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EXTERNAL DEBT CRISIS AND DEVELOPMENT

Letter dated 20 September 1990 from the Permanent Representative of Yugoslavia to the United Nations addressed to the Secretary-General

I have the honour to transmit herewith the report on debt and development in the 1990s of the Round Table on Debt and Development, held at Sveti Stefan, Yugoslavia, on 28 and 29 June 1990. It is my belief that the document may be of value in the course of the discussion of the issue of debt at the forthcoming forty-fifth regular session of the United Nations General Assembly.

I should be grateful if you would have the text of the document (see annex) circulated as a document of the General Assembly, under agenda item 83.

(Signed) Darko SILOVIC
Ambassador

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ANNEX

DEBT AND DEVELOPMENT
IN THE 1990s

REPORT OF TM INTERNATIONAL GROUP

OF INDEPENDENT EXPERTS

WORLD SCIENTIFIC BANKING MEETING

B E O G R A D

25 JUNE 1990

Contents

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troduction

1. The International Group of Independent Experts was established in response to the proposal of tho II: World Scientific Banking Meeting, held in Dubrovnik, Yugoslavia, on 7-10 June 1989, "to investigate possible measures to meet the requirements for resumption of growth and financial stabilization over the next six years or so, and their implications for international debt policy", *(Concluding* Ytatement by the Chairmen.)

2. The Group met in Tokyo on 15-17 April 1990 and in Beograd on 23-24 June 1990, chaired by Dr. Katuo TAKAHASHI, the Programme Director of the Sasakawa Peace Foundation. It submits this report to the Round Table on Regaining and Further Enhancing Development Momentum in the Context of Rapid Global Change, to be held in Sveti Stefan, Yugoslavia, under the auspices of the World Scientific Banking Meeting Permanent Secretariat, Peograd and European Center for Peace and Development, Beograd, and with the assistance of the United Nations Development Programme and the Yugoslav Federal Government.

3. The report consists of the following sectionor

(a) a review of the present debt and development situation in debtor countries;

(b) major challenges in the 1990s and policy reforms in developing countries;

(c) an assessment of international debt policy;

(d) need for an analytical framework: for the solution of the debt problem;

(e) reflections on implementation of international debt policy;

(f) overcrowding of financial markets and need for an interim debt arrangement:

(g) aid and trade policies!

(hi references; and

(i) list of experts.

I Present debt and development situation

Continuing perverse resource transfers

4. At the Dubrovnik June 1989 meeting , "there was an apprehension that over the near and medium term, the position of many debtor countries would remain es tremsl y serious". This apprehension was justified . The adverse resource transfer on loan account from developing countries -- the excess of their debt service payments over 1 oan recei pts (disbursements) -- is now higher than ever: US $ 52 billion from all developing countries, of which 32 billion from the severely indebted countries, estimated for 1989 (Table 1). The cumulative total of this "net resource transf er i n the wrong direction" in the phrase of Dr.Karl Otto Poehl, President of the Bundesbank 1/, moving from the severely indebted middle income countries, ham now reached us $ 185 billion during 1982-89, a staggering mum on any reckoning. A particularly disturbing development in 1988 was that even the 1 ow income severel y indebted countries, mostly in Africa, experienced a negative resource transfer on loan account.

Table 1. Debt-Related Net Flows and Transfers, 1980-89
(US$ billions)

Country group	1980	1981	1982	1983	1984	1985	1986	1987	1988 a	1989 b
Net flows c										
All developing countries d	66.5	84.0	74.5	62.3	47.5	33.5	26.6	21.9	20.1	25.6
Severely indebted	35.1	50.4	41.6	29.2	21.8	7.5	9.0	13.9	8.6	11.1
Low income	5.9	7.0	6.8	5.7	3.4	0.7	3.6	3.9	2.4	3.8
Middle income	29.1	43.4	34.8	23.5	18.4	6.8	5.4	10.0	6.3	7.2
Moderately indebted	15.4	14.9	14.7	15.3	11.8	13.1	12.5	10.1	6.3	10.4
Low income	3.9	4.7	6.0	6.2	4.2	3.3	4.3	5.5	4.4	4.5
Middle income	11.5	10.2	8.7	9.0	7.5	9.8	8.2	4.6	1.8	5.9
Net transfers c										
All developing countries d	19.6	22.7	6.4	-2.4	-21.9	-36.2	-38.2	-40.3	-52.0	-51.6
Severely indebted	5.3					-33.9	-26.3		-31.3	-31.7
Low income	3.7	14.4	4.3	3.0	0.2	-2.4	1.3	1.9	-0.5	1.0
Middle income	1.7	6.8	-6.3	-14.1	-20.1	-31.4	-27.7	-21.6	-30.8	-32.6
Moderately indebted	6.3	3.2	2.0	2.6	-2.6	-1.0	-2.8	1.0	-11.0	-8.1
Low income	1.9	2.4	3.3	3.4	0.8	-0.1	0.4	-6.6	-1(-0.3	-0.7
Middle income	4.4	0.8	-1.3	-0.8	-3.5	-0.8	-3.1			-7.3

a. Estimates.
b. Preliminary estimates.
c. Flows and transfers on account of all debt.
d. DRS countr tea.

