3 One consequence of the rise in debt-service payments has been a decline in net transfers to low-income countries since 1980. Total net transfers to low-income Africa, after reaching a peak of \$2.7 billion in 1980 in nominal terms, declined to \$1.1 billion in 1983; and net transfers to low-income Asia have also fallen since 1980, though not as sharply as to Africa. In Africa, 16 countries registered negative transfers at some time in the period 1971-81. Completing the picture of net resource transfers, official grants to low-income Africa have also declined since 1980.

3.4 As payments difficulties have intensified and other sources of finance have dried up, there has been a growing reliance on short-term debt, particularly in countries which have significant arrears on revolving credits to commercial banks and on imports from foreign suppliers. For many Sub-Saharan African countries, it is believed that short-term debt and trade arrears may have reached a quarter of the total debt outstanding, and in some cases—for example, Tanzania and Zambia—they may equal annual export earnings. A consequence of this accumulation of arrears is that fresh trade credit has dried up for many countries. Many low-income countries are importing food and oil, two essential items, largely on a cash basis. In the instances where finance is available, rates of interest have reportedly reached 30 per cent or more.

Factors Affecting Low-income Country Debt

3.5 A variety of factors have contributed to the deteriorating debt situation of low-income developing countries, especially in Africa.

(i) *Terms of trade*

3.6 They suffered a serious deterioration in their current external balance with the decline in their terms of trade, and specifically with the increases in oil prices. Between 1973 and 1982, low-income African countries lost as much as 20 per cent in the purchasing power of their exports. This, together with a decline in the volume of exports, contributed to a trebling or quadrupling of their current account deficits in real terms. Low-income Asia lost about 10 per cent in the purchasing power of its exports but was able, in part, to counteract the adverse price movements through a diversification of exports, particularly through expanded exports to the Middle Eastern oil exporting countries and through remittances from migrant workers.

Table 3.3: Terms of Trade (% annual change)

	1965-73 (annual average)	1973-80 (annual average)	1981	1982	1983
Low-income Asia	-0.5	-1.4	-0.1	-1.6	-0.6
Low-income Africa	-0.1	-1.5	-9.9	-0.9	4.6

Source: World Bank, *World Development Report, 1984*.

(ii) *Reduced aid*

3.7 In seeking to meet current account deficits by capital flows, low-income countries have relied mainly on aid, but ODA has also declined in real terms. Gross disbursements of ODA rose by 54 per cent between 1975 and 1982, and nominal net transfers, after deducting repayment and interest, by 37 per cent. But net transfers declined by 5 per cent in real terms, and by 30 per cent for the four major ODA recipients (Egypt, India, Indonesia and Pakistan), when account is taken of changes in exchange rates and prices of goods procured through ODA. Looking to the future the prospects are no better. With a Seventh Replenishment of IDA fixed at \$9 billion, it is predicted that Africa will suffer a 21 per cent reduction in real terms compared with commitments in the IDA-6 period; and so will 13 other countries outside Africa.

(iii) *Increased use of private markets*

3.8 Increased current account deficits in real terms, combined with declining aid, led low-income countries to rely more and more on non-concessional export credits and private capital markets. They were attracted by negative real interest rates and the absence of strings. The upswing in commodity earnings in the late 1970s also engendered confidence in some countries that they could service commercial debt. Two-fifths of the increase in the total long-term debt of the low-income countries between 1975 and 1983 was accounted for by non-concessional flows; as a result, the share of concessional debt fell from 71 per cent of the total in 1975 to 60 per cent in 1983.

3.9 A consequence of increased reliance on private markets has been a hardening of terms. This was most evident for variable interest rate commercial debt, but was also true for ODA debt, in respect of its declining grant element. Multilateral loans—for example, from the IMF—have also become more costly. In Africa, average interest rates on loans of all kinds rose from 4.2 per cent in 1971 to 10.1 per cent in 1981. Parallel with this, loan maturities on African debt fell from 22 years in 1971 to 15 years in 1982; and the average grace period from six to four years.

(iv) *Internal factors*

3.10 While external factors have played a major role in explaining the rise in indebtedness and debt service in low-income countries, internal factors were also important. These include natural hazards such as drought which led countries to buy food through external borrowing; and policy deficiencies in the areas of production, savings incentives and debt management.

