

Chapter 5

Debt and Resource Flows: Future Prospects

5.1 A view widely held in Western governments, international agencies and banks is that, while the debt crisis has assumed serious dimensions in the last few years, the policies developed in response to it—as reviewed in Chapters 2–4—coupled with economic recovery in the industrial countries, should restore the debt situation to a manageable level. This view is well articulated by the IMF. In the 1984 issue of *World Economic Outlook*, it said (p.68):

Assuming moderate rates of growth in the industrial countries, some fall in real interest rates, and unchanged terms of trade, and assuming also that the non-oil developing countries continue their present adjustment policies, the conclusion is reached that most groups of these countries can achieve adequate rates of growth of GDP (although somewhat below the rates attained during the 1960s and 1970s), while restoring a manageable position with respect to their current accounts and debt-service burden.

In this chapter we shall review the plausibility of this scenario over the rest of the 1980s.

Debt Situation: Some Projections

The aggregate picture

5.2 In order to appreciate the precariousness of the prospects for an improved debt situation, it is important to understand the assumptions on which an improvement is predicated in the medium term:

- (i) the industrial countries will grow at a rate of 3 to 4 per cent per year, and, as a result, developing countries will be able to increase their export earnings significantly as in the past;

- (ii) the real rates of interest will decline substantially compared to the present levels;
- (iii) the price of oil will remain stable; and
- (iv) a significant number of developing countries will continue to generate trade surpluses.

Based on these assumptions, most exercises on the debt situation project an improvement in the medium term. (See Appendix 5.1 for a summary of various projections and the assumptions underlying them.) There are, however, some difficulties with such an assessment. First, the underlying assumptions seem optimistic, particularly when we consider that all of them must be realised simultaneously. Second, even if all the assumptions were to be realised, the picture is much less reassuring when we look at the debt profile for some individual countries or sub-groups of countries. Further, it is assumed that adequate financial flows, including new bank lending, will be forthcoming in the rest of the decade to meet the financing needs of the developing countries—an assumption that may not be easily fulfilled even if the debt situation were to improve as projected. We discuss these themes below.

Fallible Assumptions

(i) Growth in industrial countries

5.3 The projected improvement in the debt situation is highly sensitive to the industrial countries attaining a modest recovery, achieving a growth rate of 3–4 per cent in the rest of the decade.

5.4 A point of agreement among all the projections is that, if the industrial countries were not to attain the assumed growth rates, the debt situation could deteriorate seriously. According to the IMF, if the industrial country growth rates were to be one percentage point less than the assumed rate in the base case projections (i.e. 2.25 per cent instead of 3.25 per cent), the debt-service ratio of the non-oil developing countries would rise all through the rest of the decade compared to the levels in 1983, which were already high. Professor Cline (1983) concludes that a fall of one percentage point in industrial country growth could be seven times more important, in terms of its impact on the debt situation of developing countries, than a one percentage point rise in interest rates, serious though the latter would be.

5.5 The assumed growth rate of 3–4 per cent for industrial countries for the rest of the decade, while low by historical standards, is predicated upon a continuation and improvement in an economic recovery which is so far both uncertain and uneven. Growth has been strong in the United States and, to some extent, in Japan; but in Western Europe it remains

weak. In the current year, 1984, the growth rate of GNP in the European economies is projected at less than 2.5 per cent, compared to 6 per cent in the US and 4.75 per cent in Japan (averaging 4.25 per cent overall as against 2.4 per cent in 1983). Moreover, most analysts forecast a decline in industrial country growth in 1985; the OECD forecasts a decline in the US to 2.5 per cent and in Japan to 3.75 per cent. The growth rate in industrial countries, on average, is expected to decline from 4.25 per cent in 1984 to 2.75 per cent in 1985.

5.6 The idea of higher and steady growth runs wholly counter to the reality of a world characterised by cyclical booms and slumps and by periodic shocks. Even if the industrial countries achieve a growth rate of 3–4 per cent on average in the rest of the decade but characterised by booms and slumps, it is doubtful whether the debt situation will improve, particularly if the next phase of the cycle is a ‘slump’ rather than a ‘boom’. As noted above, the growth rate of industrial countries is generally expected to decelerate markedly in the coming one to two years; and if this deceleration in growth were to be as pronounced as that of 1981–82, the debt situation would worsen markedly.

