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"AID AND THE DEBT CRISIS"

BACKGROUND DOCUMENTATION FOR PARTICIPANTS

January 26-27 1989

DEALING WITH THE DEBT CRISIS

A WORLD BANK SYMPOSIUM

PROGRAM

JANUARY 26–27, 1989

International Economics Department
Debt & International Finance Division
The World Bank

7624

Note: All sessions will be held in the World Bank H Building Auditorium. The entrance is located on G street, between 19th and 20th streets.

Dealing With the Debt Crisis
A World Bank Symposium
Program

Thursday, January 26
Registration: 8:15–8:55 am

Session 1. The Debt Crisis in Perspective (9:00 am–12:45 pm)
Chair: Stanley Fischer, World Bank

Barber Conable, President, World Bank
Welcome and Opening Remarks

Jean Baneth, Director, World Bank
Introduction and Review of World Debt Tables

John Cuddington, Georgetown University
"The Extent and Causes of the Debt Servicing Crisis of the 1980s"
Discussant: Albert Fishlow, University of California, Berkeley

John Underwood and Charles Humphreys, The World Bank
"The External Debt Difficulties of Low-Income Africa"
Discussant: Stephen O'Connell, University of Pennsylvania

Coffee Break

Peter Nunnenkamp and Hans-Joachim Huss,
The Kiel Institute of World Economics
"Bank Lending to Developing Countries in the 1980s"
Discussant: Ken Froot, MIT

E.V.K. Fitzgerald, K. Jansen and Rob Vos
Institute of Social Studies
"Structural Asymmetries, Adjustment and the Debt Problems"
Discussant: Simon Teitel, IDB

Lunch

Session 2. Alternative Approaches I (2:30-6:00 pm)
Chair: David Bock, World Bank

William Cline, Institute for International Economics
"The Baker Plan: Progress, Shortcomings and Future Evolution"
Discussant: John Shilling, World Bank

Eugene Versluysen, World Bank
"A Review of Recent Proposals to Deal with the Debt Overhang"
Discussant: Richard Feinberg, Overseas Development Agency

Michel Bouchet and Jonathan Hay, World Bank
"The Market Menu"
Discussant: Luis Luis, Institute for International Finance

Coffee Break

Jeffrey Sachs, Harvard University
"Efficient Debt Reduction"
Discussant: Marcelo Selowsky, World Bank

Stijn Claessens and Ishac Diwan, World Bank
"Conditionality and Debt Relief"
Discussant: Guillermo Calvo, IMF

Friday, January 27

Session 3. The Constraints on Creditors and Debtors (9:00–10:15 am)
Chair: Jean Baneth, World Bank

Harry Huizinga, Standford University
"The Commercial Bank Debt on Developing Countries: How Have Banks Been Affected?"
Discussant: Anthony Saunders, New York University

Ishrat Husain and S. Mitra, World Bank
"Future Financing Needs and the Constraints on Scope of Action"
Discussant: Mohsin Khan, IMF

Coffee Break

Session 4. Lessons From Secondary Markets (10:30 am–12:45 pm)
Chair: Jean Baneth, World Bank

Vasilis Hajivassiliou, Yale University
"Do Secondary Markets Believe in Life After Debt?"
Discussant: Homi Kharas, World Bank

Daniel Cohen, CEPREMAP
"Is the Discount on the Secondary Market a Case for LDC Debt Relief?"
Discussant: Eduardo Borenzstein, IMF

Barry Eichengreen, University of California, Berkeley, and CEPR, and Richard Portes, Birkbeck College, London, and CEPR
"Dealing with Debt: The 1930s and the 1980s"
Discussant: Marilyn Skiles, Federal Reserve Bank of New York

Lunch

Session 5. The Fiscal Adjustment in Debtor Countries (2:30-3:40 pm)

Chair: DC Rao, World Bank

William Easterly, World Bank
"Fiscal Adjustment and Deficit Financing During the Debt Crisis"
Discussant: Sweder van Wijnbergen, World Bank

Helmut Reisen, OECD
"Selected Aspects of Domestic and Foreign Public Debt"
Discussant: Vito Tanzi, IMF

Coffee Break

Session 6. Alternative Approches II (4:00-6:00 pm)

Chair: DC Rao, World Bank

Michael Dooley, IMF
"An Analysis of Self Financed Buy-Backs and Asset Exchanges"
Discussant: Andrew Steer

Ruben Lamdany, IMF
"The Brazilian Debt Package"
Discussant: Robert Kahn, Federal Reserve Board of Governors

Donald Lessard, MIT
"Beyond the Debt Crisis: Alternative Forms of Financing Growth"
Discussant: Jonathan Eaton, University of Virginia

ABSTRACTS

The papers abstracted here represent the views of the authors. They do not necessarily represent the views of the World Bank, its Executive Directors or the countries they represent.

THE EXTENT AND CAUSES OF THE DEBT CRISIS OF THE 1980s

John Cuddington, Georgetown University

This paper describes the growth in external lending to developing countries in the 1970s as well as the emergence and extent of the debt servicing problems encountered in the early 1980s. In doing this, Part I analyzes the movements in LDCs' debt/GDP and debt/export ratios, which are often used as indicators of creditworthiness. It also considers differing views on the relative importance of various underlying causes of the developing-country "debt crisis." Contributing factors include shocks that are external to the LDCs involved, as well as policy choices in the LDCs themselves.

Part II describes the macroeconomic and financial environment in which the debt build-up occurred. Changing patterns of international capital flows are identified and the movements of key macroeconomic variables are examined to determine the extent to which the experience of the 1970s and early 1980s should be considered atypical. In an environment characterized by numerous sources of uncertainty, it is often difficult to determine whether individual borrowers and lenders acted in a manner that should *ex ante* have been judged to be imprudent, or whether their current problems are more accurately attributed to "bad luck." Some risk-taking is obviously desirable. Policy makers—both borrowers and lenders—must assess the nature of various risks in order to act in their constituents' best interests.

