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EXTERNAL DEBT CRISIS AND DEVELOPMENT

Recent evolution of the international debt strategy

Report by the Secretary-General

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I. INTRODUCTION

1. In its resolution 45/214 of 21 December 1990, the General Assembly requested the Secretary-General to report to the Assembly at its forty-sixth session on the implementation of that resolution. In the 22 operative paragraphs of that resolution, the Assembly covered all major international and domestic aspects of the debt crisis as it affect8 developing countries and some other countries with serious debt-servicing problems. The Assembly also recognized the relevance to the subject of appropriate national economic policies and expansion and liberalization of world trade and urged multilateral financial institutions and donor countries to assist effectively those developing countries adversely affected by the situation between Iraq and Kuwait.

2. In particular, as part of its global economic monitoring in the _World Economic Survey, 1991_ and its monitoring of trade and trade-related financial issues of development in the United Nations Conference on Trade and Development (UNCTAD) publication _Trade and Development Report, 1991_, 1/ the Secretariat has reported recently and in considerable detail on the debt situation, the international economic environment and policy development8 that affect the debt-servicing ability of developing countries. The present report, which draws heavily on those two publications, first assesses the major developments of the past year, Then, a8 a continuation of the effort8 of the Secretary-General to promote understanding among debtors and oreditors and contribute to a durable solution of the crisis, certain ideas are put forward to assist in focusing discussion in the General Assembly.

II. STATISTICAL, INDICATORS OF INDEBTEDNESS

3. The external debt of capital-importing developing countries reached a new peak of $1.2 trillion in 1990 after remaining practically unchanged during the period 1987-1989. The increase in the stock of debt was due not to any substantial expansion in the flow of lending to developing countries, but rather to the 1990 weakening of the dollar, which translated loans denominated in non-dollar currency into larger numbers of dollars than before. Net lending was only $8 billion more in 1990 than it had averaged in the two previous years. Debt owed to official creditors continued to represent an increasing share of the debt of developing countries, as private creditors, particularly commercial banks, were systematically reducing their exposure to debt-burdened countries. Private debt has also been cut down through a series of conversion8 and repurchases, usually at a considerable discount, and in some cases through non-renewal by debtor countries themselves of certain credit lines when those reached maturity. 2/

4. With the slow rise in total debt, coupled with international policy measure8 to provide debt-service relief, one would have expected to see major improvements in the debt indicators of developing countries. Reality, however, was more complex to the extent that the behaviour of other factor8

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that were also significant for amelioration of those indicators, such a8 interest rates, growth of international trade, commodity prices and domestic investment and growth, were not, in general, conducive to lower ratios. In fact, 1990 was not a favourable year for most developing countries as the gulf oonfliot and recession in parts of the industrialized world led to slower economic growth, falling aommodity prices end reduced export revenues, particularly in energy-importing developing countries.

5. Nevertheless, the ratio of external debt to exports improved for various groupings of developing countries in 1990 (see table 1), largely on the strength of higher petroleum-export earnings, However, since the oil sector usually contributes a smaller share of total output than of exports, the oil factor did not carry over to the debt/gross national product ratio in all cases. Thus, the ratio of external debt of capital-importing developing countries to gross national product (GNP), which had declined during 1988-1989 increased during 1990 and for sub-Saharan Africa reached a new peak of 102 per cent (see table 1). That region owes what is now equivalent to its annual output of goods and services.

6. In 1990 the ratio of debt service to exports remained relatively constant at about 16 per cent, whereas it had declined in the three previous years. Such an aggregate figure, however, conceals divergent trends among the various regional and country groupings. For the group of 15 heavily indebted countries, the debt-eervice ratio improved once again in 1990. It fell to about 27 per cent, its lowest value in 11 years, due largely to export-revenue gains of the group's oil exporters. As table 1 shows, the debt-service ratio in sub-Saharan Africa rose in 1990 and is now higher than it was in 1980.

7. The debt-eervice indicator is determined by the behaviour of the value of (a) debt-serviae payments and (b) exports. The value of debt-serviae payments may be thought of as the product of stock of debt outstanding and ratio of debt service paid to level of debt outstanding. That ratio has been called the average terms of debt servicing, 3/ and those average terms reflect the results of reschedulings, interest-rate reductions and arrears accumulation, as well as of any change in the composition of the debt itself, for example in share of concessional debt, Value of exports, the denominator of the debt-service ratio, is the result of volume exported and prices obtained.

8. For the group of 15 heavily indebted countries, lower debt-service ratios in 1989-1990 were due to both lower debt-service payments, as the stock of debt stabilized and average terms improved, and increased export revenues. With respect to the latter, it is worth noting that only in 1988 did the value of exports from that group of countries become higher than in 1980. The increase in value of exports was due entirely to an increase in volume since the unit value of those exports remained depressed for the entire decade. In 1990, the export volume of those countries was almost 40 per cent higher than in 1980, while their export prices measured in current dollars were 10 per cent lower than those that had prevailed a decade before (see figure I).

Table 1. Debt indicators of capital-importing developing countries, 1980-1990

(Percentage)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990 a/
Ratio of external debt to GNP											
All countries	26.4	28.9	33.5	37.6	37.8	40.2	42.6	44.0	38.8	35.2	37.3
15 heavily indebted countries b/	32.1	35.6	44.0	55.1	55.8	57.6	60.8	65.5	55.8	48.9	51.7
Sub-Saharan Africa c/	44.9	53.2	59.5	64.2	71.5	84.9	84.0	97.9	94.5	93.5	102.3
Ratio of external debt to exports											
Al 1 countries	119.5	130.2	154.6	169.0	159.7	176.8	195.2	183.1	154.5	140.3	138.4
15 heavily indebted countries b/	168.5	200.2	251.4	287.0	271.0	288.7	342.9	334.6	287.3	262.6	248.4
Sub-Saharan Africa c/	157.2	190.7	222.7	247.3	244.3	294.7	326.3	357.3	367.6	365.2	363.6
Ratio of debt service to exports											
All countries	18.6	20.9	23.7	22.4	21.6	23.0	23.4	21.0	19.2	15.9	15.8
15 heavily indebted countries b/	31.3	37.0	44.9	40.8	39.2	37.0	40.8	34.8	36.5	29.1	26.7
Sub-Saharan Africa c/	17.1	19.9	20.8	22.4	22.3	25.6	28.7	25.0	25.4	22.5	24.5

Source: World Economic Survey 1991 (United Nations publication, Sales No. E.91.II.C.1), table A.35.

a/ Preliminary estimate.

b/ Argentina, Bolivia. Brazil, Chile, Colombia. Côte d'Ivoire, Ecuador, Mexico, Morocco, Nigeria, Peru, the Philippines, Uruguay, Venezuela and Yugoslavia.

c/ Excluding Nigeria.