Prospects for the future

3.11 In the absence of ameliorative action, the factors which have contributed to the current crisis seem likely to perpetuate it in future. Both the IMF and the World Bank expect low-income countries to have significantly lower growth rates in their export earnings than other non-oil developing countries, and their terms of trade can be expected to deteriorate further. The IMF's projections suggest that the debt-service ratio of low-income countries is unlikely to improve before 1990, even if the growth in imports is compressed to a rate lower than the rate of increase in exports, which is itself projected to be low, and even if there is a substantial decline in interest rates. In the projections made by the World Bank, the debt-service ratio of low-income Africa is projected to fall from about 25 per cent in 1983 to about 19–21 per cent by 1995, but only with a decline in per capita incomes. In fact, the implied growth rate of GDP, corresponding to the modest projected improvement in the debt situation, entails a decline in per capita real incomes at rates of up to 0.7 per cent a year in the decade 1985–95. This comes on top of steadily declining per capita incomes over the last decade (see Table 3.4) and underlines the sacrifice in terms of development and living standards which is being demanded of some of the world's poorest countries in order to keep debt serviced.

Table 3.4: Trends in Per Capita Income (% annual change)

	1960–73	1973–79	1980	1981	1982	1983
Low-income countries (including China)	3.0	2.9	4.0	2.9	3.3	2.8
Low-income Africa	1.0	-1.0	-1.4	-1.5	-2.3	-2.8

Source: World Bank, *World Development Report*, 1984.

Policy Framework

3.12 During the period 1976–83, out of 31 cases of official debt rescheduling, 21 involved low-income African countries; Africa accounted for half of all reschedulings, including commercial bank loans, in this period. Several of these countries were obliged to reschedule their debts repeatedly, with Zaire, Togo and Liberia accounting for 15 reschedulings between them. A further eight countries which had not yet rescheduled were listed by the IMF as being in arrears in 1983.

3.13 There are some important variations in the ways in which the international community has treated the debt of low-income countries as compared with that of major and middle-income debtors. *First*, since a large proportion of the debt is official, the institutional framework for renegotiation is different, involving the Paris Club and aid consortia. Paris Club procedures are reviewed below.

3.14 *Second*, the principle of writing off debt for low-income countries has been accepted by creditor countries. However, a distinction is made between ODA debt which is eligible for write-offs and official debt negotiated in the Paris Club, which is not.

3.15 *Third*, there is acceptance by the international community of the need for special action in relation to the poorest countries including action on debt as part of a wider programme. This acceptance was given expression by the New Programme of Action for the Least Developed Countries (UN Conference, 1981) and, more recently, by the proposal of the Development Committee of the World Bank and the IMF for a special action programme for Sub-Saharan Africa. As drafted, this latter programme lays emphasis on more effective donor aid coordination, supported by a special fund for Africa, and embracing Paris Club official debt renegotiation for the countries concerned.

3.16 While these important differences exist, there are also common features. There is the central role of the IMF which we shall briefly refer to here and also in Chapter 4. There is also the same distinction to be made between new money flows from aid donors and official creditors, and the stock of outstanding debt. As with commercial bank debt, increased new flows make it easier to manage the stock or 'overhang'. While the emphasis here is on the stock of outstanding debt, we would stress the obvious point that if new inflows of ODA to low-income developing countries were to be substantially increased, the seriousness of their debt problems would diminish since there would be less need to borrow on hard terms—as also would the frequency of arrears and rescheduling.

ODA Debt and Debt Relief

Objectives and experience

3.17 Some Asian countries (India, Pakistan, Bangladesh) have carried out official debt renegotiation within the context of aid consortia under the chairmanship of the World Bank. Debt relief was linked to new aid in the context of a general commitment by donors to the countries' development objectives. This approach appears to have worked well

and has helped to keep South Asia relatively free from debt-servicing problems, without the stigma of 'loss of creditworthiness' associated with default and forced renegotiation.