The paper is, for the most part, a restatement of ideas already in the literature. Its primary objective is to put the remaining papers in the volume into an appropriate historical perspective. It concludes that, although the threat to the stability of the international financial system has gradually subsided, the crisis of restoring sustained economic growth in developing countries remains. Their debt servicing problems are large in magnitude and have been very persistent. It is now clear that the debt problem is not just a short-term nuisance that a couple of years of strong worldwide economic growth can eliminate—contrary to optimistic expectations in the early years of the crisis. Hence, the need for new policy initiatives by official institutions and the "international community" at large is as pressing as ever. Dealing with or coping with the LDC debt crisis is likely to be the single most important issue in global economic development policy for the 1990s.

THE EXTERNAL DEBT DIFFICULTIES OF LOW-INCOME AFRICA

Charles Humphreys, Africa Technical Department, The World Bank

&

John Underwood, International Economics Department, The World Bank

Two debt crises affect developing countries. The more highly publicized crisis affects the middle-income "Baker Plan" countries, including Nigeria and Cote d'Ivoire in sub-Saharan Africa. The other, less well known, debt crisis affects the majority of a set of 34 low-income African countries. The total external debt of these countries, $72 billion, is less than the debt of Mexico alone. International bank exposure in these countries totals less than $10 billion. Their liabilities are mainly loans from or guaranteed by official creditors. Their debt represents no threat at all to the international financial system, which is the reason for the relatively small amount of publicity about their plight. Yet, the external debt of these low-income African countries represents, by many measures, a more severe burden to their economies than the middle-income country debt represents to those economies. At the same time, the poverty and economic rigidities in African countries make it harder for them to grow out of their debt problems without special assistance.

Official creditors and donors have recognized the difficult and long-term nature of the debt and development problems facing highly-indebted low-income countries. Since 1978, several bilateral donors have converted concessional development loans to grants in many of these countries. The World Bank's Special Program of Assistance and the Fund's Enhanced Structural Adjustment Facility, both backed by bilateral donors, were launched in 1987 to address these problems more directly. Most recently, at the 1988 Toronto Summit, donor governments endorsed the concept of concessional debt relief for low-income debt distressed countries. Industrial country governments have worked out the exact forms of that relief and have rescheduled the debt of the Central African Republic, Madagascar, Mali, Niger, and Tanzania under the new arrangements. The near term relief from these reschedulings will not be large, but the important principal of orderly debt reduction has now been put into practice. Together, these actions by official creditors and donors are important steps in restoring normal creditor-debtor relationships in these countries.

Commercial bank claims, while not a major share of total claims on debt distressed countries, remain a significant problem in a number of the most debt distressed low-income African countries. Commercial banks may tend to benefit disproportionately from the additional aid and debt reduction provided by official creditors. Some method of achieving equitable burden sharing would be useful to assure that these official resources are used to support growth. One method would be the creation of an officially backed "deep discount" debt facility to buy up long-term commercial bank claims, at heavily discounted prices, and pass the discount on to the debtor country in the form of conditional debt forgiveness, along the lines of the Bolivia buy-back, but in a manner that avoided the price increases that resulted from the method used in the Bolivian cases. Other methods include increased official tax and regulatory support for commercial bank donations of claims to aid or charitable organizations. Those organizations would use the local currency payments to support their programs in the debtor country.

To grow out of their debt crisis, even with the recent measures outlined above, debtor countries themselves must take the lead in establishing and maintaining workable medium-term adjustment programs. Once orderly and sustained adjustment is occuring, it is in the interest of donors and creditors to provide adequate external resources to support these programs. The measures noted above are steps in that direction. The external support now in place covers mainly the years 1988-90. Recovery in low-income Africa, with its economic rigidities, low investment and savings rates and infrastructural weaknesses, will extend well into the next decade. Donors must keep in mind the special external financing needs of these countries after the end of 1990, especially during discussions surrounding the upcoming Ninth Replenishment of the soft-loan International Development Association.

BANK LENDING TO DEVELOPING COUNTRIES IN THE 1980s: An Empirical Test of Major Hypotheses on Voluntary and Involuntary Lending

Peter Nunnenkamp and Han-Joachim Huss
Kiel Institute of World Economics

Considerable confusion prevails about the major factors underlying commercial bank lending to less developed countries after risk illusions have been destroyed. In the rich body of theoretical literature it is heavily debated, for example, whether or not a favourable economic performance of borrowers is honoured by increased capital inflows. It is the major aim of the paper to assess the empirical relevance of the various conjectures raised on the determinants of commercial lending to developing countries in the1980s. This is done on the basis of the hypothesis that lending is no longer governed by a uniform set of incentives but rather taking place under different lending regimes. Most importantly, a distinction between credit constrained and non-constrained borrowers, and voluntary versus involuntary lending is required.

Annual data for the 1983-86 period are pooled for 36 borrowing countries in the OLS-regressions performed to explain the distribution of net transfers and disbursements of long-term loans from private creditors. It is mainly with regard to credit disbursements that the differentiation into different lending regimes matters. In the case of involuntary lending, there is some support for the Krugman line of reasoning that unfavourable performance leads to higher disbursements; whereas it is more difficult for smaller problem debtors not benefitting from concerted lending activities to attract new credits. However, the incentive of banks to protect existing claims does not result in higher net transfers. Standard sovereign risk arguments dominate in this respect. Increasing default risks add to the reluctance of private creditors to provide additional transfers. In deciding on whether or not to continue lending, banks rely on the effectiveness of trade sanctions particularly. Moreover, in contrast to the 1970s and early 1980s, better economic policies and favourable economic performance of debtors are clearly honoured by private creditors after the debt crisis erupted. It is thus likely to pay for today's problem borrowers to intensify adjustment efforts in order to restore their international creditworthiness.

