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EXTERNAL DEBT CRISIS AND DEVELOPMENT

THE RECENT EVOLUTION OF THE INTERNATIONAL DEBT STRATEGY

Report by the Secretary-General

I. INTRODUCTION

1. The General Assembly has, during past years, examined the external debt problems of developing countries, and sought to enlarge the area of international agreement on the policy approaches required to overcome those problems successfully. Most recently, at its forty-fourth session, the General Assembly adopted resolution 44/205 of 22 December 1989, which, among other things, spelled out a number of measures that would be required in order to ensure that recent initiatives on debt, in particular those related to debt reduction, in conjunction with appropriate economic policies and a favourable international environment, have an effective and comprehensive impact on the reactivation of economic growth and sustained development in the developing countries.

2. In order to help support the General Assembly in its endeavour to enlarge the area of international agreement on policy approaches to debt problems, the Secretary-General appointed, at the end of 1989, the Honourable Bettino Craxi as his Personal Representative on Debt. Mr. Craxi was to meet with government leaders of creditor and debtor countries, heads of financial institutions and banks in the course of the next year in order to explore ways and means, propose courses of action and, in general, promote the speedy and effective lowering of the debt burden of those countries.

3. The Personal Representative on Debt has completed his task and the Secretary-General is submitting to the General Assembly the report by Mr. Craxi (A/45/380). The report of the Personal Representative contains an extensive analysis of the origin, evolution, scope and character of debt problems facing developing countries and proposes policy remedies. The present report seeks to

review the main developments in the evolution of the international debt strategy since the adoption of resolution 44/205 and to provide a brief assessment of that evolution.

II. THE EVOLUTION OF THE DEBT STRATEGY

4. From mid-1989 to mid-1990 important steps forward were made in implementing the improvements in the debt strategy called for by the Brady initiative and the Toronto agreement (see below), with a number of individual debtor countries able to negotiate their debt on more favourable terms. These developments occurred against the background of continued external financial difficulty and generally poor overall growth performance. The net transfer of resources associated with medium- and long-term borrowing by developing countries remained strongly negative, amounting to about $35 billion in 1989. 1/ This has continued to exert downward pressure on public and private investment and is a root cause of the difficulties being experienced by many countries in bringing public sector revenue and expenditure into better balance. 2/ At the same time, output growth remains, at best, stalled for most debtor countries: output is expected to fall in 1990 in the countries of Latin America taken as a group and output growth in Africa will probably again fall short of population growth. 3/

5. Since mid-1990, the external accounts of most debtor countries have come under the influence of events in the Persian Gulf. Those developments will have a major impact on a number of debtor countries and will seriously complicate economic management in many more. Short-term, emergency financial assistance on appropriate terms to help countries that are adversely affected is needed. 4/ A step in that direction has already been made by donor countries and multilateral institutions, as reflected in the communiqués of the recent meetings of the Interim and Development Committees. If events in the Persian Gulf were to have a medium- or long-term impact on debtor countries, they would generate a need for additional action on several fronts, including the debt strategy.

A. OFFICIAL DEBT

6. By the end of 1989, the debt owed to official creditors (both bilateral and multilateral) by capital-importing developing countries had grown to about $495 billion, accounting for almost half of the total medium- and long-term external debt, as compared to two fifths in 1985. 5/ The considerable increase in official debt was attributable, to a significant extent, to the capitalization of interest in official bilateral debt reschedulings as well as to the accumulation of interest arrears on bilateral and multilateral debt.

1. Official debt rescheduling

7. Since the onset of the debt crisis, the number of official bilateral debt reschedulings has increased rapidly. The rhythm of reschedulings recently reached a very high pace, with 22 meetings in 1989 at the Paris Club (where official

bilateral debt is rescheduled) and 16 in the first nine months of 1990, against an annual average of 16 during 1983-1988. This acceleration is a symptom of the short-term approach of the Paris Club, whereby the consolidation period (the period in which debt service payments to be rescheduled fall due) has been - until recently - typically 12 to 18 months. Thus, in 1989 and during the first nine months of 1990, of the 34 rescheduling countries, 26 had rescheduled at least once before. Of these, 13 had already done so three times or more and 5 at least six times. Moreover, debt service due on previously rescheduled debt has become an increasingly important portion of the consolidated amount, reflecting the inadequacy of the terms of the original agreement.

