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Economic Development and the Debt Crisis

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Debtors and creditors, including the international institutions, should work toward longer-term adjustment plans that ensure debtor countries of adequate resource flows over several years and that lead to needed policy changes during the period of adjustment.

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The prolonged debt crisis of those highly indebted countries whose debts are owed primarily to the commercial banks has resisted all the creative financial engineering efforts of the last few years.

The Baker initiative, which built on increased lending flows from the commercial banks and multilateral institutions, has produced only fitful growth. And new financing arrangements have made only a small dent in the debt problem. As for more ambitious schemes, such as an international debt facility, there is little prospect that governments or commercial banks will accept the losses such a facility would recognize.

Thus it is more likely that the current country-by-country approach will evolve — with the introduction of some new assets and perhaps the development of debt conversion techniques in conjunction with long-term adjustment programs. The banks, too, might be willing to grant debt relief if it is associated with

a change in economic policy in the debtor country or with guarantees of some type. For some countries, both creditors and debtors might prefer interest rate reductions to write-downs of the debt.

Fundamental policy changes in the debtor countries have been slow in coming. Reforms will be more likely if the debtor nations can be sure that financing will continue over several years. The benefit of such an approach is that it moves toward a longer-term solution to the debt crisis, enabling governments to concentrate on domestic economic management rather than debt negotiations. Because the debt crisis dominates policymaking in these countries, a shift toward longer-term development would itself contribute to growth.

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ECONOMIC DEVELOPMENT AND THE DEBT CRISIS.

Stanley Fischer¹

Since it was first recognized in August 1982, the international debt crisis has dominated economic policymaking in the developing countries, economic relations between the debtor and creditor countries, the attention of the multilateral institutions in their dealings with the heavily indebted countries, and private sector decisions on lending to the developing countries.

There are two major development crises in the 1980's, the crisis of the sub-Saharan African countries, whose debts are largely to governments, and the crisis of the group of countries--known as the highly indebted countries or HIC's--whose debts are primarily to the commercial banks². Data on sub-Saharan Africa are presented in Table 1³. Average per capita GDP in sub-Saharan Africa, at about \$500 per capita⁴, is now below its level

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²There are seventeen HIC's: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Ivory Coast, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. Mostly Latin-American, they consist of the original Baker fifteen, the countries singled out in the 1985 Baker strategy, plus Costa Rica and Jamaica.

³Because there is some overlap between the HIC's and sub-Saharan Africa groups, a "low-income Africa" group is sometimes used instead of sub-Saharan Africa.

⁴Measured in 1987 dollars.

in 1970. The low level of investment implies low growth and thus transfers current low levels of income to the future.

Although the African crisis is at least as serious in human terms as that of the HIC's, it is less closely related to financial developments than is the crisis of the HIC's. The African debt is owed mainly to official creditors, and much of it is concessional. Despite a debt-GNP ratio of 69% in sub-Saharan Africa, above the 48% in the HIC's, interest payments on the external debt amount of 2.3% of GNP, below the 4.0% in the HIC's⁵. Both because most of the debt is concessional and governmental, and because the total is relatively small, the sub-Saharan African debt problem does not

Table 1: ECONOMIC PERFORMANCE, SUB-SAHARAN AFRICA.*

	1965-73	1973-80	1981	1982	1983	1984	1985	1986 ^a	1987 ^a
Per capita real GNP growth	3.4	0.6	-3.8	-4.4	-5.0	-5.1	0.9	-1.8	-4.4
Current account (% of GDP)		-3.2	-8.6	-9.0	-5.7	-1.5	-0.9	-2.8	-4.7
Interest/GNP (%)			2.1	2.4	2.4	2.7	2.7	2.6	2.3
Investment/ GNP (%)	17.6	23.1	24.9	21.7	17.0	14.3	15.1	15.1	16.4

Source: World Bank.

*Countries are: Benin, Botswana, Burkina Faso, Burundi, Cameroon, Central African Republic, Congo, Cote d'Ivoire, Ethiopia, Gabon, Gambia, Ghana, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Niger, Nigeria, Rwanda, Senegal, Seychelles, Sierra Leone, Somalia, Sudan, Tanzania, Togo, Uganda, Zaire, Zambia, Zimbabwe.

^aPreliminary estimates.

have serious implications for the international financial system.

⁵The lower interest/GNP ratio in sub-Saharan Africa is also in part a result of a larger share of arrears in sub-Saharan Africa.

Accordingly the emphasis in this paper is on the debt crisis in the HIC's rather than on the African development crisis⁶.