STRUCTURAL ASYMMETRIES, ADJUSTMENT AND THE DEBT PROBLEM

E.V.K Fitzgerald, Karel Jansen and Rob Vos
Institute of Social Studies, The Hague

A world economy composed of a small number of large countries and a large number of small countries is poorly designed for stability. Policy in the large countries is determined in the main by *ex-ante* domestic considerations with the world economy taken as given: there is little interest in external repercussions except to the extent that they frustrate such policy. Nonetheless, the size of the major industrial economies is such that these repercussions—and particularly their interaction—define the state of the world economy. In contrast, macropolicy in small economies is to a great extent determined by the state of the world economy and as markets do not clear smoothly, imbalances are resolved through relative economic power. Only when, by coincidence or by design, the major economies of the world are simultaneously situated on a consistent expansionary path can there be stability and progress in the world's economic and financial relations. Unfortunately, such periods are rare.

The purpose of the present paper is modest although its scope is wide. Our analysis of the global macroeconomic imbalances that gave rise to the current economic and debt crisis of the Third World indicates that the debt crisis is largely the reflection of the subordinate position of developing countries in a unstable world economy: the ripple in the economies of the industrialized countries in the North becoming a tidal wave in the Southern oceans. Rather than serving to smooth inter-regional imbalances, international financial intermediation has contributed to international instability. This paper traces the aggregate adjustment patterns of developing countries in reaction to these external shocks, concentrating on the problems in international finance and differentiating between "private" and "official" borrowers as the two main "blocks." These two not only have different debt characteristics but also, due to their different economic structures and capacities (which gave rise to the lending differentiation in the first place) have adjusted in rather different ways to the crisis. In particular, we argue that successful efforts have been made to raise tax ratios and to export a larger proportion of

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Session 1.

Instead of the Nunnenkamp and Huss Paper, the third paper presented will be:

Barry Eichengreen, University of California, Berkeley, and CEPR, and Richard Portes, Birkbeck College, London, and CEPR
"Dealing with Debt: The 1930s and the 1980s"
Discussant: Marilyn Skiles, Federal Reserve Bank of New York

Session 4.

Instead of the Eichengreen and Portes Paper, the third paper presented will be:

Peter Nunnenkamp and Hans-Joachim Huss,
The Kiel Institute of World Economics
"Bank Lending to Developing Countries in the 1980s"
Discussant: Ken Froot, MIT

Session 6.

The third paper presented will be:

Ruben Lamdany, World Bank
"The Market Based Menu Approach in Action: The 1988 Brazil Financing Package"
Discussants: Silvina Vatnick, World Bank
Robert Kahn, Federal Reserve Board of Governors

THE BAKER PLAN: PROGRESS, SHORTCOMINGS, AND FUTURE EVOLUTION

William R. Cline, Institute for International Economics

Global economic conditions were broadly favorable to debt management under the Baker Plan (late 1985–1988), except for the collapse of oil prices. Major Latin American debtors achieved important reductions in interest/export ratios. While the banks provided new money that was one-third lower than the Baker Plan target, the multilateral development banks raised net flows by only one-tenth of the targeted $3 billion annually. If the IMF and bilateral export credit agencies are included, net capital flows from official sources to the highly-indebted countries actually fell, from $9 billion annually in 1983–1985 to $5 billion annually in 1986–1988.

Political fatigue is evident in major debtor countries. However, their recent growth stagnation has been caused primarily by internal economic distortions (high fiscal deficits and inflation), not the debt burden. Of the six large Latin American debtor countries, the three with the largest outward transfer of resources relative to GNP (Chile, Colombia, Venezuela) achieved the highest growth and lowest inflation in 1986–88, indicating that external debt does not explain high inflation or low growth in Argentina, Brazil, and Mexico.

While the basic international debt strategy remains valid, intensified policy efforts are necessary. Banks should provide multi-year new money packages. Banks should confer senior status on "exit bonds," and the World Bank should then guarantee these instruments, to make viable substantial voluntary debt reduction by interested banks. Bilateral and multilateral creditors should raise annual net capital flows to the highly-indebted countries by $10 billlion annually and the banks by $5 billion to cut the outward resource transfer from these countries in half over the next three years. The central determinant of success in emerging from the debt crisis, however, will have to be sound economic policies in the debtor countries themselves.

output by both blocks, in line with current orthodoxy on structural adjustment. In the case of private borrowers, this would clearly have lead to both fiscal and trade surpluses were it not for the debt service burden. In the case of official borrowers, the deficits persist for structural reasons. Against the background of these findings, we discuss three recent proposals to deal with the debt crisis in terms of their potential contribution to the rectification of imbalances in world trade and finance, and to the attainment of a sound macroeconomic equilibrium consistent with renewed growth in the Third World. Rather than trying to formulate new policy solutions, this paper assesses these proposals in relation to the observed behaviour of the international economy and the domestic economies of our two categories of developing countries.

A REVIEW OF RECENT PROPOSALS TO DEAL WITH THE DEBT OVERHANG

Eugene L. Versluysen
Debt and International Finance Division, The World Bank

The paper provides a detailed review of the more recent debt proposals that recommend alternatives to market-based debt workouts. Proposals differ widely in their recommendations, depending on whether they seek to stimulate new lending, or to provide unilateral debt relief, but the explicit aim of most is to reduce the amount of net resource transfers to creditors, especially for countries where negative resource flows have accentuated the decline in living standards or occur before the basis for resumed growth has been established.

Debt proposals fall into two main categories—new money plans and debt relief plans—that aim to deal respectively with cases of "mild" debt overhang (debtor illiquidity) or "severe" debt overhang (insolvency).

The author argues that additional commercial lending--the main tenet of new money plans--may be of little help in countries where overindebtedness has created severe debt overhangs. In such cases, adding to the debt burden is unlikely to stimulate growth and investment, especially in environments of uncertain commitment to adjustment. But, even then, long-term official lending at below-market rates and with strict conditionality, can support adjustment efforts or, when it funds specific projects, promote productive investment and growth. This justifies efforts to increase the volume of official lending to all borrowers regadless of the severity of their debt overhangs.