Source: DRS. (Debt Reporting System) of the World Bank, in World Debt Tables 1989-1990, Volume 1, Analysis and Summary Tabl es, December 1909, page 9.

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Decline in commodity prices

5. The difficult situation in financial transfers was aggravated by a renewed weakness of commodity prices -- they fell 12% between March 1999 and March 1990. 2/ Broadly, the commodity slump has now been with us since 1980. In the judgment of the United Nations Secretariat, "if commodity prices, including oil, had remained at their 1980 levels throughout the decade, it is likely that the debt crisis would have been averted". 3/

6. In 1989, coffee and cocoa, two key export commodities of developing countries, suffered major declines. Coffee, their second largest commodity export after petroleum, collapsed due to a breakdown of the International Coffee Agreement, hopefully temporarily. Cocoa collapsed because of excessive production, caused by a boom in planting in the early and mid-1980s, partly encouraged by international lenders financing the adjustment programmes. The effects on West Africa, a major producer, have been catastrophic; this is the second time in the last 25 years that this region is experiencing an economic, social and political upheaval due to a massive fall in commodity markets.

International interest rates

7. International interest rates are gradually moving upwards, this time under the influence of an upward shift in the formerly low-rate financial centere in West Germany, Japan and Switzerland. The Swiss rates are now at the same level as in the United States, the high-rate area since the late 1970s: 8 1/2% for a one-year certificate of deposit as of early May 1990, a development in Switzerland which would have been considered unbelievable only two years ago. The effects on the debtor countries can be catastrophic: it has been estimated that each one percentage point increase in international interest rates means extra interest payments by these countries of US $ 3-4 billion dollars per year. This affects particularly the middle-income debtors which have borrowed heavily on a floating-rate basis.

Decline in domestic investment

8. In the two main debtor regions, Latin America and Sub-Saharan Africa, the rate of investment has fallen by one-quarter to one-third between the early 1980s and 1988,

with no indication of recovery in 1989-90. The investment decl ine has been caused by several factors operating wrth different force in different countries: massi ve outward transfer of resources reducing the aggregate pool of savings available for investment, reductioin in public investment due to budgetary crises and short-term policies of adjustment, reduction of private investment due to increases in interest rates (the real rate3 in some developing countries exceed easily 30 percent per year, making any investment pr-ohibitive) and depressed demand in the process o f adjustment. The decline of investment of the estimated maqni tude (Table 2) may have occurred in the past only during the Great Depression of the 1930s in the industrialized countries.

Table 2. Investment-to GDP Ratios, Selected Low and Middle-income Regions. 80-88

	1980	1981	1982	1983	1984	1985	1986	1987	1988 a/
Sub-Saharaa Africa	20.8	20.8	17.6	14.9	11.5	12.5	14.6	15.8	14.1
Latin America and Caribbean	24.2	23.6	21.4	16.9	16.7	17.5	17.4	18.2	15.7
Europe, Middle Eaat and North Africa	27.8	27.7	27.0	29.0	28.3	26.8	26.9	25.9	25.8

a) Preliminary estimates.

Source: The World Bank, Annual Report 1989, page 27.

9. "The fall in investment has been so severe that some countries may not even have been fully replacing depreciating capital. In Africa, the minimum investment needed to replace depreciated capital is estimated at 13 percent of GDP, and seven Sub-Saharan countries had investment rates below that level in 1997. Similarly, the minimum investment rate to replace capital in Latin America is estimated at 14 percent, and three countries were below that level in 1987". 4/ The situaition probably worsened in 1988 and 1989. In additiion to adverse impact this trend has on the economic and social conditions of these countries, it hae aggravated thsi r environmental situation significantly.

Stagnation and decline in real income

10. Per capita income in Sub-Saharan Africa and Latin America fell in most years since 1980, at least partly as a result of forces described above. The same occurred in most major debtor countries in other regions -- in North Africa and Southern and Eastern Europe, and in the Far East (Table 3).

Table 3. Growth of GDP and GDP per Capita 1981-86 in Selected Low and Middle-w Regions (average annual percentage change)

	GDP			GDP per caoita		
	1981-86	1987	1988 a/	1981-86	1987	1988 a/
Sub-Saharaa Africa	0.4	-1.4	3.0	-2.6	-4.5	-0.4
Latin America and Caribbean	1.4	2.7	1.4	-0.7	-0.6	-0.6
Europe, Middle East and North Africa	3.3	1.6	2.5	1.1	-0.5	0.3

a) Preliminary estimates.