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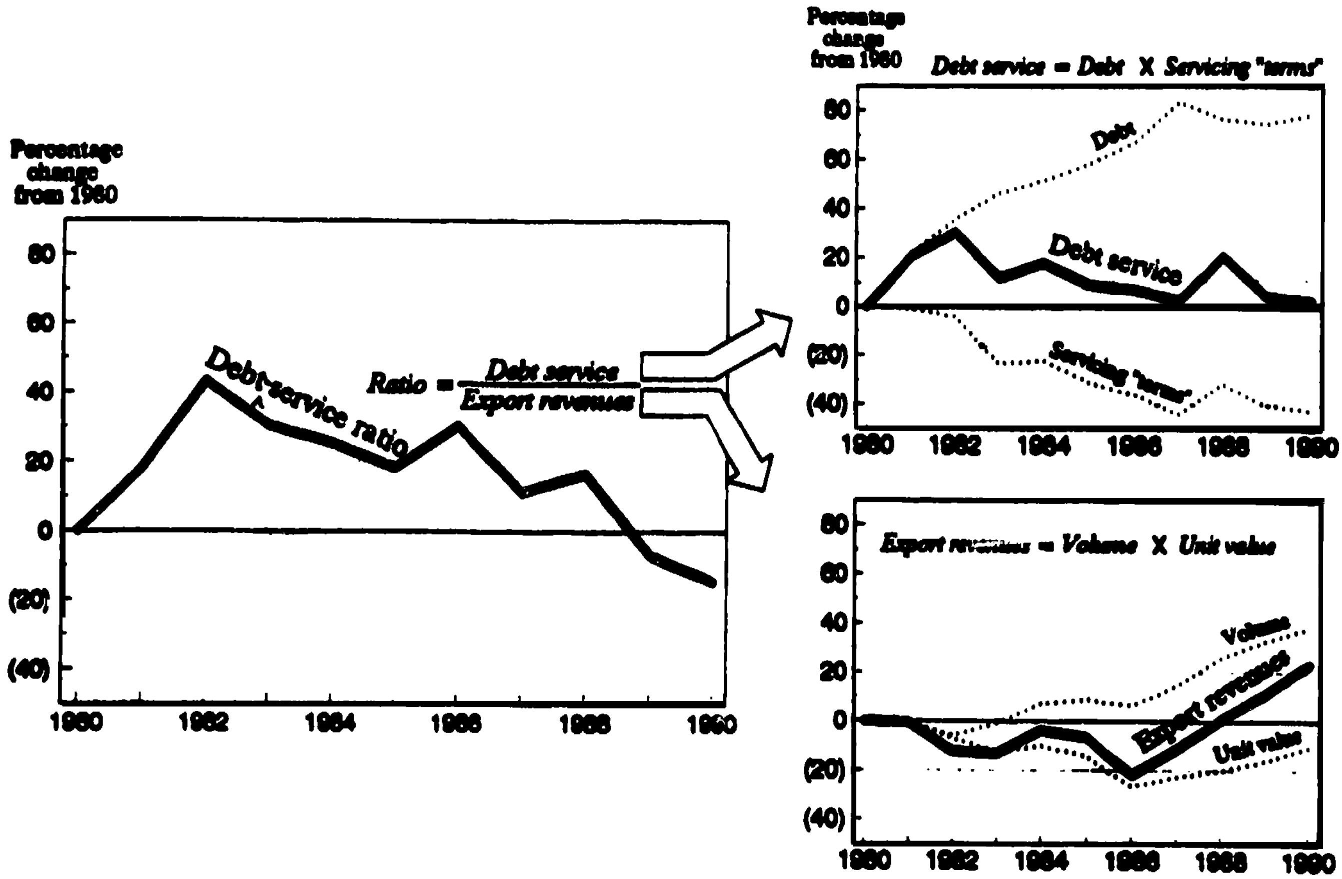
Figure I. Sources of the change in the debt-service ratio of 15 heavily indebted countries, 1980-1990



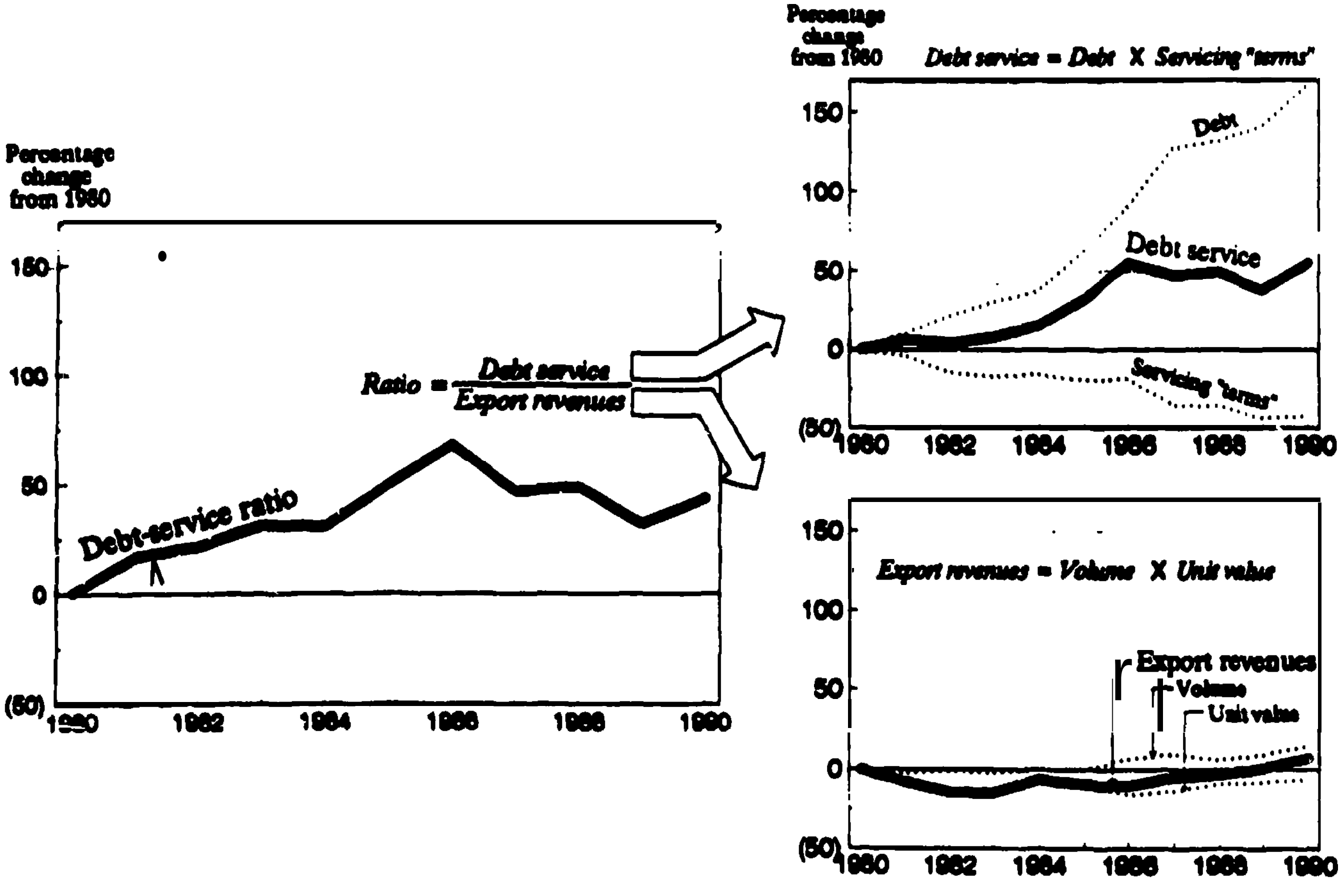
The debt service ratio first rose, but ended the decade lower than in 1980...