(ii) *Developing country exports*

5.7 There is also some uncertainty as to whether the industrial country growth would continue to have the same degree of impact on developing country exports as in the past. In the short term, in spite of the recovery in industrial country growth in 1983–84, commodity prices have tended to decline. Between mid-July 1983 and mid-July 1984, the dollar prices of non-food agricultural commodities fell by 19 per cent and of metals by 16 per cent. In view of the expected decline in industrial country growth in the coming one to two years, it is doubtful whether these falls will be reversed in any significant manner. In the medium term, there are two other factors which cast doubt on the ability of the developing countries to increase their export earnings. First, during the 1970s developing country exports came to be diversified away from industrial countries, with a greater proportion going to other developing countries—oil exporters and others. Immigrant remittances from workers employed in the oil-exporting countries were also a strong component of exchange earnings for some developing countries during the decade. Therefore, if the revival in growth is confined to industrial countries—with growth in oil-exporting and other developing countries somewhat muted—the exports of developing countries might not revive as strongly as one might be led to believe from the past evidence. Secondly, there is evidence that, in spite of the avowed desire to reduce protectionism, the industrial countries, in fact, intensified protectionist measures in 1983, at a time when recovery was under way. Furthermore, at the margin, the additional exports produced as a result of developing country adjustment measures, in particular from more competitive real

exchange rates, are likely to be price-sensitive manufactures which face the maximum protectionist stance. In the absence of a liberalisation of trade, therefore, developing country exports may not revive as strongly as past trends might suggest.

(iii) *Interest rates*

5.8 The projected global improvement in the debt situation assumes a decline in interest rates. The IMF, for example, assumes that interest rates on commercial credits, after continuing at the 1983 levels up to the end of 1985, will decline by three percentage points during the rest of the decade. If interest rates were not to fall at all, compared to 1983 levels, the results would be much worse.

5.9 So far, the experience has been far from encouraging. We have seen the demolition of hopes, widely held when we began this study, that there could be a speedy return to manageable levels of interest rates. Instead, they have risen—in the case of Euro-dollar rates from below 9 per cent at the low point in 1983 to 12.25 per cent in July 1984. Some analysts believe that they will continue to rise further. No less an authority than Dr. Martin Feldstein, in his capacity as Chairman of President Reagan's Council of Economic Advisers, recently warned that short-term rates would rise further, and continue high throughout 1985, even if ameliorative action were taken on the US budget deficit. An improvement in the debt situation of developing countries projected on the assumption of a fall—or even a constancy—in interest rates should, therefore, be viewed with scepticism.

5.10 In the absence of a fall in interest rates from the current levels during the rest of the decade, the chances are that the real rates of interest on commercial debt will either equal or exceed the projected rates of growth in real export earnings of the non-oil developing countries. These are projected at less than 5.5 per cent per year for the rest of the decade, compared to about 5–7 per cent real rates of interest at present. The projected rate of growth in real export earnings for the net oil exporters, whose commercial borrowing is significant, is, in fact, less than 3 per cent per year for the rest of the decade. The rate of growth in real export earnings of the low-income countries is also projected at less than the average for non-oil developing countries as a whole. The full significance of this comparison lies in the fact that a country whose export earnings growth consistently falls behind the real rate of interest must be, realistically, treated as 'insolvent' rather than merely 'illiquid'. For a country with balanced trade, an excess of interest rate on external debt over the rate of growth in exports leads to deeper debt-servicing difficulties. But we do not start from a balanced position.

(iv) *Price of oil*

5.11 A further uncertainty is the future price of oil. The oil supply situation, however, is dependent not only on the balance between the demand for and supply of oil, arising out of normal economic growth and production trends, but also on a continuation of political stability in the few major oil-supplying countries of the world.

5.12 The impact of a change in the price of oil cannot be viewed entirely in terms of the net debt situation at the global level. A fall in the oil price would threaten the more indebted oil-exporting countries,¹ while a rise in the price would worsen the debt situation of the oil-importing countries; but the gains and losses of countries arising from a change in the price of oil are not transferable, and the strains arising from such a change may not be accommodated evenly by a redirection of the financial flows. A big change in the oil price in either direction could have disturbing consequences for the debt situation.

(v) *Continued adjustment by developing countries*

5.13 The projected improvement in the debt situation also assumes that many of the developing countries will continue to generate export surpluses, as they have started doing at the behest of the IMF. As noted in earlier chapters, the adjustment effort has entailed a severe cut in imports and in GDP; in the projections made by the IMF, the volumes of imports of the major borrowers are not expected to exceed their 1981 levels until 1987, and in respect of the net oil exporters, until 1988. In the case of Sub-Saharan Africa, adjustment is called for on top of a decade-long decline in per capita incomes.