Developments in the highly-indebted countries are summarized in Tables 2 and 3. The immediate aftermath of the onset of the debt crisis is reflected in the 13% decline in per capita real GDP over the period 1980 to 1983. Slow but positive growth (on average in the HIC's) since 1984 has reduced the decline in per capita income since 1980 to just over 9%. Part of the increase in income to 1981 was based on borrowing that would have been unsustainable even without the worldwide recession and real interest rate increase that began in that year. However, for some of the HIC's, per capita income in 1987 was below that in 1975; the gains of more than a decade have been wiped out⁷.

Table 2: ECONOMIC PERFORMANCE, SEVENTEEN HIGHLY INDEBTED COUNTRIES.

	1965-73	1973-80	1981	1982	1983	1984	1985	1986 ^a	1987 ^a
Per capita real GNP growth	4.4	2.8	-2.6	-4.9	-5.4	0.1	1.1	1.6	0.8
Current account (% of GDP)	-1.3	-2.7	-5.2	-5.9	-1.8	0.1	0.1	-1.5	-1.6
Interest payments/GNP (%)		1.3 ^b	3.8	4.8	5.4	5.4	5.1	4.5	4.0
Investment/GDP (%)	21.4	24.9	26.0	22.4	18.0	17.9	18.5	19.2	20.2

Source: World Bank

^aPreliminary data; ^bEstimate for 1975

⁶See Underwood (1987) for a discussion of the latter.

⁷Among the major HIC's, per capita real GNP in Argentina was 12.6% lower in 1987 than in 1975; by contrast per capita real GNP in Brazil rose 30.1% between 1975 and 1987.

There has been an extraordinary turnaround in the current account of the balance of payments of the HIC's over the past six years. The current account deficit averaged nearly 6% of GNP in 1982; over the period 1984-1987 it averaged 0.7% of GNP. Improvement in the current account was matched by a decline in domestic investment⁸ implying a fall in net capital formation to half its previous share of GNP. In some heavily indebted countries net investment is essentially zero.

The major decline in investment is both a symptom and a cause of the development crisis confronting the HIC's. The severe reduction of imports caused by adjustment to the debt crisis likewise hampers growth. The internal transfer problem arising from the budgetary impact of higher interest payments both results in higher taxes and, through monetary financing of the deficit, contributes to the serious inflation problem of many of the HIC's. These are the factors that make the debt crisis also a development crisis.

Developments on the trade and debt fronts in the HIC's are described in Table 3. Net private capital inflows have virtually disappeared, and even total capital inflows have been much smaller since 1982 than interest payments abroad: The most remarkable feature of the debt strategy

⁸Total GDP for the seventeen heavy debtors is in the range \$750-1000 billion.

 Table 3: TRADE AND DEBT DATA, HEAVILY INDEBTED COUNTRIES.

	1970-79	1980	1981	1982	1983	1984	1985	1986	1987 ^a
Total external debt (\$ bill)	96	288	350	390	421	438	452	472	485
Net private borrowing (\$ bill)	12.3	29.3	3.1	35.6	19.7	14.8	6.1	4.0	5.0
Debt/export ratio (%) ^b	148	175	209	268	305	285	303	365	327
Terms-of-trade change (% p.a.)	6.4	8.6	0.6	-2.3	-1.0	0.7	-2.3	-14.3	-0.4
Non-oil commod. prices (% p.a.)	11.1	9.8	-13.1	-10.8	5.5	1.5	-11.3	0.6	0.3

 Source: World Bank

^aPreliminary.

followed since 1982 is that the heavily indebted developing countries have been transferring real resources of close to 5% of their income to the developed creditor countries⁹. Despite the virtual cessation of capital inflows, debt burden indicators, such as the debt to export ratio, have not improved since 1982¹⁰: the effects of the increased volume of exports and decreased volume of imports were offset by a worsening of the terms of trade.

The picture for the debtors is not entirely bleak. Real interest rates have fallen between 1982 and 1988, a change that is reflected in Table

⁹Net transfers from the HIC's declined to 2.4% in 1987, as a result of lower interest rates, increased lending by private and official creditors, and the accumulation of arrears by some debtors.

¹⁰The debt to GNP ratio for the HIC's also increased over the period 1982-1987.

2. Net exports showed extraordinary growth. Budget deficits have been reduced despite falling incomes and the burden of interest payments. Some commodity prices began to recover in 1987. The period has seen a shift toward rather than away from democracy.