Source: The World Bank, Annual Report 1989, page 25.

11. Stagnation and decline have affected the lower income groups with a particular force. Real wages have fallen drastically in many countries: in Africa, on the average, they fell by 50 to 60 percent between the mid-1970s and late 1980s. 5/ Unemployment and underemployment have increased almost everywhere. Adjustment programmes have not helped:

> "There was very limited attention in the first group of structural adjustment loans to the social implications of adjustment.. . ". 6/ "As the decade of the 1980s progressed, the impact of stabilization and certain types of structural adjustment on the most vulnerable and disadvantaged socioeconomic groups became an important concern". 7/ . . . "Adjustment-induced growth is proving to be a far-off achievement, and trickle-down has not reached the poor adequately. Because of the weight of human suffering we cannot simply sit back and wait for growth and adjustment to occur." 8/

Considerable attention is now paid to poverty prablems in adjustment programmes; but their effects inevitably will be limited unless there is resumption of economic growth, an increaese in employment, and fairness in income distribution.

II Major challenges in the 1990s

Tasks ahead

12. Three key tasks are facing the debtor countries in the 1990s: resumption of economic growth, alleviation of puverty, and financial stabilization.

13. Resumption of economic growth is not possible without an increase in efficient investment producing tradeables. Alleviation of poverty calls for recovery of pub: it expenditures on social services and welfare, in addition to rising employment and improved real wages. Financial stabilization calls for reconstruction of fiscal systems in many countries, fur reduction of interest payments on public debt, and fur reduction of armament spending.

Policy reforms in developing countries

14. In recent years, there have been significant changes in the institutional framework in developing countries. While the basis is still fragile, an increasing number of these countries are moving toward pluralistic democracy. This shift was noticeable in most Latin American countries in the 1980s, and is taking place in a number of African countries now.

15. Since the beginning of the debt crisis, and in some cases and same sectors even before, the developing countries have made substantial progress in econumic reforms in three critical areas: 9/

(a) Economic (incentive) product pricing is becoming a rule in most developing countries. Major price distortions have been removed and prices essentially decontrolled in energy, agriculture and industry. Exceptions still exist, but the general policy and trend have been in the direction of incentive pricing.

(b) Priority is now giver. to export development almost everywhere, particularly in diversified fields. This has involved devaluations in most cases, and duty-free imports of inputs for export production and other incentives in many. There is virtually no developing country today where the critical importance for growth of increased foreign exchange earnings has not been recognized. Most countries have also adopted measures to attract direct foreign investment.

(c) Fiscal discipline is now recognized as being of major importance for orderly economic growth and avoidance of balance of payments crises. In Latin America, "the transformation of attitudes towards fiscal discipline has been profound. There are still lively debates as to how the phrase 'fiscal discipline' should be interpreted and there are still political arqumento about who ohould bear the burden of fiscal consolidation, but, in sharp contrast to the position a decade ago, the importance of ffocal discioline is now widely accepted. Al thouqh most countries need further consolidation and a few have not yet started the process, a great deal has already been achieved". 10/ The World Bank, reporting on the developments in 23 countries implementing Bank-supported proqrammee ("early-intensive-adjustment-lending-countries"), calculated that their fiscal deficits as a proportion of GDP fell from 7.6% in 1981-82 to 4.6% in 1985-88. This group consists of 7 countries in Latin America, 13 in Africa, 4 in Asia and 1 in Europe. 11/ Fiscal improvement has boon widespread rather than limited to one qeoqraphic region.

A major obstacle to -Further curtailment of the budget deficit are interest payments. In 17 highly indebted countries, interest payments on external debt amounted to 4.3% uf GNP in 1988. 12/ In addition, there are interest payments on internal public debt, which are formidable in some Cases.

Inflation and the need for resource inflow and resumption of growth

16. Most dobtor countries have not bssn successful in another major reform: elimination of inflation. Especially

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for this poor, it i a crucially important to contain inflation. The latter accelaratsd through 1989, particularly in Europe and Latin America, al though devel opments in 1990 may be more favorable if the on-going stabilization efforts in several major countr i es prove successful.

Table 4. Consumer prices in developing countries 1985-89, average annual percentage change

	1985	1986	1987	1988	1989
Develoorng countries	35.8	26.6	35.3	59.3	86.3
Africa	11.9	12.2	12.6	18.9	...
Asia	8.0	5.6	7.4	11.8	10.2
Europe	26.6	27.0	41.2	80.1	[illegible]
Middle East	14.0	11.8	...	...	...
Western Hemisphere	37.7	82.3	116.1	218.0	350.0

Source: IMF Memorandum, 7 May 1990.