...mainly because export volume rose and the debt stopped growing.

Source: Department of International Economic and Social Affairs.

9. The ratio of debt service to exports for sub-Saharan countries deteriorated during the last 10 years. Debt-service payments of those countries increased during the decade despite an improvement in debt-servicing terms, Official lending to sub-Saharan countries grew significantly through the 19808, and thus offset the improvement in servicing terms. Furthermore, export revenues did not contribute significantly to improving the debt-service ratio. Export prices failed to recover their 1980 levels, while the increase in volume exported raised export earnings only marginally (see figure II).

Figure II. Sources of the change in the debt-service ratio of sub-Saharan Africa, 1980-1990 a/



The debt service ratio rose until mid-decade, and then stabilized...

...as servicing terms improved while the debt continued to rise.

Source: Department of International Economic and Social Affairs,

a/ Excluding Nigeria.

III. DEBT OWED TO OFFICIAL BILATERAL CREDITORS

10. Debt reschedulings with partial debt or debt-service forgiveness, always within the context of an internationally approved adjustment programme, have become common elements of the debt strategy of creditor Governments. Recently, debt cancellation and debt-service relief have also been extended to middle-income countries.

11. Debt owed to official creditors constitutes a major share of the total debt of least developed and other low-income countries. Most of it is related to official development assistance (ODA) loans, which in 1989, the latest year for which data are available, accounted for two thirds of the outstanding debt of least developed countries and 35 per cent of their annual debt service. 4/ Official debt write-offs can consequently contribute significantly to easing the debt burden of those countries. By October 1990, the total amount of official debt cancelled had come to almost $11 billion, but the total debt forgiven has increased substantially since then as creditor countries implemented outstanding commitments and announced new initiatives. For example, by mid-1991 the United States of America had fully implemented debt-relief measures announced in July 1989 in favour of sub-Saharan countries pursuing economic-reform programmes endorsed by the International Monetary Fund (IMF) or the World Bank. Under this initiative, the United States cancelled $550 million of debt owed by 14 countries from the sub-Ssharan region. At present, most ODA from the United States to least developed countries is provided in the form of grants. The majority of members of the Development Assistance Committee (DAC) of the Organisation for Economic Cooperation and Development (OECD) now have all-grant or mainly-grant programmes with least developed countries and the remaining ODA debt outstanding of those countries to some DAC members involves relatively minor amounts. 5/

12. Until recently, there has been relatively little debt forgiveness extended co middle-income countries, except for such symbolic gestures as the cancellation of $16 million of Chilean debt for food-aid loans in early 1991 within the context of the Enterprise for the Americas Initiative (EAI). 6/ After the conflict in the Gulf, however, the United States cancelled $7.1 billion of military loans extended to Egypt, and Arab creditors cancelled an additional $7 billion.

13. Rescheduling, as opposed to writing off debt, is usually negotiated at the Paris Club, an informal group of government creditors that meets at the French treasury to ensure that all creditor Governments give equivalent concessions. Activity at the Paris Club has slowed down since the Secretariat reported to the General Assembly last year. 7/ Only seven agreements were negotiated with developing countries during the last quarter of 1990 and the first two quarters of 1991, compared with 23 agreements signed over the same period in 1989-1990. Moreover, by mid-1991, the Paris Club agreements of about 30 countries that had been candidates for future reschedulings had expired, some over six months before.

14. The reduction in Paris Club activity seems to be due to the difficulties debtor countries are facing in implementing adjustment programmes in conjunction with IMF. The requirement that the rescheduling country conclude a prior agreement with IMF continues to be an essential feature of Paris Club practices, and IMF negotiations are sometimes protracted and difficult, thus delaying debt rescheduling and worsening the country's external financial position. Meanwhile, arrears accumulation normally makes the country ineligible for export credit insurance and reduces its access to trade finance.

15. Among the agreements that were signed over the past year with developing countries, "Toronto terms" were applied to Burkina Faso and Senegal, which is usually considered a lower-middle-income country; Nigeria and the Philippines benefited from the new "Houston terms"; and Panama obtained the standard treatment accorded in debt rescheduling with no debt-reduction provisions. 8/ Finally, Egypt and an Eastern European country, Poland, received "exceptional" treatment, that is, official creditors agreed to reduce the entire stock of those countries' eligible debt by 50 per cent. Debt reduction will be effected through a menu of options from which individual creditor Government? will choose in follow-up bilateral agreements. Those options include (a) principal reduction, (b) interest reduction and (c) partial interest capitalization on concessional terms. Creditor countries also agreed to set up voluntary debt-swap facilities, which could include up to an additions1 10 per cent of outstanding claims. 9/

16. Although creditors have argued that special political considerations weighed heavily in their decision to grant unprecedented levels of debt relief to Egypt and Poland, the central significance of those agreements lies in their recognition that a higher magnitude of debt relief than heretofore granted is required if severely indebted countries are to make progress in economic transformation and structural adjustment at a politically acceptable rate.

17. However, although some creditor countries want to extend additional debt relief to other low-income and lower-middle-income countries in need that are embarking on major adjustment programmes, other creditor countries are reluctant to accord new concessions in the restructuring of official debt. The leaders of the seven major industrialized countries that met in London in July reaffirmed the uniqueness of the Egyptian and Polish cases. Furthermore, although admitting that there was a need for additional relief measures for low-income countries "going well beyond the relief already granted under Toronto terms", 10/ they did not adopt the proposal of the United Kingdom of Great Britain and Northern Ireland, informally known as the Trinidad terms. It was suggested that additional debt-relief measures be considered by the Paris Club but no recommendation was given as to how extensive debt relief should be.

18. The Trinidad.terms call for the cancellation of up to two thirds of the total stock of eligible debt owed by low-income countries, that is, those that are eligible for financing from the International Development Association (IDA). 11/ However, applying the Trinidad terms per se would not, among half

of the countries potentially eligible for those terms, reduae their debt burden sufficiently. 12/ For some of those countries, Paris Club debt is only a small share of their total official debt, with debt owed to non-Paris Club bilateral creditors and international financial institutions accounting for a much larger portion. Moreover, the Trinidad terms, like the Toronto terms before them, would not affect the entire debt owed to the Paris Club since they exclude from rescheduling all debt contractsd after a certain date, *known* as the cut-off date, which is set when a debtor first comes to the Paris Club for assistance. Most countries by now have had to arrange a sequence of Paris Club reschedulings over several years.