8. A number of improvements, however, have recently been introduced in Paris Club practices, most notably following the Toronto agreement on concessional relief for poor debtors. Moreover, multi-year rescheduling agreements (MYRAs) have been reintroduced. 6/ Most recently, the Paris Club has lengthened rescheduling maturities and grace periods for lower middle-income countries with high levels of official debt.

9. The Toronto agreement of June 1988 has provided Paris Club creditors with a range of options regarding the official bilateral debt owed by low-income countries: (a) partial forgiveness of debt service; (b) longer repayment periods; and (c) concessional interest rates. The Toronto agreement marked a major advance in the debt strategy in that for the first time creditor Governments recognized the need for concessional relief with regard to non-concessional official debt.

10. Creditors initially offered the Toronto terms to sub-Saharan African countries included in the World Bank's Special Programme of Assistance (SPA), most of them least developed countries; so far, 17 of these African countries have benefited from this initiative. 7/ In 1990, Bolivia and Guyana also obtained Toronto terms. All the beneficiary countries are eligible for World Bank financing only through the International Development Association (IDA).

11. Implementation of the options offered in the Toronto agreement has revealed a number of shortcomings. 8/ The scale of relief they give rise to is extremely limited. For the 15 countries benefiting from the Toronto terms in 1989, the savings on interest payments in that year were less than 2 per cent of the debt service payments of those countries; and several of them will still have to make payments at least three times higher than those they have been able to make in recent years. The small impact of the Toronto scheme reflects its low concessionality: for the 15 beneficiaries, the overall grant element was, on average, about 20 per cent, less than one quarter of the average grant element in new loans and grants extended to severely indebted low-income countries.

12. Another reason for the limited scope of the measures is that only debts meeting certain criteria can be rescheduled. Moreover, only debt service payments falling due during short consolidation periods benefited from the new terms, with the result that repeated reschedulings, which are time-consuming, remained necessary. Some creditors have financed the cost of debt relief by transferring funds from their aid budgets, thus reducing the additionality resulting from the Toronto measures.

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13. Reflecting the growing perception of the inadequacy of the Toronto terms, a number of creditor countries have recently put forward bold proposals involving massive debt reduction. At the second United Nations Conference on the Least Development Countries, held in Paris in September 1990, the Government of the Netherlands called for the cancellation of all official bilateral debt owed by least developed and other low-income countries facing severe debt problems and implementing sound economic policies. 9/ At the recent meeting of the Commonwealth Finance Ministers, 10/ the Government of the United Kingdom proposed that Paris Club creditors should reduce the entire stock of official bilateral debt owed by eligible countries by two thirds, with the remaining debt rescheduled over 25 years and interest payments capitalized for the first 5 years.

14. Many middle-income countries whose debt is owed mostly to official creditors also face serious financial difficulties. The issue of debt reduction for those countries has begun to receive increased attention by creditor countries. For instance, in June 1990, France announced measures to lower interest rates on its non-concessional loans to four middle-income countries of sub-Saharan Africa. 11/ At the same time, the United States launched a programme aimed at reducing its official claims on Latin American countries, within the framework of the "Enterprise for the Americas" initiative dealing with the region's trade, investment and debt. The programme envisages a substantial cancellation of concessional loans and the payment of interest in local currency, which may be used to support environmental projects. Furthermore, a portion of non-concessional official loans (such as export credits) would be sold in the market in order to facilitate the conversion of debt into equity and debt-for-nature swaps.

15. Following the recommendations made at the Houston Summit, the Paris Club adopted in September 1990 a new package of measures in favour of heavily indebted lower middle-income countries with high levels of official debt. These measures include the extension of rescheduling maturities to 15 years (with a grace period of up to 8 years) for non-concessional loans and to 20 years (with a grace period of up to 10 years) for official development assistance (ODA) loans. In addition, the new treatment allows limited amounts of debt-equity swaps and other debt conversions - such as debt for nature and debt for aid - by creditor countries on a voluntary basis. 12/

16. Official creditors continue to require that a rescheduling country conclude a prior arrangement with the International Monetary Fund (IMF). This often causes delays, which in turn worsens the country's financial position. Indeed, the link with Fund conditionality has tended to become even stronger; creditors now make the implementation of some rescheduling agreements contingent upon the debtor country meeting performance criteria under Fund arrangements.