On the other hand, eligibility to debt reduction and forgiveness should be reserved for countries with severe debt overhangs that have not yet benefited from voluntary debt reduction, and be subject to strict conditionality and surveillance. For the same reasons middle-income countries with mild debt overhangs should not be granted debt relief, except on a voluntary basis through market-negotiated debt reduction and reschedulings.

The paper recommends continued adherence to a case-by-case approach on the grounds that plans that aim to provide an all-embracing solution to the debt crisis with a single mechanism could create more problems than they would solve. In addition, excessive globalization would also make it more difficult to establish consensus among several protagonists with diverging interests.

The paper observes that plans to raise official and commercial lending to the HICs are receiving widespread support, and that some proposals are already being implemented. The Japan recycling plan is in force; the World Bank's recent capital increase will enable it to expand its own project and program lending; a number of developing countries are already active in risk hedging through interest and currency swaps; through co-financing programs and direct guarrantees, the World Bank is increasing its catalytic role to stimulate commercial lending to selected HICs.

By contrast, proposals to grant formal and unilateral debt relief to selected HICs have so far been shunned for two main reasons. Official circles balk at the budgetary implications of appropriating tax revenues to fund debt concessions. For their part, commercial creditors fear that large-scale debt relief would involve substantial losses.

But recent developments indicate that in the longer run the political and market consensus may support publicly-funded debt relief to selected HICs if their debt servicing should threaten to degenerate into total economic collapse and political chaos in problem debtors. The first precedent is that Paris Club creditors have already agreed on the need for genuine concessions to low-income Sub-Saharan Africa and are now applying debt relief formulas in their debt reschedulings to those countries. More importantly, since late 1987 VDR has gained greater acceptance from commercial banks and, as exemplified by Brazil's debt rescheduling agreement of late 1988, there is an emerging consensus in banking circles that VDR can be compatible with new lending.

THE RISE OF THE MARKET-DRIVEN "MENU" APPROACH TO THE DEBT WORKOUT PROCESS

Michael Bouchet and Jonathan Hay
Debt Management and Finance Advisory Services Department
The World Bank

The purpose of this paper is to examine the various elements which underlie the evolution of the debt workout process and the emergence of a "menu" of financial instruments. In particular, the paper considers the legal and regulatory obstacles to a widening of the menu and to the negotiation of further debt reduction between commercial banks and debtor countries.

Since the inception of the crisis in 1982, the concerted debt strategy has been aimed at normalizing the relationships between debtors and creditors through a process of economic adjustment supported by negotiated financial relief necessary to carry borroweers through a difficult period. Debtor countries were called upon to adjust faster and more drastically than they might otherwise have done, owing to a sharp reduction in external finance and despite mounting social demands for immediate economic gains. The banks were invited to put up more fresh money than their shareholders may have wished in the face of capital and profitability constraints. Throughout this process, international financial institutions have provided leadership in designing and monitoring sound macroeconomic policies and also in financing a substantial—and growing—portion of LDCs' overall borrowing requirements.

The coordinated case-by-case approach to the debt workout process, essentially a crisis containment strategy, has produced notable results. For one thing, although a chain reaction of defaults was a spectre that many, at the outset, thought was inevitable, there have not been any massive and generalized defaults during this period. Most of the highly indebted countries have embarked on socially demanding economic adjustment programs resulting in a partial restoration of growth, notwithstanding sharply reduced current account deficits. In addition, in the period 1982–88, external financing support of adjustment has been provided by private and official creditors, in the form of debt rescheduling and "concerted lending" operations by the former, and con-

ditional financing by the latter, including the rescheduling of a large portion of principal and interest payments by Paris Club creditors.

The aforementioned achievements resulted from the so-called "conventional approach" to the debt workout process that has been the modus operandi for the last five years. Four main elements helped to impose the "system's order" at the time of Mexico's 1982 debt crisis. Firstly, the international financial system was in a highly fragile position in 1982. Many banks were overexposed to LDCs in relation to their capital. The concentration of assets in a small number of large debtors—essentially in Latin America—raised the spectre of a severe liquidity crisis in many banking institutions if a series of concerted refinancing operations could not be implemented. Secondly, the systemic risk of a chain-reaction of defaults in the wake of Mexico's crisis was a serious concern for bankers and policy-makers in the OECD. The emergence of a cartel of debtor countries has been a recurrent threat during the initial phase of the crisis. Third, a rigid legal and regulatory framework has bound creditor banks together despite large differences in exposure and long-term strategies. Fourth, an orderly resolution of cash-flow difficulties has been imposed through a uniform and sequential treatment applied to all debtor countries. A set of core rules comprised the following elements: the approval of a Fund's standby arrangement conditional on a "critical mass" of bank commitments; a specified cut-off date for rescheduling debt service payments; punctual servicing of interest payments, i.e., no rescheduling or capitalization of interest; and a pre-crisis base date for determining pro rata new money contributions.

This strategy, adopted in the fall of 1982 and refocussed by the Baker Plan of October 1985 has, however, been facing mounting challenges in the last three years. In particular, an adequate combination of economic adjustment and external financing has not been achieved for several reasons. First, commercial banks are becoming increasingly skeptical about the prospects for improved creditworthiness in the debtor countries within a realistic time frame. Adverse developments in the world economy and policy slippages in several debtor countries—including the largest debtors—have delayed the resumption of growth and a gradual return of these countries to capital

markets to an unforeseeable future and, consequently, weakened the credibility of the concerted lending process as a short-term temporary measure. Even under optimistic scenarios, the potential trends in debt indicators and mounting domestic political difficulties in implementing reform programs suggest that the process of restoring creditworthiness and reaccess to markets will be long and uneven. As a result, banks' willingness to participate in concerted packages is clearly flagging while countries' readiness to embark upon socially difficult adjustment programs is also flagging, owing to shrinking net external financing support.