19. Although the initiatives described above indicate an important evolution in official international thinking on debt management, such efforts are restricted to tackling specific categories of debt and therafore fall short of meeting overall international cash flow and investment needs for adequate growth of indebted countries.

IV. DEBT OWED TO COMMERCIAL *BANKS*

20. Developing country debt owed to commercial banks reaohed *a* peak of $417 billion in 1987. Since then, that debt has been declining because (a) a few countries without debt problems, the Republic of Korea in particular, decided to reduce debt levels and (b) debt-equity conversions and debt-reduction operations gained momentum. 13/ Debt reduction and debt-service relief were later incorporated into the international debt-management strategy with the launching of the international debt initiative informally known as the Brady Plan (after the Secretary of the Treasury of the United States who proposed it in 1989). That initiative dominated commercial-bank-debt negotiations in 1990 and 1991, and agreements were reached with Costa Rica, Mexico, Morocco, Nigeria, the Philippines, Uruguay and Venezuela. Only a few reschedulings have been negotiated outside the initiative's framework since 1989.

21. One characteristic of the negotiation* concluded so far has been the diversity of instruments, sometimes specially tailored to the conditions of the country concerned, contained in those negotiations' restructuring agreement. 14/ Such diversity reflects both the need to attend to the diverse objectives of debtors and creditors and, to some extent, the increased flexibility of all players involved. Debt reduction is usually attained by a buy-back operation or by the *conversion* of the eligible debt into lower-valued long-term bonds. Either the bonds have a reduced face value and carry a commercial interest rate or they have the same face value (in which case they are called par bonds) and carry a reduced interest rate. In the latter case, interest relief can be either temporarily accorded or extended up to the maturity of the bond. The new bonds are usually backed by sero-coupon bonds of the United States Treasury or other similar instruments that mature on the same date as the bonds and thus guarantee principal repayment at maturity. Other so-called enhancements guarantee interest payments during a specified, rolling period of time. Rescheduling of the non-converted debt and new loans

are also oomponenta of some of the agreements. The new money extended is usually an agreed share of the creditors' exposure that was not converted *into* bonds or tendered for cash.

22. Despite the diversity of options for debt rescheduling and debt-service relief, the recently concluded agreements share several common features. First, those agreements are supported financially by the multilateral financial institutions that have made special aonaurrent lending, a part of which is usually set aside to purahase the guarantee instruments. Disbursements on suoh loans are subjeot to the aountry's adherenoe to the targets set by an economic progranune that has the endorsement of those institutions. 15/

23. Seaond, Latin American paokages have recovery provisions under which banks would regain some of their concessions if there were fortuitous developments in their economies. In Mexico and Venezuela, those provisions are attaohed to the price of oil; in Costa Rica, to overall economic performanaer and in Uruguay, to the price of a basket of commodities.

24. Third, although the economies of countries restructuring their debt are quite heterogeneous , they have obtained relatively homogeneous relief in terms of net reduction *in* interest charges. Par bonds carry fixed interest rates that range only from 6.25 to 6.75 per cent per annum, 16/ There is very little difference even in the fixed spreads that are added to the fluotuating base rate in floating-rate loans. In general, spreads reflect creditors' perceptions of the risk in lending to the aountries aoncernedt but for debt-restructuring countries, the spreads *range* only from 0.81 to 1 percentage points. Moreover, in the aase of bonds that pay a full commercial rate on a reduced *faae* value, the disaounts negotiated ranged only over 5 percentage points, from 30 to 35 per cent. 17/

25. The overall amount of relief a aountry obtains depends *on* (a) the mix of instruments that *aro* included in a specific package, (b) the hanks' choices and (c) the general market's perception of the country's ability to service its debt as expressed by the amounts buyers bid for that debt on the secondary market. As the discount offered by various bond instruments are very similar across countries, one country may obtain greater relief than another when there is a buy-back option, the secondary market is heavily discounting the country's debt and a large number of banks opt *for* the buy-back.

26. Costa Rica, whose debt was traded at a discount of 82 per cent, could erase about 60 per cent of its commercial bank debt and save the equivalent of 40 per cent of its total 1989 interest bill. 18/ Debt relief obtained by the other countries was far less than that. In fact, net overall debt reduction, that is, the net reduction of bank claims minus the funding of enhancements, was not more than 3 per cent of the 1989 long-term debt *for* Mexico and Uruguay and was actually negative, in other words, raised the debt outstanding, for the Philippines and Venezuela. 19/

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27. Interest savings obtained were thus below expectations and, except for Costa Rica, represented only 5-8 per cent of those countries' total 1989 interest bills. Total debt-service relief, *however*, was considerably greater beaause prinaipal repayments were either aancelled or prepaid. Cancellation took plaae through debt repurahaaes while prepayment occurred because the *new* long-term bonds, the so-called Brady bonds, had their principal repayment fully guaranteed by the debtor country's purohase of United States Treasury zero-coupon bonds. Total annual debt-serviae relief over ths next four years will range from about 2 to 6 per cent of those countries' 1989 gross national produat. 20/

28, Nevertheless, benefits for the countries concerned go beyond amount of relief per se. *More* important is whether their restructuring agreements accelerate those countries towards creditworthiness; that is, renewed access to private-market lending as a significant source of net capital inflows and net financial transfers. Analysis of this issue must be highly tentative in so far as the agreements are so new and some not yet even operational. 21/ Results so far are mixed. For example, the Philippines returned to the *negotiating* table in 1991 after natural calamity and the crisis *in* the Middle East made the economic assumptions of its adjustment and financing programme obsolete. Like Costa Rica, the Philippines has not yet regained access to private-credit markets. On the other hand, *Mexico* has experienced a boost of *investor* confidence *in* its economy's future both at home and abroad, *due* to the debt agreement, progress in domestio adjustment and the prospect *of* a new trade arrangement with Canada and the United States, which led to return of some flight capital and lowering of domestio interest rates. Also, *Mexican* borrowers have slowly started *to* regain some access *to voluntary* private-aredit markets. 22/ In early 1991 the *Mexican* Government returned to the Eurobond market as a sovereign borrower, issuing public debt for the first time since 1982. Some Veneauelan companies have also been able to obtain private credit, albeit in limited amounts, through the bond market. Finally, Chile, which significantly reduced its debt through a unilateral debt-conversion programme, became the first country, and the only one as of mid-1991, to secure a voluntary, sovereign bank loan since the beginning of the debt crisis in 1982.