5.14 It is clear that an adjustment effort of this order would be extremely difficult to sustain. As two observers of the Latin American situation have put it:²

In most [Latin American] countries, stabilisation plans have been sold as a short, necessary operation, soon to result in a new burst of growth. In some they are being instituted by technicians without

1. As Sir Jeremy Morse put it in evidence to the UK Parliament: 'Obviously, if there was a sharp break in the oil price that could create a secondary, at any rate, problem, perhaps at worst a crisis in the position of some of the oil countries. I think that is one danger. The other danger, of course, is recession deepening into depression, meaning that the arithmetic generally fails. I suppose those are the two which in my bank we have at the back of our minds.'

(*House of Commons Select Committee on International Monetary Arrangements*, Vol II, Q 1496.)

2. Thomas O. Enders and Richard P. Mattione, *Latin America: The Crisis of Debt and Growth*. (Washington D.C.: The Brookings Institution, 1984, p.56.)

broad political consent. When the crisis in some countries drags on with per capita incomes below 1980 levels, as they may be for much of this decade, and without credible promise of relief, it is easy to imagine resentment and frustration exploding and turning against governments when they fail to persuade the United States and other industrial countries of the need for more generous terms. Not only would the current broad but weak trend towards democracy falter, but public order and national security could also be at risk.

It is interesting, in this context, to note the projections made by the Inter-American Development Bank for Latin America, which are based on two alternative assumptions: (a) that per capita consumption remains constant; and (b) that unemployment does not rise. The projections show that the debt-service ratios of seven selected Latin American countries would continue to be above 40 per cent through the rest of the decade under the assumption of constant per capita consumption, and above 50 per cent if unemployment were not to rise further. This illustrates the difficulty of the task involved.

5.15 The projected improvement in the debt situation is thus predicated on the fulfilment of a number of crucial assumptions simultaneously. Moreover, even on this optimistic scenario, the developing countries are expected to face a rise in their debt-service ratios in the immediate future, due to the substantial rise in amortisation payments expected around 1986–87. The picture is also worrying when we look at the prospects for some individual countries or sub-groups of countries.

5.16 As we noted earlier in Chapter 3, the improvement projected in the overall debt: exports ratio does not apply to low-income countries. The IMF projects that the debt of low-income countries, excluding India and China, in relation to their export earnings will be roughly at the same level in 1990 as in 1983—i.e. at more than three times export earnings. In the meantime, it is projected that they will face a worsening in the debt-service ratio in the immediate future, in common with the rest of the non-oil developing countries. The projected interest payments ratio also shows hardly any improvement; it is expected to stay at about a tenth of their export earnings to the end of the decade.

5.17 There are some major borrowers whose debt situation is not expected to improve. Professor Cline's study, for example, indicates that the debt ratio is likely to rise in respect of seven countries out of the 21 studied. Oil exporters are particularly likely to see worsening ratios. Of the most important debtors, interest payments are projected to remain above half of export earnings to the end of the decade for Argentina, and in respect of Brazil they are projected not to fall below a fifth of export

earnings. For Mexico and Brazil, debt-service ratios through the rest of the decade are not expected to change significantly from the levels which led to debt-service payments difficulties in 1982 and 1983.

5.18 The significance of a worsening of the debt situation—or lack of a substantial improvement—even in respect of a few major borrowers is that a sense of crisis can be expected to hang around the international banking system and severely test the stamina of current ad hoc arrangements.

Forecasts of the 'Financing Gap'

5.19 We turn now to the future level and pattern of financing flows. In its optimistic scenario, the IMF, for example, projects a current account deficit of some \$63 billion by 1987 and \$86 billion by 1990 for the non-oil developing countries. If we assume that these countries will need to increase their reserves by \$12–15 billion annually, their financing needs would be in the order of some \$75 billion by 1987 and \$100 billion by 1990 (see Table 5.1).

5.20 This financing gap could be met, if we assume, as the Fund does, that in the medium term (i) official development assistance (ODA), other official flows including export credits, and the exposure of commercial banks will remain constant in real terms, and (ii) direct foreign investment will rise in real terms; and if we make the further assumption that (iii) the net use of Fund credit will be of the order of some \$8 to \$10 billion. The plausibility of such an outcome is in doubt, however. The above assumptions on financing flows imply a substantial departure from the trends in the immediate past. We shall now review the prospects for new flows individually.