17. In part, the lack of success in combating rnflation has been due to the multiplicity of objectives and problems o f timing and sequencing in economic adjustment proqr ammes. Correction of fiscal deficit has sometime been done through increases i n indirect taxes ‘instead of raising and collecting profit and land taxes) and thue in product prices. Remaining fiscal deficits were largely f inanced b y resorting to the inflation tax, since foreign finance waa no longer easily available. Conflicts between stabilization and adjustment policies may also arise from davaluatione that are required to improve the country's competitive positron in the world market. In the short run, however, generation of external surpluses has drained qoode from the domestic market and fuelled inflation bv higher import prices. Al1 this mitigated against price stabilization. The latter calls for an inflow of resources, parallel with the restoration o f a sound fiscal system and exchange rate stabilization. The job of reconstruction of the monetary system remains to be done in many developing countries, and t h i s is hardly possible without the solution of the debt problem. The same holds for the resumption of investment in debtor countries -- a fundamental condition for resumption of economic growth.

Eastern Europe in transition and debt challenge

19. An expansion in external trade and financial relationships is likely to result from reforms in Eastern Europe. The initial impact of these reformatory changes on the financial position of some countries has been negative, however, and a further worsening may be inevitable before any improvement occurs. Eastern European countries will need a sizeable resource inflow over the medium term. Some are facing many of the same problems as other middle-income heavily indebted countries, however under more complex circumstances. Unemployment and drastic price increases are emerging as key immediate issues, and they have to be handled while at the same time formulating and executing institutional reforms and, in some cases, finding solutions to an acute debt problem.

19. A widely debated problem is the advisability of using debt-equity swaps. It is believed that this technique can be useful for some Eastern European countries too, however rather as a tool to attract foreign investment then as a debt reduction instrument. Other debt reduction techniques, if available, should be used first because they generally allow the debtor country to capture a substantially larger part of the secondary market discount than in the case of debt-to-equity swaps which leave the main part of this discount in the hands of the investor. That is why all the countries having already negotiated officially supported debt reductions suspended debt-to-equity swap programs till the conclusion of the agreement. If, however, such a comprehensive agreement were not to be reached in foreseeable future, it may be advisable to admit debt-to-equity swaps at an early stage in suitable cases.

III International debt policy

Recent evolution

20. Two changes in international debt policy during the last twenty four months have opened a new phase of major potential significance. The 1988 Toronto Summit decision opened the door for reduction of principal or interest on bilateral official debt of poor countries, mostly African. The 1989 adoption of the Brady plan, which followed the earlier French and Japanese initiatives, opened the door for reduction of debts of middle-income countries, owed to commercial banks. Both actions have been slow in

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implementation, and the results so far and current estimates have been disappointing; in the case of the Brady plan, this was partly due to the likelihood that both debtors and private creditors continue to be engaged in bargaining on a better deal in transferring risks and losses to the public (wait - and - see attitudes). And both the Toronto and the Brady initiatives have left areas not covered, such as debts to official creditors of middle-income countries and debts to commercial banks of low-income countries, But the principle of debt reorganization, including scaling it down and/or reducing the rate of interest, now have been recognized.

Toronto decision: low income countries' debts

21. "Twelve Sub-Saharan African countries have rescheduled debts at the Paris Club (official creditors) under Toronto terms. The short-term cash flow benefit is relatively small. The estimated savings on interest payments for these countries amounts to US $ 50 million in 1989, or 2 percent of their total debt service falling due in that year..."13/

22. "Some progress also has been made in the forgiveness of bilateral development assistance loans. It is estimated that if all the new forgiveness plans announced by individual creditors are fully implemented, the reduction in the stock of Sub-Saharan debt would amount to US $ 5 to 6 billion, or 8% of their outstanding debt in 1989. Again, the cash flow relief from these measures is not likely to be large...".13/

23. Even though every cent counts, in Africa and elsewhere, the above reductions in aggregate interest payments and in debt outstanding must be considered only a marginal contribution to Africa's debt problem. Toronto decisions apply to a very mall part of aggregate debt service: most of the latter is owed to private banks and international institutions, and they are not covered by the Turonto decisions.

24. Proposals have been made to recycle a part of African debt service to financing intra-African trade and investment, thus promoting regional integration. This is an important objective, and a specific scheme should be elaborated by African institutions as soon as possible and submitted to African creditors. Such a scheme should be accompanied by an in-depth analysis of the factors that caused the failure of previous integration attempts.