Second, a gradual fragmentation of the international banking community has emerged owing to varying regulatory regimes to which banks in different countries are subject, divergent long-term business interests in LDCs, and large differences in country risk exposure. The improvement in commercial banks' financial conditions has removed much of the systemic pressures for defensive lending. Banks show meager appetite for new money facilities that end up taxed by loan-loss provisions and penalized by secondary market discounts. As a result, individual bank behavior is increasingly driven by accounting, regulatory and fiscal considerations. The extensive set of contractual provisions that were initially helpful in facilitating the cohesion of commercial banks in restructuring and new money negotiations, is less and less effective in maintaining the forced solidarity among creditor banks. In addition, banks face intensified pressures, both regulatory and competitive, to strengthen their balance sheets. The syndication of new money loans, therefore, is proving to be very complicated and subject to long delays, and the benefits of holding all the creditor banks together are increasingly questioned.

Third, the community of active creditor banks keeps shrinking as a growing number of institutions are not prepared to contribute to new money exercises. Regional and small-exposure banks strive at redirecting their lending toward traditional domestic and trade financing business. Some banks may wish to leave the lending process-even at the cost of significant writedowns. As a result of these developments, in various countries that have refrained from rescheduling their debt, economic adjustment and punctual servicing of debt obligations have not always been rewarded by the financial

markets. Commercial banks have reduced their exposure in a few countries (sometimes those with the better economic programs) where concerted lending operations did not require that stable or slightly rising exposure be maintained. Overall, the growing reluctance of banks to provide additional financing and the weakening of bank cohesion have resulted in mounting strains on the conventional "new money" approach.

In response to these increasing strains, the "market rationale" is being substituted for the "system rationale" which has been the prevalent mode from the outset of the debt crisis, notwithstanding its efficiency gradually losing in credibility. A "market-based menu approach" has begun to emerge particularly during the negotiation of Argentina's 1987 debt restructuring. More recently, the August 1988 comprehensive debt restructuring for Brazil included a number of attractive features that aimed at encouraging a prompt response of the commercial banks. This menu approach recognizes the diverse interests and constraints of the international banking community by providing more flexibility in the debt workout process. In addition, the menu approach implicitly reflects the longer-term framework that the protracted nature of the problem facing the highly indebted countries requires.

EFFICIENT DEBT REDUCTION

Jeffrey Sachs, Harvard University

It is now widely acknowledged that under some circumstances, debt reduction can improve the welfare of creditors as well as debtors. A large overhang of debt can lead to important inefficiencies that worsen the economic performance of the debtor, and thereby diminish the expected returns of the creditor. Despite the recognition of this point by leading banks, and the international financial institutions, the actual implementation of debt reduction has been remarkably limited. Bolivia remains the only case of a sovereign debtor that has been able to negotiate a fairly comprehensive arrangement (with favorable results in line with the basic argument for debt reduction). This paper explores the reasons for the limited progress in debt reduction, focussing on the structure of debt negotiations as a major impediment to efficient debt reduction agreements.

The main theme of the paper is that debt reduction poses important collective action problems that cannot be efficiently handled in the framework of "voluntary, market-based" approaches currently championed by the World Bank and the rest of the creditor community. A number of important distortion arise in the negotiating process because of the special position and incentives of the money center banks, and the recognized readiness of the official creditor community to contribute funds to avoid a brekdown of creditor-debtor relations

The paper also suggests practical remedies to the collective action problem, stressing that debt restructuring cum sub-market interest rates (perhaps linked with credit enhancement from the official creditors) provide the most direct mechanism for an efficient an equitable sharing of losses among the creditors banks.

CONDITIONALITY AND DEBT RELIEF

Stijn Claessens and Ishac Diwan
Debt and International Finance Division, The World Bank

A large external debt can have perverse incentive effects on the willingness of a country to adjust and invest and on the willingness of the creditors to provide new financing. This can lead to inefficient outcomes as investment opportunities that can benefit both the debtor and its creditors are not undertaken in the debtor country. Without an injection of liquidity and/or a writeoff of future debt obligations, additional investment will not be undertaken by over indebted countries. At issue in the debt crisis is thus the way in which the current costs and the future benefits of additional investment will be divided between the debtor and creditors.

This paper shows how more efficient sharing mechanisms can be achieved which exploit existing investment opportunities and achieve a high growth equilibrium by the infusion of appropriate amounts of liquidity and by appropriate reductions of future debt obligations. The combinations of liquidity and debt relief chosen will, however, have to satisfy a time consistency constraint, i.e., the debtor will have to have the right incentives after receiving the new liquidity to invest such that the creditors are appropriately rewarded. The paper shows that under this constraint, many Pareto improving combinations of liquidity and debt relief are possible and that the chosen combination will depend on the bargaining strengths of the two parties.

More importantly, the paper shows that a technology which allows debtors to precommit themselves to investment levels can lead to additional efficiency gains over and above the gains from appropriate amounts of liquidity and debt relief. Allowing for precommitment on investment releases the time-consistency constraint and allows for larger investments, larger amounts of liquidity and larger debt repayments. As a result, the set of allocations for which debtor and creditors stand to gain increases and high growth equilibria can be achieved.

The analysis yields important policy implications, with particular important interpretations in terms of conditionality and debt relief. The paper shows that debtors that have lost their creditworthiness fall in two broad categories: those that experience a weak debt overhang and those that have a

strong debt overhang. In cases of weak debt overhang, new loans and precommitments on investment can be sufficient to restore creditworthiness and achieve a high growth equilibrium. However, in cases of strong debt overhang, debt relief is also needed in combination with precommitments on investment. In this latter case, the third party, e.g., multilateral institutions, should refuse to provide the precommitment technology unless a portion of the outstanding debt is written off. Otherwise, new loans cannot lead to a restoration of creditworthiness.

The important problem the precommitment technology raises for the third party (e.g., the multilateral) is how the efficiency gains will be distributed between the creditors and the debtor. Besides strategic concerns, the existence of externalities can influence this choice.