There has also been very real progress for the creditor banks and for the international financial system. Most important, neither the commercial nor central banks have had to deal with large-scale debt defaults. Balance sheets of creditor banks have been strengthened by additions to capital and loss reserves in the United States and Europe, by the weakening of the dollar for those foreign banks that lent in dollars, and by reductions in foreign exposure. There is an active secondary market in developing country debt, and debt to equity swaps are a reality. The optimist (for example, Feldstein, 1987) can take solace in the failure of the worst fears of 1982--that there would be a worldwide financial crisis--to eventuate. He can point also to some successes, such as Korea and other southeast Asian countries, and the earlier problem case of Turkey.

But the fact remains that six years after it began, the debt crisis is very much alive. None of the major Latin American countries has restored normal access to the international capital markets; major debtors in both Africa (Nigeria) and Asia (the Philippines) are likewise far from having normal access to the international capital markets. Even a country like Colombia, which has rigorously met its payments, finds it difficult to roll over its debts. At least one major debtor has been in trouble each year. Most important, growth prospects in many of these countries are weak, as they are in sub-Saharan Africa.

In this paper I review the debt strategy followed since 1982 and recent developments in the debt crisis, evaluate alternative solutions, and discuss the actual and potential roles of the World Bank and the IMF.

I. Debt Strategies.

Figures 1 and 2 show the ratio of (long-term) debt to GNP and the ratio of interest (on long-term debt) to GNP respectively for the highly indebted countries over the period 1976 to 1987. The real long-term debt of the highly indebted countries grew by 13% per year on average from 1975 to 1980 while the nominal debt was growing at more than 21% per annum; interest payments on long-term debt nearly quadrupled over the period, with the interest to GNP ratio on long-term debt rising from 1.3% to 2.3%. It was this period of rapidly rising debt that laid the seeds of the debt crisis.

Over the next two years the total debt of the HIC's rose another \$100 billion, or by 35% (16% in real terms). The interest bill on long-term debt increased from 2.3% of GNP to 3.7%. The interest burden of the debt, measured as a ratio to GNP, had thus almost tripled between 1975 and 1982¹¹. But the increase in the ratio of nominal interest to GNP between the mid-seventies and 1982 substantially understates the increase in the interest burden of the debt. With the decline in the rate of inflation over the period¹², the real interest rate had risen from less than 1% per annum to

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¹¹Because the HIC's were exporting an increasing share of output over this period, the ratio of interest to exports rose less rapidly, from 8.6% to 20.4%.

¹²Between 1975 and 1980 the average rate of inflation in the United States (GNP deflator) was 7.6%; over the next five years it was 2.1%. The average real interest rate on U.S Treasury bills was 0.2% for the second half of the seventies and 8% for the first half of the eighties.

more than 7% per annum--and the interest burden had thus increased far more than three-fold. By 1982 the debt crisis had begun.

The debt crisis had three causes: imprudent macroeconomic management and borrowing by the debtor countries; imprudent lending by the international banks; and the increase in the real interest rate, decline in commodity prices, and recession associated with counter-inflationary policies in the industrialized countries in the early 1980's. Imprudent macroeconomic policies allowed the exchange rate to become overvalued to the point where it was certain that a major devaluation would have to take place, thereby ensuring that domestic residents would prefer to hold foreign assets. Capital flight on a massive scale took place from several of the large debtors, including Mexico and Argentina. Imprudent lending policies allowed loans to borrowers, government and private, that were in no position to repay when the lending would have to stop; this lending was motivated in part by the view that governments would not default, or at least not be allowed to default. It was based also on the view that foreign governments implicitly guarantee the obligations of private firms in those countries. This view was justified ex post by the fact that most of the governments assumed even the unguaranteed debts of their private sectors. In Chile for instance, nearly two thirds of the government debt was originally private; in Argentina one third was originally private.

In addition, the rise in the real interest rate completely changed the nature of the debt problem. With a real interest rate of less than 1%, the level of the second half of the seventies, a change in domestic policy in the debtor countries would have made it possible to grow out of the debt

overhang relatively easily; with the step change in real interest rates to the 5-8% range of the 1980's, few countries could realistically hope that growth would reduce the debt burden without massive current account improvements.

Muddling Through.

When the debt crisis broke in 1982, default by a major debtor would have subjected the international banking system to potential bankruptcies, with consequences that could not be predicted and possibly not be controlled. The debt strategy followed from 1982 to 1985 was therefore directed at preventing default by any major debtor--in particular, Argentina, Brazil or Mexico--and preventing the development of a debtors' cartel. Hence the approach had to be on a country-by-country basis.