29. Certain well-known and solidly established companies from large debtor countries whose Governments have not reaahed an agreement with their commercial banks have also been able *to* attraat some sporadic private financing, 23/ although the funds obtained have been very costly, Some placements have been successful due to the high yield and ample collateral offered. Bonds have usually attracted investors avid for high returns who had become disenchanted with the lower interest rates offered *in* the major markets. Moreover, the rare bank loans that may be available to some companies from debtor countries currently *carry* wider spreads than last year's due to banks' increasing concern over profitability and liquidity. 24/ That trend may indicate just how precarious the present situation is. If such a trend persists, the increasing cost of bank funds and the accessibility of bond markets to only the larger and better-known borrowing entities may add to those difficulties the heavily indebted developing countries already face in raising funds on international capital markets.

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30. All in all, only a few of the countries with heavy debt burdens have been able to return to the private-capital markets and the amounts raised have been quite limited. That return is, however, a beginning. But, as the increase in interest arrears during last year attests, for the vast majority of debtors a return to the market still seems distant.

31. The faot that arrears have been accumulated even in countries able to produae substantial foreign-trade surpluses indicates that foreign-exchange availability is *not* a suffiaient condition *for* debt servicing. Moreover, as most of those countries' aommeraial-bank debt is owed directly or indirectly by Governments, debt servicing is coastrained by a State's ability to finance suoh a payment domestically, particularly when it does not itself generate foreign currency. 25/ In other words, a Government needs resources to finance acquisition of the foreign-currenay surplus from the private sector, but when that Government is unable to generate fisaal revenues quickly and instead resorts to domestic borrowing, going further into debt to pay foreign interest is no longer an aaaeptable option. As domestic financial markets in most of the countries under consideration are small, large increases in public debt have to be absorbed by their respective central banks. Such an arrangement leads to an excessive expansion of the monetary base, which inevitably has inflationary consequences. 26/

32. Although it provides some short-term cash-flow relief, the arrears option ends up inflicting heavy costs on the countries concerned, particularly those whose economies are weakest. Trade credits, if available at all, may become more difficult and more costly to obtain and foreign investment may be scared out of the country. Moreover, domestic economic decisions become more difficult to make because of uncertainty over the future macroeconomic and exchange-rate policies that might be adopted to mobilise the resources to repay the arrears. In such a climate, important investment decisions might well be postponed. None of these elements help the country return to a sustainable growth path.

33. The increase in interest arrears has been paralleled by the expansion of commercial-bank-debt reduction via debt conversions outside structured reschedulings. Debt-equity swaps, in which debt is exchanged at a discount for equity in a local investment, were among the first mechanisms developed to reduce the stock of debt and the cost of servicing it. 27/ Although a series of new mechanisms, such as debt for nature, debt for health and debt for education, have recently been introduced they have contributed very little to debt reduction owing to the small amount of debt they usually retire. 28/

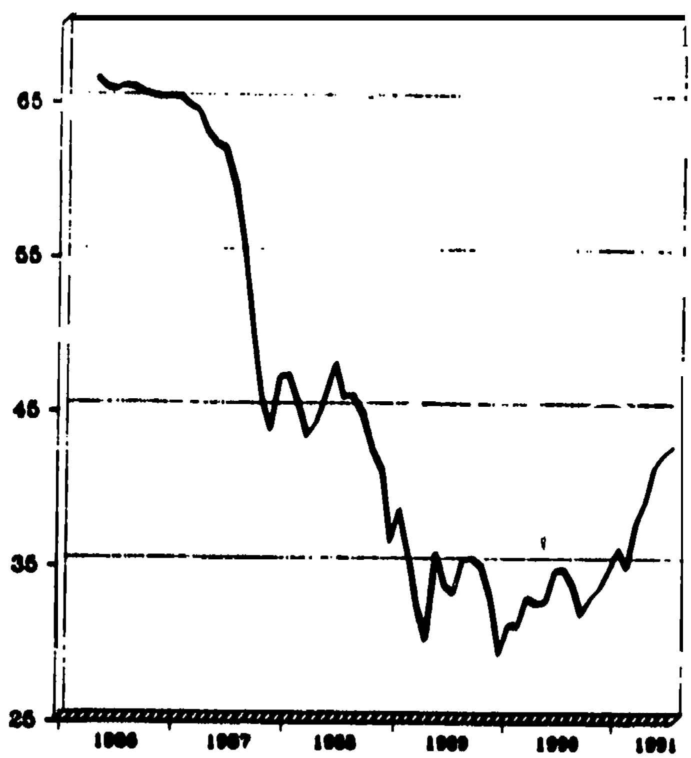
34. One recent trend is the use of debt swaps to finance privatization programmes. Argentina, for instance, was able to cancel 11 per cent of its commercial-bank debt by privatising two large public companies through debt-equity swaps last year. One reason for the increasing popularity of such an instrument is that its operations do not have the potential inflationary impact of other swaps. Since it does not involve the transfer of liquidity from the public to the private sector (assets are exchanged instead), there are no assets adding to inflationary pressures already existing within the

/...

economy. The launching of privatization programmes with provisions for debt-swap financing in many debtor aountries may help to explain the recent improvement in seoondary market quotations of developing countries' debt instruments (see figure III).

Figure III. Market bids on credits of 15 developing countries, 1986-1991

Percentage of face value



Source: Department of International Economic and Social Affairs, based on data of Salomon Brothers, New York.

35. Debt oonversions and debt buy-baaks are not costless, however, for debtor countries. Governments must finance the operations involved, and limitations on public finances may constrain the use of those instruments, in particular when increased domestia indebtedness and additional inflationary pressure have to be avoided. 29/ Furthermore, although suah operations reduce interest payments and alleviate the foreign-exahange constraint an economy faces in the short run, the swaps may exert some balanae-of-payments pressure in the future as the profit, dividends and capital originating from those operations are repatriated.

V. DEBT OWED TO MULTILATERAL CREDITORS

36. In 1990, the dobt owed by aapital-importing developing countries to multilateral creditors, including IMF, the World Bank and the regional development banks, reached about 8235 billion, which corresponded to over 19 per cent of the total stock of debt that those countries owed in that year and aonstituted an inarease in the share of their indebtedness to multilateral areditors as well. The ratio of multilateral to total debt had been about 18 per cent in 1989 and 15 per cent in 1985. 30/ While other creditors had been pulling baak or seeing their claims reduced through debt-reduction operations, the multilateral institutions had been increasing their lending.

37. Even when accumulating arrears to other oreditors, debtor countries usually try to remain aurrent in servicing the debt to multilateral creditors owing to the complete financial isolation which aould result if they did not. Nevertheless, some countries were foraed to suspend servicing of their debts to multilateral areditors in recent years. By the end of fiscal year 1991, arrears of six months or longer to the World Bank and IMF had risen to $1.8 billion and $4.0 billion respectively. Eight countries were in arrears to the Bank and nine to the Fund, almost the same number as for the year before (seven in arrears to the Bank and eleven to the Fund). 31/

38. Multilateral debt is not subject to formal rescheduling, which would otherwise introduce an element of payment flexibility for countries that owe a considerable portion of their debt to such institutions. Recently, however, certain creative ways of dealing with the problem have been developed, such as the "rights approach" now applied in IMF. A aountry in arrears cannot reaeive new loans from the Fund, but it can now accumulate rights towards future finance from the Fund by adhering to an economic programme monitored by the Fund. The debtor country receives financial assistance from individual donors and creditor countries to support its adjustment programme and help meet its obligations to the Fund during the period of the programme so that arrears do not increase. By the end of the timetable set by the Fund-monitored programme, arrears are to be repaid and access to Fund credit is to be restored. Indeed, the first drawing may help repay a bridge loan that clears the last of the arrears.