Brady plan: middle income countries debts

25. As of 11 April 1990, three debtor countries have reached agreements with creditor banks under the Brady plan; Mexico, Philippines and Costa Rica. It is reported that additional two -- Venezuela and Marocco - have reached agreements with banks in principle. In a partial arrangement, Chile had borrowed from the Bretton Woods institutions for a buy-back from banks of a fraction of its debt. These six actual and potential beneficiaries over one year of implementation compare with an estimate of 39 beneficiaries over three years, made when the plan was launched, in March 1989. The World Bank is now estimating that with the total of US $ 30-35 billion available for financing the plan, "total debt and debt service relief would amount to US $ 4 billion annually", 14/ or under 19% of the debt service obligations (amortization and interest) of the severely indebted middle income countries of US $ 66,886 million projected for 1989. 15/ To put these numbers in perspective, World Bank staff adds: "A two percentage-point increase in international interest rates would completely wipe out the maximum amount of debt and debt service reduction that can be achieved under the new strategy, while leaving the borrowing countries with the additional debt burden of 30 to 35 billion dollars resulting from loans in support of debt and debt service reduction operations". 16/ It thus would seem that the US $ 4 billion annual interest savings is a gross rather than a net figure; net figure would be only slightly above US $ 3 billion per year, or 5% of current debt service of severely indebted middle income countries. Either 3 or 6 billion dollars savings per year is not a negligible figure by any means. But as in Toronto decisions, spread over a large number of countries, these savings are marginal in relation to the size of the aggregate burden.

26. Several major points have been made recently concerning the experience in the implementation of the plan:

(a) Commercial banks have practically stopped new lending. Creditors which have decided to take a loss on their outstanding loans are unwilling to increase their loans. 17/ However, banks have stopped voluntary lending to most of these countries already before the implementation of the Brady plan.

(b) Countries whose debts are owed mostly to international institutions and bilateral public creditors cannot benefit from the plan, and these debts are substantial in a number of cases. 18/

(c) International institutions have financed debt reduction which is not deep enough. Hence too many public resources have been absorbed in too small improvement of creditworthiness. 19/

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(d) Much greater emphasis ehould be placed on reduction of debt service payments in the near future rather than on long-term debt reduction; "the need is For net reduction in net transfer today". 20/

(e) "The resources provided under the Brady plan are insufficient to support on a adequate scale debt relief arrived at through voluntary negotiations in which creditors can choose whether to participate or not, , . <But> more resources to support debt relief may make the banks more optimistic about the prospects of the debtor countries and so more inclined to cling to their claims instead of conceding debt relief. At the very least, more banks are likely to try free riding..." 21/ "None of the <debt> initiatives <IMF-designed stabilization plans, Baker plan, Brady plan> have worked <because> public resources have never been sufficient and making them larger, in the context where the banks could choose whether to Join in, would be rather 1 ike a dog chasing its own tail". 22/

(f) "The program appears unlikely to produce definitive debt settlements in most cases and may in fact create a new set of uncertainties about future debt management and official private burdensharing". 23/ This statement by the World Bank management appears to reflect the fear that debt reduction does not go far enough, that private sector will not lend in the future, and that the Bank wi 11 be loft holding tho bag.

IV Need for an analytical framework

27. Two basic flaws have existed in the approach to the debt problem since the beginning of the crisis:

(a) No detailed estimates appear to have been made, on a country-by-country basis, of the cnpi tal requirements for overcoming the crisis and restoring a satisfactory rate of growth over the medium term; or if such estimates have been made, they do not appear to have been used in putting forward the past international overal1 debt policies.

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(b) No attempt seems to have been made to examine the prospects for long-run debt servicing capacity, on a country-by-country basis, and determine the extent of debt relief or of cash-flow rearrangement accordingly. There has been general talk of "debt overhang", with no clear and argued specific analyses of the size and assumptions.

Missing estimates of capital requirements and related issues

28. Several prominent analysts have drawn attention to the analytical empty space:

(a) "The Bank and Fund have not received a mandate to work out the implications for the debtor countries of resuming the growth process which North and South both agree is an indispensable objective for growing out of the debt crisis. This in turn means that the capital requirements for adjustment with growth in the debtor countries as a whole have not been studied by the Bretton Woods institutions, let alone agreed upon by the international community. The rate of growth of the debtor countries emerges as a residual, a by-product of the feasible rate of *borrowing* . . . The figures for debt relief or debt reduction currently discussed are based more on some kind of guess as to political feasibility than on any scientific analysis of the data. In the absence of such an investigation, the debt strategy will continue to be an improvised affair in which the solutions proposed tend to amount to the minimum steps necessary to keep things going instead of being a reasonable approximation to growth requirements... The capital exporters obviously have the right to take their own positions on the capital to be provided both overall and to individual countries. But they should at least be in possession of independently determined facts and analyses." 24/

"The prospect is for South-North net transfers to be maintained almost indefinitely at a level of US $ 45-55 billion annually with an accompanying build-up of debt due to arrears. If this situation is to be turned around, which it must, creditor governments (and banks) must first adopt targets for reduction in negative net transfers and then compute: (a) what levels of relief are necessary to achieve reductions of the targeted magnitudes; (b) how such relief might be shared among bilateral, multilateral and private creditors; and (c) what levels of new lending are necessary to accompany debt relief to achieve net transfer reduction targets.