3.18 The principle that debt relief should be treated as a legitimate form of aid was given a good deal of attention by the Pearson Commission in its 1969 Report.¹ However, it failed to achieve much headway by adopting a bilateral case-by-case approach in the case of the overwhelming majority of low-income countries which lacked the coordinated aid consortium framework of the major South Asian ODA recipients.

3.19 Generalised debt relief was called for by the developing countries but this was resisted on the grounds that inequities might be generated by generalised solutions. A compromise agreement was reached in 1978, embodied in UNCTAD Resolution 165, under which donors undertook to adjust the terms of bilateral ODA retro-actively as a means of improving net flows. From the viewpoint of developing countries, the resolution had several deficiencies. *First*, it did not specify eligible countries. Eligibility came to be interpreted as referring to the 'least developed' countries, but each donor was left to decide for itself. *Secondly*, retro-active terms adjustment (RTA) is equivalent to debt cancellation only where a country receives its aid in grant form. Of the 17 countries which are members of the OECD Development Assistance Committee (DAC) only ten provide aid to the 'least developed'—let alone to other developing countries—entirely in grant form. And, *thirdly*, the resolution entailed no binding commitment; as a result the United States has not implemented RTA and other donors have varied in their commitment and methods.

Impact

3.20 The UNCTAD Secretariat estimates the total nominal value of debt relief granted as \$5.7 billion, of which \$3.3 billion was in the form of debt cancellation. About half the debt was owed by 'least developed' countries. In the case of a few specific countries, the proposed action has had a substantial impact. Eight 'least developed' countries had more than half their total debt written off and, for seven others, the proportion was over 20 per cent. In the case of all other countries, however, the impact on their outstanding debt was almost negligible. Even for the major beneficiaries, the gain has been limited by the fact that ODA debt relief has not been treated as additional money but has been taken from elsewhere in aid budgets. None the less, what debt relief has achieved, even in these cases, is to increase the availability to the recipient of untied foreign exchange.

1. *Partners in Development: Report of the Commission on International Development*. London: Pall Mall Press, 1969.

Future initiatives

3.21 One way of giving quick and helpful relief to a substantial number of the poorest countries would be a commitment by donors to a complete ODA debt write-off (by converting past loans to grants) for the category of 'least developed' countries. This could save them approximately \$100 million in debt service annually, a trivial sum for the donors but an important sum for some very poor countries.

3.22 For the remaining low-income countries (defined as those eligible for IDA financing) there could be a concessional arrangement which falls a little short of the proposal for the 'least developed countries'. One element could be the acceptance by donors of the remainder of loan payments in local currency rather than in foreign exchange; the local currency balances could be used for the local costs of future aid programmes.

3.23 It should, of course, be made explicit that the donor initiative is in the context of enlarged ODA flows rather than merely a different means of providing existing aid.

Rescheduling of Official Debt: The Paris Club

3.24 The Paris Club is the forum within which countries negotiate the rescheduling of public sector debt owed to the 17 governments of the DAC. It does not operate in the context of low-income countries alone; in fact, the largest absolute amounts of official debt rescheduled have been of guaranteed export credits and official loans of some major debtors—Brazil, Mexico, Poland. But the rules followed in the rescheduling of official debt are of particular relevance to low-income countries, as it has constituted a major component of their total debt.

3.25 The Paris Club was initially seen by creditors as a way of establishing common terms and conditions for debt rescheduling applications. While the Club has no written rules, a clear set of procedures and common features has evolved which will be discussed and evaluated below. Inevitably, we shall generalise, and country-level detail is briefly summarised in Appendix 3.1.

Procedures

(i) The IMF

3.26 For members of the IMF, it is a precondition of Paris Club rescheduling that the debtor has an upper credit tranche agreement with the Fund (no exceptions have been made since 1977). Also, in most cases, the continued validity of the Paris Club agreement has been made dependent on the debtor maintaining a satisfactory arrangement with the Fund.

(ii) *Interest*

3.27 A central principle of the Club is that interest rates on restructured loans are at commercial rates, and that interest payments are maintained throughout. The precise determination of interest rates is made bilaterally.