2. Multilateral debt

17. For a number of developing countries, multilateral debt represents an important share of their total debt. The service on this debt has become so large that net financial transfers from multilateral institutions to developing countries have declined sharply and a number of debtor countries are experiencing

difficulties in meeting their obligations. In 1989, for instance, developing countries transferred about $4 billion to IMF and net lending itself by that institution (disbursements minus amortization) was a negative $2 billion. Net transfers from the World Bank to the severely indebted middle-income countries were negative in fiscal years 1988 and 1989, and reached a modest positive amount of $1.4 billion in fiscal year 1990. A number of countries are in arrears on their multilateral debt. By mid-1990, 10 countries were in arrears on their IMF debt for an aggregate amount of $4.4 billion, while 7 countries had accumulated arrears with the World Bank totalling $1.8 billion.

18. Multilateral financial institutions have taken some measures to alleviate the servicing burden and thus help avoid arrears on multilateral debt. For instance, in 1988, the World Bank decided to put aside 10 per cent of repayments to IDA to help IDA-eligible countries pay their interest on debt owed to the International Bank for Reconstruction and Development (IBRD) (which was contracted at market rates); a number of donor countries provided additional resources for this purpose. IMF has introduced the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) to provide balance-of-payments assistance on concessional terms to low-income countries.

19. However, the Fund has had to take further measures to deal with the problem of already existing arrears. The Fund has thus mobilized additional resources from its developed members through support groups to help those debtor developing countries in arrears to the Fund that are willing to adopt corrective measures. The success of these support groups has so far been limited, as only two countries (Guyana and Honduras) have cleared their arrears with IMF under this approach. Early this year, IMF adopted the "rights" approach, under which a member with massive and protracted arrears could earn "rights" - based on sustained performance during the period of a "rights accumulation" programme monitored by IMF - towards future financing up to the equivalent of arrears outstanding at the outset of the programme.

B. DEBT OWED TO PRIVATE BANKS

20. A notable event on the private debt front during the past 12 months was the start made in implementing the strengthened debt strategy, adopted following the initiative proposed last year by United States Secretary of the Treasury, Nicholas Brady. Agreements were reached first with Mexico, the Philippines and Costa Rica, followed later by Venezuela and Morocco. Those agreements offer creditor banks various options of debt and debt service reduction and new money lending. To date, the choice of banks has been known only for the Mexican, Philippine and Costa Rican deals. Very few new restructuring agreements were signed outside the Brady framework 13/ and some concluded previously have become inoperative. Arrears on commercial bank debt have continued to accumulate, almost trebling to $18 billion between end-1988 and March 1990.

21. Debt and debt service reduction has appeared as a central element of the strengthened debt strategy. However, the amount of reduction in prospect falls considerably short of what is required. 14/ One study estimates that the Mexican

agreement will increase its cash flow by about 2 per cent of GDP, that is, about half that country's target; it also concludes that most of the relief reflects the restructuring of principal repayments other than the reduction in interest payments or in debt itself. 15/ Similarly, the Philippine agreement is more akin to a conventional rescheduling than debt reduction. 16/ In both the Mexican and Philippine agreements, debt reduction operations are counterbalanced by debt increasing ones. 17/

22. Stimulating alternative sources of private capital and the reversal of capital flight are also part of the debt strategy. As regards other sources of financing, however, almost all types of capital flows to debt-distressed countries have declined altogether over the past eight years. Foreign direct investment to the 15 highly indebted countries, for instance, declined after 1982 and, despite efforts by their Governments to encourage it through liberalization policies and new incentives, in 1988 inflows of foreign investment were at about half their 1982 level in real terms. The macro-economic disorder and sluggish growth associated with the debt overhang has acted, and continues to act, as a powerful deterrent to the repatriation of capital and to foreign investment. Neither should be expected to take place on a large scale as long as the unsettled economic conditions prevalent in debt-distressed countries persist.