At present the process works in reverse with constraints on debt relief and new money determining levels of net transfer for individual countries and for the Third World as a whole. As long as the process keeps working in this fashion there is virtually no prospect in sight for a reversal to a more sensible situation from the viewpoint of debtor countries and global welfare." 25/

"Advising on policies is nothing new for international financial institutions, since they have been doing thim for years. Advising on debt relief, however, will require some change in their approach. In the past, thry have tended to work within the framework of what external resources they thought might be available rather than in terms of what were necessary to permit economic reform and make it politically palatable." 26/

"Designing a genuine credible adjustment-with-growth-and-equity package for a given LDC cannot be achieved in a routine, stylized fashion we have become accustomed to in recent years... What is needed instead is a full-fledged review of the specific characteristics of each of the major countries in question and an assessment of its position along the growth path. This assessment would be followed by a determination of the country's potential for reentering the international capital market within five to ten years, the actions needed to get there, and the preferred sequence of these actions. In other words, we need to fashion genuine structural change packages... together wrth an estimation of the additional financial resources... needed to facilitate the adoption of these packages from a political point of view." 27/

29. Difficulties of making capital requirements estimates should not be under-estimated, and they are well known. The required net resource inflow depends on a vamt bundle of internal and external factors. It is crucially important to prn-point the underlying assumptions of any projection and critically discuss whether they are reasonable. As far as economic policies of debtor countries are concerned, capital requirement calculation must be based on the best available economic policy set to contain moral hazard problems. Also,

our knowledge on the effects of internal adjustement measures and external shocks on capital requirements is limited. These limitations do not mean, however, that financial requirements estimates should not be done, as they are indispensable for decision-making; they mean that care should he taken in making them.

Missing analyses af debt servicing capacity

30, The extent *of* debt relief is now determined by bargaining between the banwm as a group and individual debtors in case of debts to banks; and by the decision of creditor qovernmontm in case of official loans. The market price of debt serves am one of the elements in determining the scaling down debts to banks; but the World Bank notes that "in actual negotiatioins, the secondary market price... might not be a good predictor of the terms of <debt reduction> transactions because the secondary markets are relatively thin, and demand and supply may be influenced by agents wrth shrewd behaviour on either aide, raising ths issue of moral hazard. Moreover, it may only be possible to nogotiate large-scale transactions by offering a premium over the secondary price". 28/ A comment on present practice suggests "injection of much-needed economics into the negotiations and use of much <analytically derived> estimates as a starting point for guided bargaining on the extent and form of debt reduction". 29/

31. In came of good long run growth prospects, the cash flow problem over the ahort and medium term may be resolved through postponement of amortization (repayment of principal), and partial or total capitalization of interest and payment in local currency for a temporary period. In cases of poor long run prospects, in addition to some of theme measures a reduction in the rate of interest is needed, the extent of the reduction depending on growth expectations. What needs to be avoided is a "viciously growing debt" -- debt growth continuously faster than product. 30/

32. The assumption concerning the future rate of interest plays a major role in determining the "debt overhang" and hence the needed debt relief. (If interest rates were to fall anywhere near their historical real level, much if not all of the "overhang" of middle income countries would disappear.) In thr 3 respect, contingency provisions can be made to allow for future changes. Capitalized interest can be wrrtten off in parr in case an assumud decline in the internatioinal rate of interest dons not take place. Concerning unexpected development3 in export prices and natural resource discovery, a contingency provision can allow for changes in either direction of the obligations of the debtor.

33. Modalities of debt relief would vary from case to case, taking into account the practice which has been developed already and the numerous proposal-3 which have been made. "A strength of the Brady plan is precisely its flexibility in adapting to the various mixes that are necessary". 31/

34. The coverage of debt where either a cash flow rearrangement or debt relief is proposed will vary from case to case. In principle it would cover all debts. However, it would not make much sense to apply rel ief or cash flow raarranyement vis-a-vis creditors which continue to grant new loans in excess of debt service. i-his is particularly the case with international institutions.

V <u>Mechanism of implementation</u>

35. Two possibilities were considered by the Group of Exports for the implementation of the analytical framework:

(a) Establish a Debt Restructuring Advisory Committee to serve as an "impartial debt mediator" which would prepare an official estimate of adequate debt reduction, based on the calculations of the IMF and the World Bank, to serve as a starting point in creditor-debtor negotiations; act as an honest broker in negotiations between the debtors and the creditors; and use its good offices to persuade the top leadership of the debtor countrioe to adopt and sustain "sensible" pol icy measures. Committee members can be chosen from major creditor governments, the IMF, World Bank, the regional development banks and independent development experts from developing countries. The Committee can draw on otaf f resources of the member internatioinal inotitutiono.