(iii) *Consolidation*

3.28 As in the case of bank debt, consolidation periods are short, with usually only a year's repayment to be considered at a time. But there have been several instances of 18-month or 24-month consolidation periods. In other cases, there is 'conditional further rescheduling' (i.e. an extension of the consolidation period subject to the fulfilment of specified IMF conditions) or a 'goodwill clause' which makes a somewhat vaguer commitment to future rescheduling.

(iv) *Maturities*

3.29 To a greater extent than with bank rescheduling, terms have been generally a little easier for low-income countries than for others. For example, the maturity of rescheduled loans has never been less than 8 years, and in three cases it was between 11 and 16 years. This compares with an overall average of $6\frac{1}{2}$ to 10 years maturity.

(v) *Coverage*

3.30 The coverage of the rescheduling agreements has traditionally been restricted to principal on medium-term loans, amounting to an average of 85 per cent of the principal due. Interest is now regularly included and so are arrears outstanding at the beginning of the consolidation period (but on less generous terms than the payments falling due). Previously rescheduled debt has, however, invariably been excluded, as has debt owed to multilateral institutions.

(vi) *Special cases*

3.31 There has been some sensitivity to particularly acute balance of payments problems. A major departure was made in the case of Sudan in February 1983. The rescheduling covered 100 per cent of arrears on principal and interest payments resulting from previous consolidations as well as 100 per cent of payments due in 1983 on short-, medium- and long-term debt. In addition, half the interest due in 1983 on the amount rescheduled was capitalised and consolidated along with the other payments, and provision was made for considering similar treatment in the second year at an annual review meeting. Finally, the repayment period (16 years) follows a six-year grace period during which no payments, except interest, will be made. Attempts to treat this as a precedent have, however, been resisted.

Evaluation

3.32 Several major deficiencies have become apparent in the existing arrangements as they affect low-income countries. They are, if anything, more serious than in the case of bank loans and major debtors. *First*, the experience of rescheduling reveals that official creditors are less sensitive than private creditors to the implications of their negotiations for new financial flows. Within the bank rescheduling context there is at least an implicit understanding that new loans will be provided to help service interest. However, the main export credit agencies respond to impending renegotiation by withdrawing cover, and there are often long delays, even after agreement is reached bilaterally, before cover is restored.

3.33 The central involvement of the IMF should in principle help inasmuch as it is a catalyst to encourage new lending. In practice, however, it has been conspicuously less active in orchestrating new official lending for low-income countries than in working with the banks to ensure new 'involuntary' lending to major debtors. Indeed, its own methods have often aggravated the situation. The insistence on brief consolidation periods is linked to the IMF's preference for short-term standby arrangements. This, in turn, leads to frequent, rather than once-and-for-all, rescheduling operations and to repeated loss of export credit insurance cover.

3.34 More generally, and not only in relation to export credit agencies, there has been little coordinated effort during rescheduling exercises to increase the supply of additional finance. Yet lack of support in the form of new money can undermine the whole credibility of the Fund's approach to adjustment programmes which require working assumptions to be made on capital flows. The Fund has now started to play a more direct role in this context. Thus, in the case of Sudan, it was decided that although an IMF arrangement was approved in principle it would not go into effect until the necessary private and official finance was forthcoming. The Fund has also recently taken the initiative in several cases, in calling a parallel meeting of aid donors so that the needs of the debtor country can be more adequately addressed.

3.35 A *second*, and related, point is that the Paris Club format has led to an insistence on short-term—usually one-year—Fund programmes, and on the conditionality associated with such programmes which is largely inappropriate to the circumstances of low-income countries. We shall pursue these arguments in more detail in Chapter 4. Suffice it to say here that most low-income countries have structural problems which need medium- to long-term programmes to increase the supply of tradeable goods and services. New investment may have a high short-term import content which requires sustained and consistent

external financial support over a number of years. Moreover, the need to build up infrastructure and human capital may well necessitate higher outlays on 'non-tradeable' activities in the short run, which generate no foreign exchange directly. The short-term nature of Fund programmes is, as we have noted, linked to short consolidation periods. A recent departure to ease this problem slightly has been the extended consolidation period offered to Cuba; but it is scarcely over-generous (2 years 4 months).