39. Most arrangements for dealing with the arrears problem at the Fund, the World Bank and other multilateral lenders involve the extension of financial

assistance by creditor Governments in exchange for adoption by the country in question of an economic-adjustment programme, usually monitored by IMF, that will lead the debtor, so all concerned believe, to economic reaovery. Resources can be mobilized by a support group of areditor countries and aaoumulated in an account administered by one of the multilateral institutions; Funds are to be used to olear *arrears* and support *the* adjustment programme until normal relations with those institutions are re-established. *Such* arrangements have been applied in Guyana, Honduras and Zambia, and programmes for additional countries in arrears may be expected.

VI. DEBT PROBLEMS OF COUNTRIES AFFECTED BY THE GULF CRISIS

40. *The* invasion of Kuwait by Iraq put renewed pressures on the balance of payments of *a number* of developing countries as oil priaes suddenly increased, worker remittances were reduced, serviae earnings evaporated in tourism, transportation, transit trade and other seotors, and export markets were lost. Although only preliminary and very tentative estimate8 of foreign-exchange losses caused by the conflict are available, those estimates indicate the order of magnitude of the losses inflicted by the arisis on developing countries, particularly those that suffered from a combination of the above-mentioned factors. In some countries, foreign-exchange losses amounted to one fourth of 1989 total foreign-exchange *earnings.* 32/

41. Countries without major macroeconomic imbalances that had been experiencing rapid economic growth before the crisis were able to finance the larger *current* account deficit caused by the Gulf conflict relatively easily, but those countries constituted just a few cases.

42. Countries that had already been experiencing economic difficulties were harder hit by the crisis. In some countries, foreign-exchange reserves that had already been very low further restricted ability to absorb the shock. In others, financial position was weakened and creditors were made more cautious when reserves were quiakly run down in the faae of higher oil bills and lower foreign-exahange inflows. India is a case in point. The Gulf crisis intensified the country's financing difficulties and led to increasing problems in servicing its debt by mid-1991, so that India had to use part of its gold reserves to secure new borrowings with which, inter alia, to service its debt on a timely basis,

43. Multilateral financial institutions adopted a series of emergency measures to respond to the increased financial needs of developing countries. The World Bank group increased its regular lending programmes by $1.1 billion in 1991 and expanded the IDA programme by almost $900 million in behalf of affected countries. The IMF increased the flexibility of dieburaements and the effective maximum size of drawings from its existing arrangements. *For* instance, an oil element was added to the Compensatory and Contingency Financing Facility (CCFF), whose coverage was also broadened to include losses from a variety of services besides travel receipts and worker remittances.

44. While such efforts attest to the rapid response capacity of the Bretton Woods institutions, two difficulties remained connected with the international-scale answer to the crisis, First, the World Bank and IMF cou only compensate for a relatively small share of the foreign-exchange losses experienced. Ad hoc bilateral assistance was made available to certain countries but was based on political as well as economic criteria. Moreover despite the fact that the Gulf conflict itself and its economic consequences bore no relation to the economic policies of developing countries and were fully expected to be of temporary duration, internationally agreed adjustmen programmes were still required of countries that were to benefit from the ne actions of IMP and the World Dank. In other words, financial assistance was mainly seen as a supplement to that required for an adjustment effort that w needed in any event. A major concern was that the adjustment programmes should not be derailed by the Gulf crisis.

VII. CONCLUSIONS

45. The debt crisis is entering its second decade. During the difficult first 10 years of the crisis, the international debt strategy evolved considerably. With hindsight it can be said that that strategy began with a misconceived diagnosis of the balance-of-payments difficulties of heavily indebted countries, whose crises were thought to have arisen from a temporar illiquidity. After a few years, it was realized that the debt had grown far too much to be serviced in full, given the sharp decline in finanaial flows developing countries and the increasing difficulties severely indebted countries were facing in resuming significant rates of economic growth. The international community gradually came to accept tho idea that long-term relief was a necessary component of the debt-management strategy.

4s. However, reduction of the debt burden by itself was never thought to be sufficient to reverse the dismal economic performance of debtor countries. Changes in domestic policy were also required, although there was considerab dispute about the proper content of the new policies. 33/ Sound stabiliaati programrnes, in any event, were understood to have a better chance to succeed when supported by adequate external financing and a dynamic international economic environment.

47. How effective has the current, more structural approach to overcoming t debt crisis been? One indicator of success might be the number of debtor countries that have regained creditworthiness in the eyes of official and private creditors, as indicated by a return to regular cover by official export-credit agencies and renewed access to voluntary private-capital markets. In those *terms,* some progress has been registered but success has been limited. Most debt-crisis countries still need additional rounds of rescheduling at the Paris Club and the deep discounts that remain in secondary-market bids on most developing-country bank debt point to a continuing crisis. But, as noted above, there have been some signs that voluntary private-capital flows are beginning to return to some severely indebted economies in the form of project-related finance and borrowings by

private or State-owned companies and official entities. Such a trend suggests that private creditors may resume lending to countries, if not at first to their Governments directly, once those countries are making progress in debt management and following policies that are successful in stabilizing the maaroeaonomy and in reducing major price distortions. 34/

48. Yet, it would be premature to assert that the end of the crisis is near. General-purpose lending has thus far been resumed only to the Governments of Chile and Mexico, and in very limited quantities. Funds are otherwise usually channelled to companies that already have an international reputation and are financially strong and large generators of foreign currency. Few developing country companies meet all those requirements. Moreover, loans to such borrowers are considered highly speculative by the market and so, as interest charges are quite high, most potential borrowers are precluded from accessing the private-capital markets. Indeed, even including those countries with renewed access, debtor-country investment is still depressed ant3 adjustment has yet to reach its payoff in resurgent growth.

49. Overall, prospects for augmented private-capital inflows in the near future are limited. It is now widely accepted that the mushrooming of commercial bank loans to sovereign borrowers that occurred during the 1970s will not be repeated because the international banking industry has itself changed considerably in the past decade and for several reasons will not take on a significant addition of lending exposure to developing countries. After the catastrophic experience of the 1980s, it seems more likely that banks will revert to their traditional role of suppliers of trade finance and project-related credits, which is not to say that credit will be easily available even for those purposes. The recent erosion in the capital base of Japanese and United States commercial banks, for example, may reduce their lending until those banks have restored their financial position. Moreover, the implementation of the Easel rules on capital adequacy, by which banks have to hold capital equivalent to at least 8 per cent of their risk-weighted assets, may leave fewer funds available at a higher cost, even to creditworthy developing countries. 35/

50. Foreign direct investment is another source of capital that seems willing to undertake the commercial risk of investment once the uncertainties assoaiated with the debt overhang are cleared up and the economic policies pursued by the potential host country are perceived as leading towards sustainable growth. Foreign direct investment, however, can meet only a portion of the needs for development finance.