23. The present approach thus depends critically on increased new lending by banks. It is often argued that adequate solutions can be found by giving creditors the options either to reduce debt and debt service or to provide new money. The extent and strength of creditor banks' interest in providing new money is, however, questionable. A number of impediments to new lending exist, including the low perceived credit worthiness of most debtor developing countries, owing in large part to a lack of sustained improvement in their external financial positions, as well as competitive pressures in the banking industry and new regulatory requirements (for instance on capital adequacy). 18/ Some of these impediments have intensified over the years. For instance, between mid-1989 and early 1990 a number of banks in the United States, the United Kingdom and Canada undertook a second round of reserve increases, thus increasing further the cost of new lending, since reserves would presumably have to be expanded in parallel with any new loans.

24. Finally, the experience of the three Brady deals implemented so far (Mexico, Philippines and Costa Rica) shows how difficult it is to obtain new lending. In the Mexican and Philippine agreements, for instance, the amounts of new money raised fell far short of expectations. 19/ In the Costa Rican agreement, no attempt was made to obtain new money.

25. Some other features of the agreements implemented to date have given rise to concern. For one, the agreements have rendered the remaining debt more difficult to restructure. A large proportion of bank loans have been transformed into bonds and those have been perceived as exit instruments since they generally exempt the holders from future restructuring and new money calls. Furthermore, additional multilateral debt (which in principle is not possible to restructure) has been incurred. Second, the agreements contain recapture clauses for creditors in the event of a significant rise either in the price of petroleum (in the case of Mexico

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and Venezuela), or in GDP growth (in the case of Costa Rica). But no recapture clauses in favour of debtor countries, in the event of a significant deterioration in their economic situation for instance, is included in those agreements. Such an asymmetry would be justifiable only if debt and debt service were reduced by a sufficiently wide margin to reduce vulnerability to external shocks.

26. The implementation of the Brady initiative has suffered from the absence of internationally set targets for the medium-term cash flow and debt profile of the country whose debt problem is being addressed. As a result, there has been a tendency for the extent of debt and debt service reduction to be shaped by the balance of negotiating strength rather than by objective needs. In some of the recent agreements, the imbalance in negotiating strength was offset in part by the United States Government. However, this is not part of the formal architecture of the strategy. In the Costa Rican agreement, the decision of IMF and the World Bank to provide financial support to the country's adjustment programme despite its arrears, greatly helped persuade banks to sign the agreement. Such an attitude towards financing assuranes by multilateral financial institutions, more systematically applied, could be a powerful instrument in increasing the scope for debt and debt service reduction. However, recent discussions within the Group of Seven and IMF suggest that such a course may not be followed.

III. CONCLUSIONS

27. At the present juncture, it is impossible to foresee the full economic consequences of events in the Persian Gulf. The conclusions drawn in the following paragraphs as regards the debt strategy implicitly assume that the adverse economic impact of the crisis on debtor countries will be relatively short-lived and largely offset by additional external finance. Should either of these assumptions prove to be wrong, further consideration of the debt strategy would be required that goes beyond the issues raised below.

28. For many heavily indebted developing countries, both low-income and middle-income ones, it is increasingly recognized that debt and debt service reduction must be given more prominence in the debt strategy and that such reduction must be implemented by a wider range of creditors. Policies to put into effect this broadly shared view have already gathered momentum in the past 12 months with the wider application of Toronto terms to low-income countries, the conclusion of a number of debt and debt service reduction packages under the Brady plan, several unilateral initiatives regarding debt reduction by official creditors and the proposals made by some creditor Governments involving further measures to reduce the official debt burden, thus broadening the scope for policy action.

29. Nevertheless, the progress made in the implementation of the debt strategy has been limited. The amount of debt reduction that has been negotiated so far has been modest and has not led to the restoration of normal creditor-debtor relations, external viability or robust growth in most highly indebted countries.