3.36 *Third*, the terms of rescheduling have caused concern, particularly in respect of interest rates. There is no consistency between creditors in relation to the interest charged. In general, there has been a movement reflecting higher international interest rates and the withdrawal of the subsidy element from export credits. In some recorded cases, there has been an increase in rates from 6 to 12 per cent consequent upon rescheduling. The overall result has been to increase the present value of future debt-service obligations over those of earlier loans—an extraordinary imposition on low-income countries in current circumstances.

3.37 *Fourth*, there has been only a modest attempt to relate maturities and grace periods to the circumstances of low-income countries. The terms for Sudan were generous and have been partially replicated for a handful of other cases (for example, Madagascar) but there is a reluctance to generalise the treatment.

Future adaptation

3.38 It follows from the above that the changes required in the operation of the Paris Club, as it affects low-income countries, are fundamental rather than minor. The main point is that the distinction between rescheduling one form of official debt (ODA) on concessional terms, involving debt write-offs, and another (official loans including export credits) on commercial terms is artificial and unhelpful to low-income countries. There are several implications:

- in an ideal world in which ODA flows were much larger and rapidly increasing, the optimal and most equitable solution to the external financing problems of low-income countries would be achieved by new flows rather than relieving the most heavily indebted countries of their loan obligations. However, in a situation of declining new concessional flows in real terms and chronic problems of low-income country indebtedness, it makes little sense for one set of official creditors to demand commercial debt rescheduling terms. Greater concessionality and write-offs in the context of the Paris Club are inevitable, as some individual cases have already demonstrated;

- insistence on treating official debt in the Paris Club independently of the activities of aid donors, results in the imposition of a short-term framework for economic management which is inadequate and may undermine medium-term development programmes. A better approach is that adopted in the case of Sudan, and mooted in the proposed special action programme for Sub-Saharan Africa, which links aid donors and official creditors in a coordinated approach to existing debt and new lending, in the context of a medium-term programme;
- once the above approach has been accepted in general terms, a variety of specific implications follow, including the adoption of multi-year rescheduling—i.e. much longer consolidation periods—linked to medium-term IMF loans or World Bank programme loans; increased grace periods and maturities; concessional interest rates; and a coordinated approach by export credit agencies involving firm commitments to a prompt restoration of cover in the case of agreed reschedulings and programmes.

Domestic Policies and Debt Management

3.39 Internal economic management plays a crucial role in preventing and resolving debt crises. Low-income countries, no less than others, need to pursue disciplined fiscal policies and to adopt realistic exchange rates, as well as offering adequate incentives to producers of food and exports.

3.40 One issue of particular importance in low-income countries is the absence of proper machinery for debt management, since many governments lack trained personnel. Many debt problems have been made worse because governments have not known, even approximately, the extent of the national external debt and future debt-servicing obligations. This has made their debt more expensive and burdensome by incurring penalties for late payment and by reducing further their ability to obtain new credit; and it has greatly hampered their negotiations for further finance with the IMF and others.

3.41 Many governments do not have a full picture of their external debts primarily because of an inability to monitor and control borrowing by parastatal institutions, which is generally government guaranteed but in many of the countries has been largely uncontrolled, and by the private sector. This needs to be overcome by establishing appropriate institutional machinery to manage debt and its repayment, both public and private.

3.42 The essential elements of a debt management system are:

- (i) the appointment of a central agency to monitor the contracting, utilisation and payment of all external loans;
- (ii) the establishment and regular updating by this agency of a full inventory of external debt and debt-service obligations;
- (iii) the management and analysis of these data in order to provide information on payment of interest and principal due, on currency of payment, and on other key variables;
- (iv) balance of payment forecasts which can be used in conjunction with debt projections to formulate an appropriate borrowing policy.

At present low-income developing countries make use of banks to advise them. International agencies can also assist governments which lack the manpower or experience to operate systems of this kind, and the Commonwealth Secretariat is among those seeking to extend its operations in this area.

3.43 While no amount of good debt management will avoid the acute problems of countries which have been faced with stagnating or declining revenues from one or two export commodities and with a massive increase in their import bill for oil, it should be possible for them to incur expenditure obligations which are appropriate not to the revenue peaks in the commodity price cycle of their exports but to some rough and ready mid-point of the cycle. This should at least minimise debt-servicing difficulties.