(i) Official development assistance (ODA)

5.21 The background as far as ODA to developing countries is concerned is one of a fall in nominal as well as real terms between 1981 and 1983; ODA in real terms fell from \$36.5 billion in 1981 to \$33.8 billion in 1983 (at constant 1982 prices and exchange rates). Most of this fall was due to a reduction in disbursements by non-DAC countries, particularly OPEC, whose ODA has been affected by declining oil revenues and by the war between Iran and Iraq. ODA from DAC countries remained constant at about \$27½ billion in 1982 and 1983, in spite of a recovery in the GNP of these countries. As the export revenues of OPEC countries remain uncertain the prospect of a recovery in OPEC aid is not promising. Indeed, the chances are that it may further decline, with the result that total ODA flows may stagnate in spite of any possible upturn in the assistance from DAC countries.

Table 5.1: Non-Oil Developing Countries: Financing Gap, and the Financing Flows: Some Projections (\$ bn)

	1983 ^a	1984 ^c	1987	1990
I. Financing needs:				
Of which:				
(a) Current Account Deficit	62	63	75 (100) ^b	100 (120) ^b
(b) Change in Reserves	56	50	63 ^c	86 ^c
II. Financed by:				
(i) Official sources ^e				
(a) Transfers	36	37	42	47
(b) Long-term borrowing (net)	13	14	—	—
(ii) Direct investment (net) ^f	23	23	—	—
(iii) Borrowing from commercial banks (net) ^g	8	9	12	16
(iv) Use of Fund credit ^h	20	21	24	28
(v) Others ⁱ	10	7	8	10
III. Residual (Unmet Financing Gap) (I - II)	-12	-11	-7	-5
	—	—	(21) ^j	(24) ^j

Notes: ^a Actual (IMF)

^b Assumed (see text)

^c IMF projections

^d Figures assumed (see text)

^e Projected for 1987 and 1990 on the assumption that they remain constant in real terms (corresponds to IMF's assumptions)

^f Assumed to grow at 9½ per cent per year between 1984 and 1990 (corresponds to IMF's assumptions)

^g Derived by assuming that bank lending will increase at 5 per cent a year during 1985 to 1990

^h Figures for 1987 and 1990 are assumptions

ⁱ Includes, among other things, unrecorded capital outflow; this is assumed to decline by the end of the decade

^j On the assumption that the financing needs will equal \$100 billion in 1987 and \$120 billion in 1990.

5.22 ODA channelled through multilateral institutions has been declining in recent years, relative to bilateral aid. Bilateral aid, which is directed towards middle-income countries to a greater degree than multilateral aid, is being increasingly made subject to commercial and strategic interests. An implication of this is that the aid flows to low-income countries could suffer in the future.

5.23 In discussing ODA, it is necessary to stress that the issue is not merely one of quantity. ODA is primarily of concern to low-income developing countries since these countries are unable to service commercial loans on any significant scale.

(ii) *Fund credit*

5.24 As explained in Chapter 4, the Fund, with an increased scale of commitments, is in danger of running ahead of its available resources—which it has met temporarily from increased borrowing. The assumptions nevertheless imply levels of financing from the Fund at \$8 to \$10 billion (net) per year over the next few years. This, it should be stressed, is considerably higher than in the past and more than the Fund's present resources could sustain.

(iii) *Export credits*

5.25 A major component of official financing is guaranteed export credit (medium- and long-term). Yet this source of finance has also fallen. According to the OECD, total medium-term export credit fell in 1982, the first year of the debt crisis, to \$33.8 billion from \$36.1 billion in 1981, with a particularly sharp cutback for the 'least developed' countries (by 40 per cent over a two-year period). These reductions partly reflect reduced demand in developing countries, faced with the need to cut back on imports. But a further factor is the refusal of export credit agencies to maintain guarantee cover for seriously indebted countries.

5.26 The prospects for increased export credit availability are adversely affected by the current difficulties of the export credit agencies consequent upon the debt crisis and the downturn in world trade. For example, the British ECGD, which covers 35 per cent of UK exports, has three-quarters of its exposure in the two riskiest categories of four. Claims on ECGD virtually doubled between 1981/82 and 1982/83. The response has been to place countries with debt problems 'off cover' until creditworthiness is established. In addition, premia have been raised substantially (by 50 per cent in the two riskiest categories), and this, combined with the effect of an agreement to reduce the subsidy element in lending, has pushed up borrowing costs. The Japanese agency has restricted or suspended cover to 60 countries; and premia were recently increased by 20 per cent. The West German Hermes agency made heavy

premia increases in April 1984. The cumulative effect has been to cut export credit availability overall, to raise the price, and to remove from cover those highly indebted countries in greatest need of external financing.