THE COMMERCIAL BANK DEBT OF DEVELOPING COUNTRIES: How Have Banks Been Affected

Harry Huizinga, Stanford University

The last six years have not seen the gradual dimunition of the developing country debt crisis that many observers had predicted and hoped for. Instead, third world indebtedness has remained high—in fact the ratio of medium- and long-term debt to GNP has gone up from 50.1 percent in 1985 to 53.7 percent in 1987 for the set of highly-indebted countries. At the same time, real economic growth in the developing countries has proven disappointing—at lukewarm rates of 3.0 and 2.5 percent in 1985 and 1987 for the same group of countries. As the current debt strategy of "muddling through" appears unlikely to produce a timely and satisfactory outcome of the debt crisis, it is warranted to discuss and explore other avenues. This chapter brings to any such discussion an account of the experience of the main creditor banking systems with LDC debt.

A main question the chapter attempts to answer is to what extent the commercial banks at present could possibly absorb LDC loan losses. Some losses by private creditors are likely to be a part of any resolution of the debt crisis in the years to come, and such losses are implicit in some of the many proposals for dealing with the debt crisis. Extending earlier work by Sachs and Huizinga [1987], the chapter finds that bank stock prices to a large extent already reflects the low quality of LDC loans, and that thus no major US bank is likely to fold if it gets a return on its LDC debt from now on that is consistent with the prices of LDC debt observed in the secondary market. Major banks in other creditor countries, such as Canada, France, Germany, Japan and the United Kingdom, are shown to be less heavily exposure to the developing countries than the top US banks. Thus these banks turn out to be even less imperiled by their LDC portfolios than the US banks.

The relative safety of almost all the top creditor banks renders their unfailing insistence on full servicing of the LDC loans less urgent and less appealing, and in principle it could open the road to partial debt forgiveness. However, it also enables the banks to boycott the by now routine reschedulings and new money packages, and at the same to withstand the accounting consequences of such a move. Some form of debt forgiveness in practice may lead

to a quicker resumption of private capital flows to the LDCs and increased investment in the developing countries—although such flows may never again reach the avalanche proportions of the 1970s, which resulted from a unique coincidence of sluggish economic growth in the OECD, large OPEC surpluses, and a number of regulatory changes within the creditor countries that directed bank leading overseas.

Commercial bank debt constitutes the largest part of LDC debt and it is in some ways the most difficult to handle—both because of the myriad of individual borrowers and lenders and because some of the relevant information is private. In 1987 commercial bank claims on LDC's stood at $644 billion, which is approximately 57 percent of a total LDC external debt of $1,130 billion; $257 million, which is somewhat less than half of all bank lending, is concentrated in Latin America, with smaller commercial bank indebtedness of $125 billion in Asia and $61 billion in Africa. The balance of this chapter is organized as follows: Section 2 reviews recent developments in the secondary market for LDC loans. It shows that secondary market prices have been on a relentless downward path, and it presents some sketchy evidence on the volume of secondary market trading of LDC loans. Section 3 looks more closely at the recent experience of the US banking system with their LDC debt, extending and updating the work on this issue in Sachs and Huizinga [1987]. As noted, a main conclusion that emerges is that the solvency of the US banks appears not in jeopardy at present on account of LDC debt. Section 4 replicates, as far as possible, the analysis for the non-US banks. If anything, the major non-US creditor banks are shown to be even less endangered by their LDC exposure than their US counterparts.

Some understanding of the regulatory environment in which commercial banks now operate is necessary to be able to construct and evaluate any plans for action and reform. The tax, accounting and regulatory treatment of LDC exposure continues to differ widely internationally, even as proposals for harmonizing bank capital requirements across nations are being ratified. Some features of the creditor nations' tax and accounting rules as they relate to LDC debt are summarized in Section 5.

FUTURE FINANCING NEEDS AND THE CONSTRAINTS ON SCOPE OF ACTION

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The demand for external financing by developing countries arises primarily to supplement domestic resources for acelerating investment and growth. Among the group of seventeen Highly-Indebted Middle-Income countries, domestic resources have been transferred abroad since 1983 to service the debt contracted in the 1970s and early 1980s. The consequences of this strategy are stagnant or declining per capita incomes, rising unemployment, falling wages and a general lowering of standards of living.

This paper asks the question: What amount of external resources would be required to achieve a reversal of the recent trends in investment and achieve some modest growth in per capita incomes? Under two differing assumptions of world economic growth and given sound domestic policies of adjustment, empirical estimates of the financing needs are made.

Under the base scenario assumptions, the seventeen countries would require about $18 to $20 billion of net new disbursements annually. While other types of financing would together provide $8 to $10 billion, it is doubtful if commercial banks would be able to fill in the gap of $10 to $12 billion a year. The reasons for the dearth of commercial bank lending are analysed in depth. It is also speculated that a more adverse external environment than assumed in this paper would pose major risks for the HICs. So would the lack of sustained domestic policy adjustments by the debtor countries.

The paper concludes that for at least 12 out of the 17 countries studied, a combination of concerted new lending, debt reduction, and reflows of capital flight would be necessary to meet a modest growth of per capita incomes. In some instances, intermittent arrears accumulations may occur.

DO THE SECONDARY MARKETS BELIEVE IN LIFE AFTER DEBT?

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This paper employs panel-data econometric techniques to examine the case for external debt relief, by exploring the relations between measures of creditworthiness and the debt discounts on the secondary market. It investigates empirically whether the discounts on the secondary market reflect a history of past repayments problems or whether they anticipate future debt crises. The answer to this question has different implications about the desirability of debt relief: If the secondary market discount is a good predictor of future debt problems and not merely a reflector of such problems of the past, then debt relief, in averting anticipated problems, will reduce the secondary market discounts and thus increase the value of the debt held by the international lenders. The estimated models are also used to analyze other issues in the international finance literature, such as whether large surpluses by the oil-exporting nations affect significantly the international lending markets after the first major oil-shock, the question of "liquidity vs. solvency," the degree to which discrepancies between official and black market exchange rates can predict future financing problems, and the importance of world factors exogenous to a country in causing debt crises. Finally, the models are used to investigate the stability over time of the processes that determine external debt repayments problems.