30. With regard to the debt owed to official bilateral creditors, there has clearly been some progress in alleviating the debt burden of low-income countries. The Toronto agreement has marked a significant step forward by providing for the

rescheduling of official debt on concessional terms. However, the degree of relief granted is inadequate as it falls far short of what is needed in order to match the debt servicing capacity of low-income countries. Several proposals have been made recently by creditor Governments that point to the need for a much bigger reduction of debt and debt service for these countries. Urgent consideration of those proposals should occur during the period ahead and actions flowing from this consideration must undoubtedly result in a further substantial strengthening of the debt strategy. 20/

31. The issue of official debt of lower middle-income countries has also received increasing attention by creditor countries. The new Paris Club policy for heavily indebted countries in this category represents a step in the right direction, but a timid one. Many of these countries will need reduction of their official bilateral debt. For them, debt reduction by commercial banks alone is not enough: official bilateral creditors also need to reduce their claims. In this regard, expeditious consideration should be given to the recent French proposal calling for a more diversified menu incorporating options involving debt and debt service reduction. 21/

32. The issue of arrears with multilateral institutions is one aspect of the global debt problem that should continue to be tackled in a co-operative spirit and through a growth-oriented approach. The priorities in this respect are a substantial increase in not transfers from multilateral financial institutions and urgent implementation of measures to alleviate the debt servicing burden and eliminate arrears. Recent increases (sometimes long delayed) in the resources of a number of multilateral financial institutions mean that multilateral lending could be set for further expansion. 22/ Moreover, multilateral financial institutions and donor countries should give urgent consideration to further measures to alleviate the burden of multilateral debt, while safeguarding their sound financial basis, as recommended by the Second United Nations Conference on the Least Developed Countries. These measures could include the strengthening and widening of existing mechanisms such as interest rate subsidies or refinancing schemes funded by reflows or special trust funds. 23/

33. With regard to debt owed to commercial banks, in general the emphasis in financial packages for highly indebted countries should be on debt reduction rather than new lending. In each case, the negotiation process should be anchored on authoritative estimates of the country's debt reduction and cash flow needs. The multilateral financial institutions could play a useful role in this regard. IMF should continue to support, in appropriate cases, the country's adjustment programme even in the absence of an agreement with private creditors. Providing creditors with additional incentives to engage in debt and debt service reduction on a larger scale and to accept steeper discounts in such operations would also be useful. A wide variety of proposals in this vein have been put forward in recent years, for instance, to establish an international debt facility.

34. National laws and regulations could also be directed more effectively towards achieving adequate levels of debt and debt service reduction. One recent suggestion (made with European countries in mind) is that creditors should qualify for tax deductions on their loan-loss provisions only to the extend that they

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participate in debt reduction packages. Another (made with the United States in mind) is that creditors who fail to participate in debt reduction packages sanctioned by IMF and the World Bank should be required to make special provisions on their loans and should not be eligible to tax relief on losses.

35. The scale of consensual debt and debt service reduction needs to be enlarged very considerably if unilateral steps are to be avoided. However, the combination of additional incentives and disincentives chosen in order to enlarge the scale of debt reductions should not be tilted in favour of increased financial support from the World Bank and the regional development banks. Unless additional funds are put at their disposal, such support could reduce lending for new investment, which is the key to successful adjustment.

Notes

1/ See table IV.2, p. 82, in World Economic Survey 1990, United Nations.

2/ For a detailed examination of the net transfer and its impact on domestic economies, see the report of the Secretary-General on net transfer of resources from developing countries (A/45/487).

3/ See UNCTAD, Trade and Development Report, 1990, table 16, and Survey update.

4/ For an assessment of the economic consequences of events in the Persian Gulf and a discussion of possible policy responses, see: "Economic consequences of the present crisis: a preliminary assessment" (TD/B/1271).

5/ World Economic Survey 1990, op. cit., table IV.3.

6/ After an unsatisfactory experiene with MYRAs in 1985 and 1986, there was a return to them in 1989 and 1990 for seven rescheduling countries. In each case the length of consolidation period was covered by a medium-term IMF programme, under either the extended Fund facility, SAF or ESAF.

7/ Benin, Central African Republic, Chad, Equatorial Guinea, Guinea, Guinea-Bissau, Madagascar, Mali, Mauritania, Mozambique, Niger, Senegal, Togo, Uganda, United Republic of Tanzania, Zaire and Zambia.