Although the process has been derided as muddling through, the monetary and fiscal authorities in Washington and other industrialized country capitals were indeed following a definite strategy. The strategy was to prevent default by providing debtors with financing in the context of an IMF stabilization program. The financing came from both the IMF and the commercial banks, whose participation was co-ordinated or concerted by officials and ensured by a combination of moral suasion and the banks' interest in preserving their original investments.

This was the right strategy at the time. Something--such as renewed growth in the world economy, a recovery of primary product prices, or a decline in the real interest rate--might turn up to mitigate the crisis while the borrowers made much-needed changes in macroeconomic policy. By 1983-84 there was reason to hope that the strategy would succeed not only in

containing the debt crisis, but also in solving it. With the rapid U.S. recovery and the impressive turnarounds in debtor trade accounts, it seemed that the debtors could generate trade surpluses that would go sufficiently far towards meeting interest payments that the commercial banks would be willing to provide new money voluntarily¹³.

However, the improvement in debtor country trade accounts was a result of import compression, through real devaluation and restrictive aggregate demand policies. The HIC's, lacking the domestic or foreign resources to finance investment, were facing a crisis of growth. Whereas in 1981 the HIC's were receiving net transfers from abroad of 2.8% of their GNP, in 1984 and 1985 they were on average transferring 5% of their GNP abroad.

The Baker Plan.

The growth crisis of the debtor countries was addressed in the next stage of the debt crisis, the announcement in September 1985 of the Baker Plan. The Baker Plan continued the country-by-country approach while singling out a group of fifteen highly indebted countries for special attention. The strategy was to shift the emphasis in dealing with the debt crisis from IMF-style contractionary stabilization to adjustment with growth. The adjustment would be both macroeconomic, in the restoration of sound fiscal policy, and sectoral, in the removal of distortions in international trade, in domestic goods and factor markets, and in the capital markets. There could be little doubt that adjustment was needed. Financing for both growth and adjustment would come from the commercial

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¹³For an optimistic scenario of that period, see Cline (1984).

banks and the multilateral institutions, particularly the World Bank and the IMF.

As the emphasis shifted to growth-oriented adjustment, the World Bank, whose comparative advantage is in the area of long-term structural adjustment, and which had been making quick-disbursing adjustment loans since 1980, began to take a more prominent role in the debt crisis. With the commercial banks withdrawing from the HIC's, and with the World Bank providing long-term loans in contrast with the IMF's original mission of lending short-term for balance of payments purposes, the Bank's share in financing of the debtor countries grew.

The announcement of the Baker Plan did not increase net resource flows to the HIC's. Table 4 presents data on net flows (i.e. disbursements minus repayments) of long-term capital to the HIC's from different sources

 Table 4: NET EXTERNAL FINANCING OF HIC'S, 1980-1987 (\$billion)*

	1980-82*	1983-84*	1985	1986	1987 ^a
1 Total long-term debt	34.4	18.6	6.3	4.8	13.0
of which:					
2 IBRD/IDA	1.8	2.7	2.6	3.4	2.3
3 Private creditors	29.7	13.6	2.3	-0.9	5.0
4 Official grants	0.4	0.6	1.2	1.2	1.2
5 Direct private investment	4.2	1.1	-0.5	1.3	2.3
6 IMF purchases (net)	1.4	4.9	1.7	-0.3	-1.4
Total long-term financing	41.7	25.2	8.7	7.1	14.0

Source: World Bank.

*At average annual rate; ^aProvisional.

Sources of lines 1, 2, 3, 6: World Bank Debtor Reporting System Data Base, except line 1, 1987 and line 3, 1987, which are estimates

Sources of lines 4 and 5: OECD DAC, except for 1987 data which are World Bank estimates. The grants data exclude technical cooperation grants, since these tend to finance expenditures not recorded in developing country balance of payments data.

for the years 1980-87¹⁴. Net capital flows to the HIC's over the period 1985-87 were well below the levels of earlier years. Net flows from private creditors, including the commercial banks, failed to respond to the Baker initiative¹⁵. Net disbursements by the commercial banks were essentially

¹⁴Net flows are defined as in the text; net transfers are equal to net flows minus interest payments. Net flows to a country may be positive while net transfers are negative.

¹⁵Note though that the commercial banks were extending new loans to the HIC's during this period: negative net flows result when the amount of new loans is less than the amount of principal repaid.

zero in 1986, their lowest level in the decade; they increased to seven billion dollars in 1987, with most of that amount being provided to Mexico (about \$4.5 billion) and Argentina (about \$2 billion) in connection with concerted lending packages. In 1986 and 1987 the World Bank group accounted for a large share of total net flows to the HIC's; much of that flow took the form of structural and sectoral adjustment loans conditioned on adjustment programs by the recipients.