(iv) *Foreign investment*

5.27 Net direct investment in all developing countries from industrial countries rose by an estimated 6 per cent annually in real terms during the period 1970–82, though there was a sharp drop in direct investment from 1981 to 1983. The IMF hopes, and projects, that there will be a considerable revival and that it will increase at a real rate of some 4–5 per cent per year during the rest of the decade. Indeed, industrial countries in general attach great importance to increased direct investment flows.

5.28 There is, however, considerable danger in creating exaggerated expectations of what is possible. The experience of the last few years has been one of cutbacks in direct investment in developing countries from \$15.4 billion in 1981 to \$11 billion in 1983 according to UNCTAD (\$13.9 billion to \$10.9 billion according to the IMF). The main reason is that direct investment is deterred by low growth, and this is likely to continue for some time in most of the heavily indebted countries. Moreover, foreign investment is unlikely to play a major role in poorer developing countries which lack strong domestic markets and well developed infrastructures. It is more likely to follow directions already favoured by commercial lenders, notably to the Far East. The experience of countries which have radically altered their foreign investment policies in favour of overseas companies suggests that, while foreign companies welcome incentives and guarantees, they are slow to respond on any substantial scale. The deflationary policies currently pursued by the debtor countries imply a contraction of domestic markets, providing little incentive for fresh investment including foreign investment. Moreover, while equity financing has the advantage of locating risk in the investor rather than the capital-importing country, it is not necessarily a cheap form of financing—as might become clearly apparent if real interest rates on borrowed capital fall back to more normal levels. Thus, while direct investment could become a factor of major importance—within a five to ten year time horizon—it is unlikely to be so in the next few years when growth could be slow, erratic and heavily skewed toward countries without debt problems.

(v) *Bank lending*

5.29 Very little new bank lending is taking place at present. Net bank lending has declined sharply since 1981; in 1983–84 it is less than one-third of the peak reached in 1981. Moreover, a significant portion of

even this reduced flow is involuntary. The banks' own current assessments are that under present conditions they are unlikely to increase exposure to developing countries over the next few years by, at best, more than 5 per cent a year in nominal terms. There are several reasons over and above the perception of major debtors as risky borrowers for the general switch from international to domestic lending, especially in the United States: the absence of new banking institutions willing to be drawn in—like OPEC and Japanese bankers some years ago—to international lending; the pressure of bank supervision and regulation. Our assessment is that without a greater element of official support there is no way in which a substantial increase in flows will be forthcoming from the banks.

(vi) *Other commercial lending*

5.30 It is possible that new forms of commercial lending could arise replacing bank lending and involving other financial institutions not so heavily exposed as the banks. One source is bond finance. Overall, in 1983, bonds overtook commercial bank lending in importance in international capital markets but developing countries remain peripheral (\$2.5 billion out of \$76 billion in 1983), and lending is largely restricted to 'low risk' economies which have little difficulty raising bank credits (for example, Malaysia, South Korea, Thailand). Without government guarantees it seems unlikely that bank financing or other types of non-bank commercial lending will provide new flows on any scale.

The Overall Picture

5.31 The prospects for financial flows, then, do not suggest that the financing needs of the non-oil developing countries can be met, even if their current account deficits remain at a restrained level. But the current account deficits of these countries would be large if many of them were not to run trade surpluses. We believe that their annual financing needs could be at least \$20–25 billion larger through the rest of the decade, were they not to run trade surpluses—which implies that their total financing needs might be in the order of some \$100 billion by 1987 and \$120 billion by 1990. At such levels of need for financial flows, even under optimistic assumptions for ODA, bank lending, direct investment, and use of Fund credit, a gap of some \$20–25 billion per year arises for which there is no obvious source of financing. If the above assumptions were to prove to be unrealistic, and if, in addition, the industrial country growth were to falter and interest rates fail to decline, the gap would be much larger.

5.32 It follows from the above that unless action is taken to supplement official flows and support private flows at a higher level, developing countries will not be able to resume even modest growth for the rest of the decade and the servicing of debt will, in all probability, be unsustain-

able. It is also important that the composition of the financial flows should be right—for an expansion in commercial flows alone would not be of great benefit to low-income countries which are not in a position to bear the high costs of them. From their point of view, there is a need for an expansion in official flows as well.