(b) Establish independent teams of experts for each debtor country that want8 them, headed by a prominent person in finance, ● conomicm or political life, to work out proposals for restoration of economic growth, suitable debt reorganization, and domestic measures to support them. These teams would draw on all sources of information and advice, including the IMF and the World Bank, but it is the teams which would be responsible for all calculations and proposals. 32/ It would be up to the debtor and the creditors whether to accept the proposals. Past

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> successful precedents for this procedure are the German and the Indonesian debt settlements of 1953 and 1970, respectivelyi both were prep ared and neqotrated by a well known German banker, Mr. Hermann Abs. The German settlement reduced its oblrgations by some 74%. 33/

35. Two prominent persons, skeptical of the possibilities of an agreed joint creditor-debtor solution, at least with respect to middle income countri es, have suqgeeted an unilateral decision of the debtors on the amount of debt relief, exercised in a conciliatory manner, and within a framework of a responsible domestic policy perhaps agreed with the Fund and the World Bank. According to Dr Knox, "there is no international mechanism to impose a sol ution on both credi tore and debtors. Unpalatable as this is to the creditors, the time has come to face the fact that the international debt problem, if it is to be solved at all, will be solved by uni lateral action of the debtors. Unilateral action has the advantage that it avoi da the two problems that have bedevilled every attempt so far to bring about sufficient debt relief through the voluntary consent of the credi tors: the free rider problem and the unwi 11 inqness of creditor country governments to put up the resources necessary to 'buy' consent on a sufficient scale". 34/ Professor Luiz Car los Bresser Pereira, former Finance Minister of Brazil, stresses that the Brady plan, a great conceptual step forward in recognitinq the need for debt reduction, will not solve the debt problem, because the plan is underfunded and it is unlikely that more public resources will be devoted to it, while its gradual, market-control led approach requires much more funds. On the other hand, the present widespread "undeclared moratoria" 35/ are very damaging as they introduce much uncertainty in debtor countries , accelerate their inflationary expectat ions and discourage investment. Hence an unilateral OF 'quasiunilateral' decision of debtors to reduce debt is needed, as a part of larger stabilization programs. according to professor Bresser Pereira. "We say quasiunilateral deci si on because the decision does not need to be fully unilateral. Negotiations will necessarily take place between the debtor and the creditor banks. It would be desirable that the stabilization plan would be undertaken under the supervision of IMF. The structural reform should have the orientation or the participation of the World Bank. But the debt reduction would have a basically unilateral character as long as the qovernment of the debtor country would Inform the credi tar banks -- including the banks of the Paris Club 36/ -- that it would only be able to pay the banks that agreed to reduce the debt and to extend it for around thirty years." 37/

'JI. Overcrowding of financial markets and need for an interim debt arrangement

37. A major change is taking place in the global financial system. In recent years, the major surplus saving economies have been Japan and the Federal Republic of Germany, whereas the largest absorber of capital has been the United State-a. The demand for German savings is now increasing snarp1y because of the unification of Germany and apecial consideration given to Eastern European countriee. The investment of Japan in East and Southeast Asian countries will increase due to improvement in their investment climate. Thus the surplus ravings flow available in the Federal Republic of Germany and in Japan for investment elsewhere will tend to decrease. In addition, there has been a general downward trend in savings in the world economy in recent years.

38. On the demand side of capital, there is likely to be an increase. It seems that the United States will continue to require high levels of external capital in the near future. While the requirements of the official flows to East European countries have been estimated at around US $ 25 billion in the coming three years, the unknown levels of the requirements of the Soviet Union may become an important factor in the coming period. Private flows to these countries are likely to be limited in the immediate future.

39. Putting the supply side and the demand side together, the financial system is entering a period when the scarcity of funds will probably be the predominant feature, thus pushing upwards the rates of interest in the near future. While financial markets frequently reveal many surprises, it is now more prudent than ever before for debt policy makers and managers to analyse the issues involved in capital requirements and debt servicing capacity of individual debtor countries in the coming period.

40. In view of the likely overcrowding of demand in financial markets and corresponding difficulties which highly indebted countries are likely to encounter in mobilizing external resources in the near future, and the time it will take to prepare and agree on a lasting solution to the debt and resource problems, consideration should he given to an interim bridqing arrangement which would include:

(a) postponement of amortization;

(b) payment of interest in three fractions:

(i) in foreign exchange at, say, 2% of outstanding debt -- the historical real rate of interest;

(ii) in local currency of the debtor, say, 3-4%, with protection of value during the period of inconvertibility. These funds should be devoted mostly to export oriented activities. For that purpose, export oriented companies may be established as joint ventures of domestic and foreign capital to be operated on a profitable basis. The interest payments through the debtor countries' exports would be eventually received by creditor banks;

(iii) the balance of interest, say 3-4%, will be capitalized into new loans payable in foreign exchange.