IS THE DISCOUNT ON THE SECONDARY MARKET A CASE FOR LDC DEBT RELIEF?

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A discount in the secondary market is a case for debt service relief but not necessarily for a write-off. I derive a "maximum repayment" rescheduling program, which trades off higher current investment for lower current debt service. The following results emerge from the analysis.

Proposition 1. The "maximum repayment" program the lenders would like to monitor involves a fixed investment rate that is smaller than the socially optimal rate and larger than the post-default rate. It involves a transfer of resources from the debtor that is a fixed fraction of GDP—a fraction that is smaller than the cost of default.

Proposition 2. When the debt-to-GDP ratio is above a floor value (h^*), the lenders can capture the "maximum repayment" value (V^*) by fictitiously splitting the debt into performing and nonperforming components. Each period, they should ask the borrower to service the performing component of the debt only, and let the performing component grow at a rate equal to the economy's expected growth rate. Meanwhile, the nonperforming asset is automatically capitalized at the riskless rate. When the actual growth rate of the economy is above (below) its expected level, the performing part of the debt is scaled up (down). When this "maximum repayment" rescheduling strategy is undertaken, the equilibrium market value of the debt is equal to V^*.

Proposition 3. When the debt-to-GDP ratio is above the threshold h^*, the debt can be written down to h^* GDP without impairing the lender's return. If the write-off is repeated each time the economy declines, and if the rescheduling is undertaken according to Proposition 2, the lenders capture the "maximum repayment" while the market price of the debt is stabilized at a constant equilibrium price below par.

Implication. Observing a discount on the debt does not automatically warrant a write-off. The discount implies the possibility of default, but lenders should not write the debt off until the possibility materializes. But the

service of the debt should always be scaled down by its market value rather than kept in line with its face value.)

Proposition 4. When the lenders reschedule the debt on a period-by-period basis, they induce the country to follow a growth pattern that exactly mimics the post-default path. The lenders capture each period the penalty they could impose on the defaulting country. As a result, they get more on a period-by-period basis, but less on average than under the "maximum repayment" schedule. Under such a ("time consistent") rescheduling strategy, a write-off and multiyear rescheduling may prove beneficial, but the gains fall short of the strategy defined in Proposition 2.

How relevant is the idea of "debt overhang" (according to which the market value of the debt may depend negatively upon its face value)? Empirical evidence presented here indicates that, at a 75 percent confidence level, 9 of 33 countries studied may suffer from a debt overhang problem. At a 90 percent confidence level, only 4 of them may be affected by it.

DEALING WITH DEBT: The 1930s and the 1980s

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Richard Portes, Birkbeck College, London and CEPR

This history of foreign lending in the 19th and 20th centuries offers a rich lode of evidence on the operation of international capital markets. The last hundred years have been punctuated by a series of crises—in the1870s, 1890s, and 1930s to cite three instances—bearing a striking resemblance to the debt crisis of the 1980s. For the historian, that experience provides an exceptional opportunity to study the long-term evolution of international markets and their adaptation to repeated shocks. For the economist, it is not possible to extrapolate directly from historical experience, since institutional aspects of the lending process, including the relative importance of bank and bond finance, the rise of supranational agencies such as the World Bank and the International Monetary Fund, and the role of creditor-country governments in rescheduling, have changed fundamentally over the past century. But even though the extent of institutional variation renders naive the hope that one might be able to draw simple "lessons from the past," it still offers the only evidence we have on the efficiency and distributional effects of different approaches to organizing international lending and readjusting existing debts.

In a series of papers we have examined the interwar debt crisis from this perspective. Our analysis has spanned the lending of the 1920s, the defaults of the 1930s, and the debt readjustments of the 1940s and 1950s. This paper summarizes and extends the main conclusions of that research. The discussion will be organized around nine major findings.

1. Interwar investors exhibited sophistication and foresight at the lending state. Our analysis suggests that the past repayment record of a country, its current political circumstances and its economic policies all figured in the determination of the risk premia on foreign bonds floated in the 1920s. There is little evidence that capital markets have grown more sophisticated over time, or that banks have a comparative advantage in processing the relevant information. To the contrary, the bond market's response to borrowers characteristics during the 1920s bears a remarkable resemblance to experience during the post-1970 era of bank finance.

2. Neither monocausal explanations, nor for that matter multivariate explanations limited to economic variables, suffice to explain the incidence and extent of default. While authors such as Diaz-Alejandro (1983) and Fishlow (1985) have pointed rightly to the magnitude of the external shock, proxied typically by the extent of terms of trade deterioration, as a leading indicator of default, our own work reveals the importance of other economic variables, including the burden of the debt and the nature of the domestic policy response, as well as non economic variables, such as proximity to a major military power and international policy links.

3. The implications of different debt-management strategies for subsequent macroeconomic performance remain difficult to isolate. In the 1930s as in the 1980s, efforts to maintain debt service tended to be associated with fiscal austerity, import compression and export subsidies, while the decision to suspend payments was often accompanied by fiscal expansion, monetary reflation and policies of import-substituting industrialization. This wholesale reorientation of a country's macroeconomic stance renders problematic any attempt to pick out the effects of external-debt management strategies and subsequent macroeconomic performance.

4. There is little evidence that countries which defaulted in 1930s incurred a cost in terms of inferior capital market access after World War II. Following the conclusion of negotiated settlements with the creditors, countries which previously had suspended interest payments and amortization were offered virtually identical access to the capital market as were countries which had maintained debt service without interruption. This is not to suggest that default was without costs in terms of market access, only that those costs were not borne differentially by countries which interrupted service on their debts, once they reached settlement agreements with the creditors. Many of the costs were external to the defaulting countries: neither defaulting nor nondefaulting debtors had significant access to portfolio capital in the decades immediately following World War II.