Experience within the group of heavily indebted countries has varied greatly in the period since 1985. There have been isolated years of high growth, in excess of 5%, in most of the HIC's. In aggregate, growth has resumed, albeit not sufficiently rapidly to restore the losses in income suffered in the period 1981-1983. Significant structural adjustments have been made in several countries, including Mexico and Chile, and a start has been made on structural adjustment in other countries, including Argentina. But structural adjustment programs are politically difficult, especially when undertaken in the context of sharp reductions in external financing and the need for budgetary contraction. None of the HIC's is yet clear of the debt crisis: even Chile, which is often regarded as the country which has made the most radical adjustments, still has an annual interest bill of nearly 8% of GNP.

The failure of the debtors to return to growth is a result first of their need to transfer resources abroad. It results too from the slowdown of the international economy, their domestic fiscal policies, and the halting adoption of structural adjustment programs. All these factors contribute to the very low rates of investment; while the importance of

structural adjustment has to be recognized, it is important to emphasize that consistent growth will not resume until investment does.

Despite the disappointing growth performance of the debtors and the low level of private net financial flows, the Baker strategy remains the only officially sanctioned approach to the debt crisis. Indeed, it has been significantly strengthened by the recent return of Brazil to the fold of a conventional IMF program-commercial bank financing package after its nearly year-long moratorium on interest payments. Brazil has the largest and most resilient economy among the HIC's, and is relatively less dependent on trade than many of the other HIC's. The failure of its challenge to the current strategy will discourage other countries that might have been tempted to try to obtain a better deal through confrontation.

The Menu Approach.

The unwillingness of commercial banks to increase their exposure in the debtor countries, combined with the development of a secondary market for developing country debt¹⁶, has led to a search for alternative ways of providing financing for the debtors while allowing the commercial creditors to reduce their exposure or change its form. The "market-based menu approach"¹⁷ has produced a host of actual and potential financing instruments that might make it easier to reach agreements between creditors and debtors.

¹⁶Prices in the secondary market are around 50% of face value for the largest debtors. However the market is primarily one in which debt is swapped rather than bought and sold for cash, and it is widely believed that prices in the market are not meaningful--and generally below the prices at which the creditors would prefer to continue to hold the existing debt rather than sell it.

¹⁷See "Market-Based Menu Approach", Debt Management and Financial Advisory Services Department, World Bank, January 1988.

There are two classes of instruments--those that seek to mobilize new money, and those that convert debt from one form to another.

New money techniques: The initial approach to the debt crisis, to concert new lending by the banks along with funding and policy conditionality from the IMF, is one new money technique. New money could also be raised by the sale of bonds, either standard fixed interest bonds which generally have a higher standing than bank credit, or by bonds with interest indexed to the prices of commodity exports (such as oil) or the volume of exports. Few commodity linked bonds have been issued, though it is easy to envisage a hedging demand for them. For instance, an oil-price linked bond would be a good hedge against changes in the price of oil.

Interest capitalization is a technique that has been often suggested but rarely used. Its benefit is that it ensures the banking syndicate stays together without extensive renegotiation. This technique has been favored by some European banks, but for regulatory reasons, not by United States banks.

Country funds have been set up for several countries, and provide the possibility of mobilizing equity financing. While such funds may well become important in future, the stock markets in most of the debtor countries are too small for these funds to make a significant contribution to solving the debt crisis.

Debt Conversions: The leading class of debt conversion instrument is the debt-equity swap. Such swaps have been undertaken by several countries¹⁸.

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¹⁸The programs in twelve of the debtor countries are described in "Market-Based Menu Approach", op. cit.

The key issues in evaluating the benefits for the debtor country are the implicit subsidy on the swap, and the question of "additionality". Consider a transaction in which debt purchased in the secondary market at say 50 cents on the dollar is swapped at face value for equity in the debtor country. In this case the debtor country is capturing none of the benefit of the market discount on the debt, and is in effect providing a 100% subsidy for the purchase of equity¹⁹. While the country likely gains short-term relief on its cash flow from the exchange of debt for equity, and probably benefits in the long run from the encouragement such swaps provide for the development of a domestic equity market, it is paying a high price for these benefits. Accordingly in some countries, for instance Chile and Brazil, the right to purchase equity in exchange for debt is auctioned, with the result that the benefit of the secondary market discount on the debt has been shared between the country and the equity purchaser. Alternatively, the transaction price for a swap could be set by specifying an explicit subsidy rate over the market price of the debt.