8/ For a more detailed discussion of the Toronto agreement and its implementation see UNCTAD, Trade and Development Report, 1989, box 7, and UNCTAD, "Debt and managing adjustment: attracting non-debt-creating financial flows and new lending" (TD/B/C.3/234), paras. 15-21.

9/ The Government of the Netherlands has subsequently elaborated its proposal by calling for a gradual cancellation of bilateral official debt, made conditional on the implementation by debtor countries of sound economic policies in the context of IMF programmes (see Press Release No. 52 of the 1990 Annual Meetings of IMF and the World Bank Group, 26 September 1990, pp. 3 and 4).

Notes (continued)

10/ See the communiqué of the Meeting of Commonwealth Finance Ministers, Port-of-Spain, 19 and 20 September 1990.

11/ Cameroon, Congo, Côte d'Ivoire and Gabon.

12/ For each eligible debtor country, such conversions may be applied to up to 100 per cent of ODA loans and direct government credits, and up to 10 per cent of guaranteed export credits or up to $10 million, whichever is higher.

13/ Zaire reached agreement with its creditor banks to defer payments of its arrears and principal due in 1989 and early 1990; Jordan agreed in principle with its creditor banks on a restructuring package, including some new money; and Honduras (whose 1987 agreement in principle proved stillborn) arrived at an agreement with two of its main creditor banks to reschedule part of its outstanding obligations. Colombia was able to obtain the refinancing of most of its bank debt due in 1989-1990. On the other hand, the agreements signed in 1988 respectively with Brazil and Côte d'Ivoire have collapsed. Negotiations on a new agreement on Brazil's bank debt started in October 1990.

14/ See, for instance, UNCTAD, Trade and Developmnt Report, 1989, Part One, chap. II, sect. B. On the adequacy of debt and debt reduction attainable, see also World Bank, World Debt Tables 1990, vol. I, p. 25.

15/ For a detailed study of the Mexican agreement and quantitative estimates, see World Economic Survey 1990, op. cit., pp. 88-91.

16/ Ibid., p. 92.

17/ In the case of Mexico, $7 billion was written off in the exchange for bonds, but the debt also increased by about $7 billion ($5.7 billion from official creditors and $1.4 billion in new money). In the case of the Philippines, the country borrowed $560 million to write off old debt and issued $700 million of new money bonds, reaching a total close to the $1.3 billion retired through the agreement.

18/ New capital ratio requirements have been set by the 1988 Basel agreement on capital adequacy. (See UNCTAD, Trade and Development Report, 1989, annex 2.) For a more detailed examination of impediments to new lending, see World Economic Survey 1989, pp. 64 and 67, and UNCTAD, Trade and Development Report, 1989, pp. 43 and 46.

19/ In the Mexican deal, banks representing 47 per cent of the debt in the deal chose to convert their claims into reduced interest bonds at part; banks representing 41 per cent of the debt chose the discount bond conversion option. Banks choosing to lend new money account for the remaining 12 per cent, which is about half the figure that had been expected. In the Philippine deal (which offered to banks two options: a new money scheme and a buy-back operation), the amount of new money raised fell far short of the target set by the Government while

Notes (continued)

more tenders for buy-backs were received than could be accommodated. A number of creditor banks chose not to participate. For more details on these deals, see *World Economic Survey 1990*, *op. cit.*, pp. 88-93, and UNCTAD, *Trade and Development Report, 1990*, pp. 27 and 28.

20/ On this issue, as well as on several other issues raised in this report, see resolution 388 (XXXVII) adopted by the Trade and Development Board of UNCTAD on 17 October 1990. That resolution, *inter alia*, urges Governments to expedite consideration of recent proposals concerning further measures to reduce the official debt burden.

21/ See Press Release No. 19 of the 1990 Annual Meetings of IMF and the World Bank Group, 25 September 1990, p. 2.

22/ These increases include, for instance, the ninth replenishment of IDA, the 50 per cent increase in the quotas of IMF, and the seventh general increase in resources of the Inter-American Development Bank. For more details, see *World Economic Survey 1990*, *op. cit.*, pp. 85 and 86.

23/ See the Paris Declaration and Programme of Action of the Second United Nations Conference on the Least Developed Countries (A/CONF.147/Misc.9), paras. 42-45.