51. In sum, although flows of direct investment and new lending to certain highly indebted countries will probably increase, the prospective volume of such flows is not likely to be adequate. Increased international cooperation is called for to augment the international capital flow to heavily indebted countries or, equivalently, help reduce their financial needs. Two means for undertaking a reduction in those needs suggest themselves.

53. First, much of the discussion about how to alleviate the debt burden of developing countries would not have even been necessary if their export earnings had increased adequately. Developing countries - at first unevenly, but now generally - have been making supply responses in the face of falling international prices. If export earnings are to reduce the need for external finance, export-promotion policies and export-diversification strategies should be supported by improved and predictable access to markets.

53. Second, debt-servicing difficulties would be eased thereby releasing resources for investment and growth, if real international interest rates were lower. At the moment, there is some concern that new demands for reoonstruation in Eastern Europe might drive up those rates instead of lowering them, but the recession in major industrialized countries has given rise to some political pressure to ease monetary stringency. Fears of resumed inflation persist, however, and a shift in the macroeconomic policy mix towards greater fiscal restraint would seem necessary if long-term real interest rates are to fall to levels more compatible with long-term growth potential and financial stability.

54. In addition, although the present international approach to the debt crisis has helped stabilize the economic situation in some countries and has demonstrated that debt-reduction schemes are practical and do not adversely affect the international financial relations of other countries, the international debt strategy needs to be strengthened. That that strategy has not delivered what it had proposed, namely, a significant reduction of the debt burden, is partially due to the compartmentalized approach to debt negotiation.

55. Middle-income countries that are substantially, but not exclusively, indebted to commercial banks have had their debts restructured mainly through bank advisory committees and may obtain relief if a Brady-style package is negotiated. Low-income countries, whose debt is largely, but not solely, owed to bilateral official creditors have had their debt restructured through the Paris Club and relief is granted through use of the Toronto terms. The problems of the least developed and other low-income countries that have substantial commercial-bank debt, as well as those of middle-income countries that are heavily indebted to bilateral official creditors, have not been adequately addressed.

56. The aommercial-bank debt of least developed countries ha8 usually been restructured under the same mechanism of bank advisory committees as has been used for countries negotiating Brady-style packages; however, no concessions have been granted so far, since the negotiations have been limited to the rescheduling of principal payments only and market interest rates have been applied. The Debt Reduction Facility (DRF) introduced in the World Bank in August 1989 for IDA-only countries, for which most least developed countries qualify, represents an important step forward in relieving those countries of their commercial-debt burden; 36/ but progress in using that Facility has been disappointing and, thus far, only one country has benefited from it. Obstacles to a wider use of the Facility need to be removed so that qualifying

countries can take advantage of its existence. The resistance of banks to relinquishing their claims may be reduced if greater incentives are made available through regulatory and tax-relief measures.

57. With respect to the official bilateral debt owed by middle-income countries, Paris Club terms (aside from the special treatment accorded to Egypt and Poland) are rather stringent. Although the so-called Houston terms attempt to deal with official debt owed by the lower-middle-income aountrieb, they offer only a lengthening of repayment terms and do not entail concsssionality. A more concerted approach therefore seems necessary so that the positive impact of relief measures that affect specific shares of a country's total debt, that is, the eligible debt, is not offset by lack of action covering the remaining debt that is not subject to concessions. As the logic of special cases emphasizes, a deeper cut into the debt overhang should be available to all developing countries in economic need that are undertaking major adjustment efforts.

58. Another shortcoming in the international debt strategy is that the amount of relief actually wrested from international commercial banks included in a restructuring agreement is very modest. As was seen above, net debt-service relief associated with restructuring commercial-bank debt has been small, especially when combined with increased debt-servicing payments to multilateral and other official creditors for loans to support enhancements. Relief accorded to debtors may even be said to have served mainly to legitimize the overall international financial cash flow, or net financial transfer, that those debtors previously achieved through arrears.

59. Relief granted by the Paris Club to low-income countries under the Toronto terms is not considered adequate, not even by the seven major industrialized countries, as was attested at their recent London summit meeting. The overall grant element on Paris Club arrangements for low-income countries has been about 20 per cent on average, which is less than one quarter of the average grant element on new loans and grants to those countries from official sources.

60. There is room to improve the effectiveness of the current debt strategy by raising the scale of debt reduction and enlarging the scope of debt eligible for restructuring. The actual degree of relief needed in any particular case has to be seen in terms of the overall financing needs of the adjustment programme and of a realistic appraisal of the medium-term debt-carrying capacity of the economy. Systematic application of this more comprehensive approach would help countries remove once and for all both the investment disincentives associated with the debt overhang and the uncertainties generated by the need for frequent reschedulings.

Notes

1/ World Economic Survey, 1991 (United Nations publication, Sales No. E.91.II.C.1) and Trade and Development Report, 1991 (united Nations publication, Sales No. E.91.II.D.15).

2/ Debt owed to official creditors represented 54 per cent of developing countries' total debt in 1990. The share was 50 per cent in 1989 and about 41 per cent in 1982, the year the debt crisis emerged (see World Economic Survey, 1991, table A.34).

3/ See World Bank, World Debt Tables, 1990-1991, vol. I, box 4, p. 21.

4/ Estimates of the UNCTAD secretariat based on information provided by the Secretariat of the Organisation for Economic Cooperation and Development.

5/ UNCTAD, The Least Developed Countries: 1990 Report (United Nations publication, Sales No. E.91.II.D.3), pp. 34-49.

6/ Chile has been the only Latin American country thus far able to benefit from the debt cancellation provisions contained in the EAI. The $16 million forgiven pertained to PL-480 loans (for food aid) contracted by Chile.

7/ See "The recent evolution of the international debt strategy" (A/45/656).

8/ Following the Toronto summit conference of the seven major industrialized countries held in June 1988, the Paris Club adopted a menu of options, the so-called Toronto terms, to be chosen by creditor countries in rescheduling the official debt of low-income countries. For non-concessional loans, it included (a) partial forgiveness with up to one third of debt service due during the consolidation period; (b) a longer repayment period (25-year maturity, 14 years of grace) at market interest rates) and (c) concessional interest rates (14-year maturity, 8 years of grace). Concessional debt was rescheduled with 25-year maturity and 14 years of grace at an interest rate that would be at least as low as the original rate, The Houston terms, which are applied to lower-middle-income countries, also resulted from recommendations coming from a summit meeting, held this time in Houston, Texas, in June 1990. Concessional loans were rescheduled with a 20-year maturity, including up to 10 years of grace; non-concessional loans were rescheduled with a 15-year maturity and up to 8 years of grace. Such treatment allows limited numbers of debt-equity swaps and other debt conversions by creditor countries on a voluntary basis. In conventional reschedulings, in contrast, the maturity and grace period are normally 10 and 5 years respectively.