The additionality question is whether the country obtains any new resources in the debt-equity program. If the transaction is subsidized, and if the subsidy goes to investors who would in any case have been purchasing equity in the country without the subsidy, the debt-equity program could end up both increasing the amount the country pays to obtain foreign exchange and reducing the foreign exchange inflow.

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¹⁹Compare a direct purchase of one dollar's worth of equity with the purchase of one dollar's worth of equity through a debt-equity swap. In the first case the purchaser pays one dollar. In the second the purchaser pays 50 cents to obtain one dollar's worth of equity. The swap is thus being subsidized.

Debt has been swapped not only for equity, but also for nature preservation in Bolivia and for direct claims on exports from Peru.

Exit bonds have been offered in a few debt restructurings. Given the reluctance of some banks to continue lending to the HIC's, they have been given the option of exiting from the banking syndicate lending to a given country, by purchasing a bond that pays a lower interest rate than the remaining debt. Exit bonds have not been successful to date, though that has much to do with the terms of the bonds.

Local currency servicing of debt, perhaps with the requirement that the debt service be used to finance local investment, can help offset the effects of the debt crisis on investment in the debtor countries. To the extent that debt servicing is reinvested in the local economy, the economy avoids the transfer problem of having to generate a trade surplus to transfer resources abroad.

The government of course faces the fiscal problem of providing the local currency with which the debt is financed. To clarify the nature of this problem, note first that the outlay side of the budget is unaffected by the change from payment of interest abroad to payment domestically: these are payments the government would have had to make in any case. In one case the government makes the payment in foreign currency, in the other in terms of domestic currency. The difference is thus that in the case of payment of interest abroad, the government is reducing its foreign reserves.

Pursuing the analysis, consider both the monetary and aggregate demand aspects of the switch from payment of interest abroad to payment at home. On the monetary side, suppose first that the government pays in

domestic currency, i.e. that it prints money corresponding to the interest payments. This can be thought of as an open market purchase of foreign exchange, which is inflationary. Alternatively, the government may borrow domestically in order to finance the interest payments. This is an open market purchase of foreign exchange and sale of domestic bonds, which has a zero monetary impact. It also has a zero impact on the size of the government's debt, though it of course affects the distribution of the debt between foreign and domestic creditors. If the domestic real interest rate exceeds the foreign rate, the shift from foreign to domestic debt may increase the interest burden of the debt.

Summarizing the monetary implications of local currency financing of the debt, the first conclusion is that domestic currency financing does not reduce the interest burden on the government, unless the government pays by printing money--which is an option it had before in any case. It is also true that local currency servicing does not have to be achieved through the printing of money. However if domestic bond markets are thin, and domestic interest rates high, local currency financing is likely to be inflationary. It should therefore typically be accompanied by some budget tightening.

On the aggregate demand side, suppose that local currency financing of interest leads to an equal reduction in the current account surplus and increase in domestic investment. This increases domestic demand, and is therefore inflationary. This reinforces the conclusion that local currency financing ought to be accompanied by fiscal tightening.

What then is the benefit of local currency financing? The benefit arises from the fact that the HIC's are suffering from extremely low rates of investment. If creditors finance domestic investment, local currency financing represents a shift of resources from transfers to foreigners into domestic investment. This is pro-growth, and therefore desirable and important. Of course, not all the interest will end up as a net increase in investment; no doubt some of the investment financed by foreigners would have taken place in any case. The initial reduction in the current account surplus caused by a shift to local currency interest payments would likely result in some offsetting increase in imports, as well as increases in investment and consumption. These results are desirable in the depressed HIC's.

The essential aim of local currency financing is though to increase investment. If that can be achieved, and domestic inflationary pressure reduced by offsetting fiscal tightening, local currency interest payments would assist the debtor countries.

The Mexican debt defeasance scheme concluded in February 1988 is an example of the technique of subordinating existing debt to new debt. By offering new bonds with guaranteed principal in exchange for existing debt, Mexico hoped to capture a large part of the discount on its existing debt. The superiority of the new instruments arose both from the guarantee of principal and from the fact that Mexico had since 1917 always met its interest obligations. In the event, the offer elicited few bids at discounts off the existing debt that Mexico was willing to accept.

The creative financial engineering undertaken in the last few years has helped mitigate the effects of the debt crisis. But none of the individual techniques invented so far, nor all of them taken together, operates on a sufficient scale to have made a large dent in the debt burden of individual countries²⁰. Net transfers from the debtors have been reduced primarily through the commitment of new money by the commercial and multilateral banks, and by reschedulings of both interest and principle.

II. Future Developments.

The prolonged debt and development crisis of the 1980's has bred numerous proposals to solve the debt problem. In this section I describe and evaluate the main approaches, and the likelihood they will be implemented.