This scheme would not apply to concessionary debts and to trade credits. Also exempted would be those creditors whose disbursements exceed a country's debt service. Appropriate adjustment would be made in cases of partial coverage of debt service by disbursements. 38/

VII Aid and trade policies

Aid policies

41. Aid flows of whatever magnitude cannot be a substitute for sound macroeconomic management and appropriate incentive systems in the recipient countries. The focus of aid should thus be on supporting the implementation of internal policy reform and the stabilization of fragile institutions. The following basic guidelines are suggested:

(a) If policy reform and growth efforts are initiated from within the countries concerned, donors should be prepared to reward domestic efforts by increasing external support. In this way donors will help to prevent that domestic objectives have to be abandoned due to lacking aid response.

(b) A considerable part of external assistance should be geared towards institution building, human resource development, control of population growth and other poverty-related areas, as social politico-economic constraints, lack of skills and institutional weaknesses constitute major bottlenecks for economic development in low-income countries.

(c) If the ruling elites in the recipient countrioo arm unwilling to Put their economic house in order and carry out. the needed soci al reforms, donors should not hesitate to cease support for these governments OF at least reduce their efforts to supply emergency relief.

42. Special attention should be paid to the recommendation8 of the Parliamentarians for Global Action, set out in their Amsterdam Appeal of 1 April 1989 for the solutions of the debt crisis and repeated in their Appeal for Human Development of 20 April 19901

"Essential is the need for a more balanced approach to conditionality which emphasi tea human devel opment . It is necessary to appropriately change productive structures, while also emphasizing:

- more expansionary macro-economic policies;

- concentrating sectoral policy on emp 1 oyment and income owning areas including rmall farming and informal activities;

- greater equity am well am coat effectiveness in income policioe and social programs;

- compensatory programs to protect health and nutrition of the poor during restructuring;

- closer monitoring of major aspects c f 1living standards, so as to respond more quickly to deprivation;

- ecological responsibi l i ty;

- democratic control of economic policy-making; and

- reduction of military expenditure."

43. Presently, low-income and aid-dopondent countries are particularly concerned that the greater worldwide competition for foreign resources wi 11 be at their expence in the first place. So, it is crucially important that international financial institutions stress their assi stance t o these countries, as they have little chance of obtaining signif icant private capital in the near future. This may be achieved by focusing the role of these institutions on poverty issues to a substantial ly greater degree than in the recent past.

Trade policies of developed countries

44. It is urgently required to strengthen the case fur liberalization of OECD import3 in order to overcome the payments problems of debtor countries. Trade is now increasingly considered preferable to aid; ard provision itself would be of limited effect in tackling the debt and development problems of most developing countries, unless the Industrialized countries remove their restrictions on imports from the former -- prucssaed nr not. Consequently, a major aspect of any meaningful internatioinal debt policy should be to facilitate the exports of developing countries and enhance their foreiqn exchange earnings, which wi 11 also foster their development.Their industrialization and diversification are crucial, and they call for access to markets.

45. As one way to this end, comprehensive liberalization schedules could be worked out, e.g. by the GATT, which would clearly pin-point the need for action in individual OECD member countries. Enforceability of much programs will remain an important problem unless the GATT has effective sanctions at it5 disposal. A feasible way out may consist of a commitment of OECD countries to compensate developing countries for refused liberalization by contingent aid pavmenta. The aid to be allocated under this rule would be determined by the estimated losses of recipient countries due to refused liberalization.

Monitoring

46. The needs of monitoring the economic and socio-political developments and government policies, as well as the negotiating process, can be met by organizing international consultative groups such as that for Indonesia. The main function of the group is to ensure that government economic policies, as reflected in the annual budget and its implementation and in other measures, are sound, so that the donor countries can estimate the assistance needs every year and have the opportunity of raising relevant questions. This will reduce the uncertainties due to misinformation or misjudgment and increase the likelihood of quick response to the country's needs,

47. The discussions in consultative groups may include even such sensitive domestic issues as land reform, as it may be necessary to improve the fundamentals of the economic conditions in the national economy. Othsr topics that are of ten important are: ta:: system and tax collection, banking system and administrative efficiency.

48. It has been suggested that the focus of bilateral debt reduction arrangements should be shifted from the Paris Club to consultative groups. 39/ It has been further suggested that representatives of other developing countries may be invited to participate in the work of the consultative groups. This may bruaden the policy dialogue and gradually evolve into regional discussions. 40/

49. The consultative grauo forum can also he used to monitar trade policies of creditor countries. This will introduce some balance in creditor - debtor relations and represent a significant step forward towards a comprehensive debt policv.

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