Notes (continued)

9/ In the case of Poland, debt reduction will occur in two stages: 30 per cent up front and 20 per cent after three years, For Egypt, reduction. will take plaae in three stages: 15 per cent up f font, 15 per cent after 18 months and 20 per cent after three years. In both accords occurrence of the first stage was contingent upon the countries' signing an agreement with IMF to restruoture their eaonomy while subsequent stages are dependent on adherence to the terms of that agreement (see UNCTAD, Trade and Development Report, 1991, part I, chap. 2).

10/ London Economic Summit 1991, Economic Declaration, para. 44.

11/ The United Kingdom proposal also suggested that the Paris Club reschedule the total stock of eligible debt in a single operation rather than in tranahes that the remaining debt be rescheduled over 25 years, including 5 years of grace and that interest payments be capitalized for the first 5 years. The proposal was introduced by the United Kingdom at the meeting of Commonwealth finance ministers held in Trinidad in September 1990.

12/ For details, see UNCTAD, Trade and Development Report, 1991, part I, ohap. 2.

13/ Debt equity swaps were already in use by some countries before 1988. The case of Chile is a prominent example. Debt conversions and buy-baaks were also present in some of the negotiations held within the framework of the market-menu approach. For details, see World Economic Survey, 1989 (United Nations publication, Sales No. E.89.II.C.1), pp. 71-75.

14/ The following is largely a summary of the analysis, which includes detailed discussion of specific agreements, in the World Economic Survey, 1991, pp. 160-168.

15/ For example, disbursements on a stand-by agreement that Corta Rica had negotiated with IMF were suspended due to the Government's failure to meet agreed fiscal targets. Support for the programme was eventually obtained from other sources and Costa Rica's own resources. Nigeria has also reached a stand-by agreement with IMF but does not intend to draw on it to support its package with aommeroial banks. Resources for clearing Nigeria's arrears and the buy-back will come from the country's own reserves.

16/ Outside that range are the Venezuelan "step-down, step-up" bonds, designed to accord temporary interest relief, whose interest rates average 5.8 per cent during the first five years.

17/ The size of the negotiated discount on face value usually reflects the amount of collateral available and the expected market price of the new bond. For details, see World Economy Survey, 1990 (United Nations publication, Sales No, E.90.II.C.1), p. 89.

Notes (continued)

18/ The Costa Rican agreement alleviated the country's scheduled debt-service burden but not its debt-related cash flow since Costa Rica had not been fully servicing its debt.

19/ Such data notwithstanding, by their agreements debt service was reduced for all those countries, notably Venezuela, whose yearly debt-eervics reduction averaged over 5 years will fall, it was estimated, by almost 6 per cent of 1989 gross domestic product (GDP, (for details, see World Economic Survey, 1991, pp. 162-164).

20/ Outside that range was the Philippines, whose total debt-service relief represented leas than 0.5 per cent of its 1969 QNP. For details, see World Economic Survey, 1991, pp. 162-163.

21/ The Uruguayan agreement was announced in December 1990; the Moroccan agreement is dependent on the conclusion of an extended arrangement with the International Monetary Fund, and the Nigerian package has been facing some difficulties and as of mid-1991 hae not been implemented.

22/ Funds obtained have been mostly company- or project-related. Credit has been extended to public enterprises by the floating of bonds in the United States and on European markets, Yields offered on those bonds have been very high, reflecting their perceived risk, with private companies paying the highest interest rates. Co-financing and prs-export loans have also been made available. Some *Mexican* companies have been successful in raising capital abroad by issuing equity on the international market, *For* details of individual arrangements, see N. Peagan, "Brave New World", Euromoney (March 1991), pp. 59-66.

23/ In July 1991, Petrobrae, the Brazilian State-owned oil company, successfully launched $200 million worth of bonds in international markets, that launching constituted the first Eurobond issue by a Brazilîan borrower since the emergence of the debt crisis.

24/ For a summary of the problems faced by financial systems in Japan and the United States, see World Bank, Global Economic Prospects and the Developing Countries (Washington, D.C. , May 1991), pp. 35-37.

25/ Governments generating large shares of foreign-erahange revenues may face similar difficulties whenever there is a persistent decline or marked instability in the world prices of the exports they control.

26/ Even in countries with more developed financial markets, Governments can only mobilize financial resources by maintaining attractive real interest rates. In the context of persistent inflation that strategy implies the need to roll over an expanding and inflation-led domestic debt, thus making fiscal adjustment an elusive goal.

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Notes (continued)

27/ Debt-equity swaps retired about $34 billion of developing country debt during 1985-1989. *For* details, see World *Bank*, World Debt Tables, p. 64.

28/ Costa Rica's programme, however, is an exception: debt-for-nature swaps undertaken during the period 1987-1989 aanoelled about 5 per *cent* of the country's commercial-bank debt outstanding in 1987.

29/ For low-income aountries, debt reduction is sometimes posslble only through grants made by donor aountries and soft loans offered by multilateral creditors. In early 1991, the Niger became the first country to benefit from a facility established by the International Development Assoalation (IDA) to help low-income aountries reduce their commercial debt. With a grant from IDA and additional funding from two donor countries, the Niger erased 97 *per* cent of its commercial-bank debt.

30/ Based on data of World Economic Survey, 1991, table A.34 .

31/ Baaed on information supplied by the Bank and the Fund (fiscal year ends 30 June at the Bank and 30 April at the Fund).

32/ The following presentation is based largely on "Economic, social and environmental consequences of the situation between Iraq and Kuwait and its short-, medium-, and long-term implications" (E/1991/102).

33/ These controversies are reviewed in another report to the general Assembly. See "Economic stabilization programmes in developing countries" (A/46/385).

34/ In the early 1980s, extensive decentralized borrowing built up claims on foreign-exchange earnings in some countries that exceeded their carrying capacity. [illegible] . and *to* help developing countries generally in better monitoring and managing their external-debt obligations, the international community has been fostering the design and dissemination of debt-management systems by UNCTAD (funded by the United Nations Development Programme), by the Commonwealth secretariat and by the World Bank. Re-emergence of new borrowing activity of the private sector and state enterprises accentuates the importance of such comprehensive systems of debt rogistration and management in developing country Governments.

35/ For a review of recent developments in the restructuring and supervision of major financial markets, see Bank of International Settlements, Sixtv-first Annual Report (Easel, 10 June 1991), pp. 102-118.

36/ For details, see UNCTAD, The Least Developed Countries: 1990 Report, p. 46,