A Debt Facility.

The overhang of the existing debt is the main obstacle to a renewal of resource inflows to the heavily indebted developing countries. Very early in the debt crisis both Kenen (1983) and Rohatyn (1983) proposed the formation of an international institution to buy debt at a price below the face value and provide relief to the debtor countries. Similar proposals have been made repeatedly since, most recently in 1988 by James Robinson of American Express and Arjun Sengupta, the IMF Executive Director from India.

²⁰Chile has gone furthest in reducing its external debt through debt-equity swaps; about 17% of the outstanding debt has been exchanged.

The proposal is for the governments of the creditor nations to set up an institution or facility, named by Robinson I2D2 (Institute of International Debt and Development), to which they would contribute capital and perhaps guarantees. The I2D2 would purchase developing country debts from the banks, at a discount. It would in turn collect interest from the debtor countries, passing some of the discount on in the form of lower interest rates.

The plan is elegantly simple in replacing developing country debt in banks' balance sheets with the liabilities of I2D2, in effect requiring the banks to lend to the I2D2. Indeed, it is even possible to imagine the I2D2 operating purely as a debt collector without any infusion of public capital: it could give the banks equity claims on whatever amounts it succeeded in collecting from the debtors.

I2D2 could be either a stand-alone organization or associated with the IMF and/or the World Bank. To protect its claims, it would need a means of making its concessions conditional on the debtors following rigorous adjustment policies. This argues for a close relationship between I2D2 and the Bretton Woods institutions. However, given that I2D2 would be the main debt collector for the commercial banks, the Bank and the Fund might prefer to maintain their distance and thereby avoid complicating their inherently sensitive relations with the debtors.

The key operational issues in the setting up of I2D2 are the prices at which it buys debt from the banks, and the amount of relief it provides to the debtors. It would be difficult to come up with the right price. Because the secondary market is thin and primarily a swap market, prices in

it are not reliable indicators of the prices at which the debt could be purchased. Further, once the I2D2 became a serious possibility, the secondary market price would reflect expectations about I2D2 operations, rather than an indicator of value.

If it does not use secondary market prices, how would the I2D2 proceed? It would have to calculate for each country the interest rate it regards as right for that country, and then offer to exchange debt at that interest rate with the banks. There is no ready objective basis for calculating how much each country can afford to pay, or should pay. This will be an issue in all debt relief schemes, and might be settled on the basis of some combination of the country's per capita income level and the losses it has suffered in the debt crisis²¹. Since the procedures it sets up for pricing debt will determine the burdens borne by both banks and debtors, and the possible extent of creditor nation government support, its operating rules and management would be certain to be the subject of protracted intensely political negotiations.

Any I2D2 type scheme creates a freerider problem. If the I2D2 buys up much of the developing country debt and makes some form of debt relief possible, then the credit standing of the debtors improves. Those creditors who stayed out of the I2D2 agreement have a capital gain. For that reason an I2D2 would have to find some means of ensuring almost complete participation by the creditors--and this would not be easy from the

²¹Sachs (1986) suggests per capita income declines since the start of the debt crisis as the basis for relief. Since the provision of debt relief through public funds is in part a result of a sense of fairness, relief if it were to be granted would be based on the level of per capita income as well as (perhaps) debt-related indicators.

constitutional viewpoint. This difficulty has led to a search for an international analog of bankruptcy procedures, but none has as yet been agreed upon.

The creation of a debt facility raises the fear that providing relief to debtors whose own past policy mistakes contributed to their current difficulties creates a moral hazard problem. Judging the effect of the precedent that would be set by giving debt relief is not simple. As Lindert and Morton (1987) point out, defaults have occurred quite regularly in the past, but that precedent has not made any of the major debtors default this time. Further, debt contracts involve both creditors and debtors, and the use of political authority to enforce the debts sets a precedent for creditors, whose incentives to exercise appropriate caution in future would be reduced.

If there were to be an overall solution to the debt problem it would almost certainly involve an I2D2 type institution. Support from the Chairman of American Express and many congressmen, as well as discussion of the Sengupta proposal by the IMF Board, appear to suggest increasing public support for a facility. If a facility were to make a contribution to solving the debt crisis, it would need either or both an infusion of public money and a willingness to impose losses on commercial banks. There is no evidence that the governments of the industrialized countries will support such actions.

The creation of a single facility to handle the widely varying problems of many different debtors and creditors is a task of major magnitude. The setting up of a debt facility is unlikely in the current

international economic environment. A change in the environment, for instance the onset of a world-wide depression, a general worsening of conditions in the debtor countries, or changes in the views of the industrialized country governments, might cause this situation to change.

Evolution of the Country-by-Country Approach.

More likely the debt crisis will continue to evolve in the direction of the last few years. Debt agreements will continue to be negotiated from time to time between each country and its creditors, mostly in the context of IMF agreements. These agreements will see a gradual reduction in commercial bank exposure in all but a few of the debtors; the exceptions are the countries in which the banks see the potential for profitable long-term relationships. Increases in official lending will in several countries offset the reduction of commercial bank exposure.

The current strategy may evolve with the introduction of new assets (such as oil-price indexed bonds, and exit bonds), further swapping of claims among banks and between the banks and the debtors (debt-equity swaps for example), and as the margins and fees on the existing debt change through negotiation. It could in addition evolve through changes in the form of international capital flows: away from floating rate commercial bank loans towards direct and equity investment. Such investments reduce the danger of future debt crises.

The banks might be willing to grant consensual market-based debt relief in circumstances where it would enhance the value of their claims on the debtors. Debt relief could enhance the value of claims if it was associated with a change in economic policy in the debtor country, or with

guarantees of some type. Policies in the debtor countries could change in association with debt relief both as a result of more effective conditionality, and because a large debt overhang creates adverse incentives for improving policy--in the sense that debtor countries see a large part of the return to better performance accruing to their creditors rather than domestic residents. The notion that debt relief can improve economic performance in the debtor countries is well-founded, and not necessarily wishful thinking.

Accounting regulations of the creditor countries suggest that different forms of relief might be preferred by the banks of different countries: for instance interest rate reductions can be granted in certain countries without requiring an immediate writing down of the value of the entire debt. Because they enable banks to realize losses on their balance sheets gradually, interest rate reductions might be preferred to write-downs of the value of the debt. Interest rate reductions also leave open the possibility for the banks of sharing in the benefits of the relief, through formulae that allow the interest rate to adjust upwards if the economic situation of the debtor improves.

The Roles of the IMF and World Bank.

The Baker Plan placed the IMF and World Bank firmly in the midst of the debt strategy. First, they were both to provide credit to the debtor countries. Because the IMF's credit is short-term, the World Bank has supplied more net flows of credit to the debtor countries than the IMF. The strengthening of the Fund's longer-term facilities will enable it to strengthen its contribution in this area.

The World Bank may play a catalytic role in the provision of commercial credit either through cofinancing or through partial guarantees of repayment streams²². However, given that the Bank is itself a commercial borrower, such credit enhancement activities would have to remain on a very restricted scale. The Bank of course provisions against guarantees, and has had a preference for guarantees of late maturities in loans.

Second, the Bretton Woods institutions were also to help bring about and monitor adjustment policies in the debtor countries. IMF conditionality has focussed on macroeconomic policies, particularly fiscal and exchange rate, while the World Bank concentrates on efficiency-enhancing changes such as the removal of quotas and reductions in tariffs, reforms of the fiscal system, and of the industrial, agricultural and financial sectors.

Although economic performance differs across countries, it is clear that the success in bringing fundamental changes in policy has been mixed. This is in part because the initial economic conditions reflect deep-seated political forces in the debtor countries: after all, it is not only in such countries that relative prices, for instance agricultural prices, are distorted. In part it may be because the low level of net capital flows to the debtors makes reforms politically more difficult.

Reforms are more likely to be instituted and sustained in an environment where the returns to reform are large, are at least in part retained at home, and abandoning them is expensive: for instance in an environment where both private and official creditors are willing to supply

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²²The Bank has provided guarantees in three cases in the past, and has agreed to links of its credit to commercial bank credit in other cases.

funds that will finance investment together with structural adjustment over a period of several years, but with strong conditionality. This suggests that the debtors and creditors, including the international institutions, should be working towards longer-term adjustment plans that ensure the debtor country multi-year net resource flows, with effective conditionality during the adjustment period.

The benefit of such an approach is that it moves towards a longer-term solution to the debt crisis, enabling the debtor governments to concentrate on domestic economic management rather than debt negotiations, while increasing the expected present value of the claims of the creditors. Because the debt crisis dominates policy-making in the highly indebted countries, a shift in the focus of policy in those countries away from short-term crisis management towards a longer-term development emphasis would itself contribute to growth. There should be no understating the difficulty of formulating and implementing consistent, adequately funded, medium-term adjustment programs. Equally there should be no understating the importance of restoring investment and growth in the debtor countries-- not only for the economic and political development of those countries, but also to prevent further worsening of the international debt situation.

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