5. The readjustment of defaulted debts entailed a protracted process of negotiation. The analogy with Chapter 11 corporate bankruptcy proceedings, in which default and readjustment permit a clean break

with the past, is no more applicable to the 1930s than to the 1980s. In many cases, interruptions of debt service were only sporadic, and uncertainty over the magnitude of transfers lingered for a period of decades.

6. In contrast to the experience of the 1980s, interwar default in some cases led to a substantial reduction of transfers from debtor to creditor. What we might call "selective debt relief" was, however, compatible with a reasonable overall rate of return to the creditors. The risk premia charged *ex-ante* sufficed to evaluate the average realized rate of return on sovereign loans above the yields on Bristish and US Treasury bonds. Losses to creditors on provincial, municipal and corporate loans, although more extensive, were still sufficient to yield positive ex post returns to Bristish investors.

7. Nothwithstanding the contrast conventionally drawn between the extent of government involvement in debt negotiations in the 1930s and the 1980s, creditor-country governments often were intimately involved in the readjustment of interwar debts. The difference between the 1930s and 1980s lies not in the extent of government intervention but in its direction. Whereas in recent years creditor-country governments have exerted continuous pressure on the debtors to maintain service on their external debts, in the1930s and 1940s creditor-country governments pressured debtors and creditors alike.

8. Global schemes to short-circuit the protracted process of bilateral negotiation proved unavailing. Nearly every element of the global plans proposed in the 1980s—a special international lending facility, matched injections of private and public funds, conversion of existing assets into new ones featuring different contingencies—was first suggested in the 1930s. Ultimately, those global schemes foundered on the issues of who should fund and control the administration of these schemes. The failure of the global plans offered in the 1930s does not leave one optimistic about their prospects in the 1990s.

9. Unlike global plans, market-based debt reduction made a useful contribution to resolving the debt crisis of the 1930s by reducing the debt overhang and eliminating marginal creditors. There is little systematic evidence that debt buybacks had a significant impact on secondary market prices, whose movement seems to have been influ-

enced primarily by changes in the prospects for a negotiated settlement. In contrast to their public statement of disapproval, creditor organizations were willing in private to entertain buybacks out of reserves as a component of the readjustment process.

FISCAL ADJUSTMENT AND DEFICIT FINANCING DURING THE DEBT CRISIS

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The sharp reduction in external financing to most high-debt countries in the 1980s forced major adjustments in macro policy, especially in the management of fiscal deficits. The debt crisis itself initially worsened public finances, since the governments of debtor countries often felt compelled to assume external liabilities of the private sector and financial system. At the same time, the near-termination of external capital flows required an increase in internal finance of public deficits. The result in most high-debt countries was increased inflation, output stagnation, and falling private investment. By contrast, some high-debt countries avoided a drastic decline in their capital inflows and did not have to reduce public deficits as sharply or increase reliance on internal financing. The outcome was much more favorable in these countries, with steady growth, low and stable inflation, and healthy private investment.

In order to study the nature of adjustment to the debt crisis, this paper focuses on a group of seven debtor countries that experienced a sharp reduction in external capital flows and rescheduled their debt in the period 1982-87; Argentina, Brazil, Chile, Mexico, Morocco, the Philippines, and Yugoslavia. The study contrasts a group of five countries that avoided rescheduling over 1982-87 and maintained access to external capital: Colombia, Indonesia, Korea, Turkey, and Thailand. The former group of countries will be referred to as "crisis countries" and the latter as "non-crisis countries."

The purpose of discriminating between the two groups is to show the adverse consequences of the cut off in external financing to the "crisis" group and the resulting policy response. The combination of a more favorable external environment and wiser policy choices made for better performance in the "non-crisis" group.

The central role of fiscal deficits and their financing has recently received increased attention in the voluminous literature on the adjustment to the debt crisis.

This paper seeks to contribute to this literature through refinement of the theoretical framework and through detailed empirical results. The paper first examines the nature of changes in external debt flows, which will show how the external debt crisis contributed to a parallel fiscal crisis in the crisis countries but not in the non-crisis countries. The adjustment efforts were concentrated on public investment in the crisis countries, while the non-crisis countries maintained stable levels of most fiscal aggregates. A resource surplus was generated in the crisis countries through the investment-led contraction of absorption, even though overall production was stagnant. By contrast the non-crisis countries had obtained a resource surplus by the end of the period through healthy growth of both production and absorption. The overall amount of fiscal adjustment was less than the decline in external financing in the crisis countries, so that they had to recur increasingly to domestic financing.

I also discuss the macroeconomic implications of the increased reliance on domestic financing of public deficits, including the significance of domestic versus external finance and the different types of domestic finance. A simple theoretical model relates the means of domestic financing utilized in the sample countries and on levels of interest rates and inflation. It shows that the crisis countries relied heavily on implicit taxes on financial intermediation to domestically finance their deficits, which explains the poor performance of private investment and inflation. The non-crisis countries largely eschewed taxes on financial intermediation for domestic borrowing at market rates, with successful results. The policy conclusions are that larger deficit reductions—preferably implemented through tax reform and reduction of current expenditures—and less distortionary means of financing would lead to improved outcomes in the crisis countries.

PUBLIC DEBT, NORTH AND SOUTH

Helmut Reisen, OECD

The recent rise in domestic public non-monetary debt and in domestic bond yields is imposing a heavier interest burden on the affected governments in countries such as Brazil and Mexico than foreign public debt does. This is a relatively new experience for developing countries, not, however, for OECD countries. The discussion of selected aspects of rising government indebtedness will therefore not only deal with some major clients of the World Bank—Brazil, Mexico, Indonesia, Korea—but also with the experiences of Belgium, Ireland and Italy.

The paper tries to answer three questions. First, what explains rising government debt since 1984 in spite of rationed foreign lending and efforts at fiscal consolidation? Major debt determinants found are: external transfers, since they imply an internal transfer of resources from the private to the public sector; fiscal rigidities because of failure to broaden tax bases and to cut government consumption; high interest rates coupled with low GDP growth, both largely explained by depressed savings and investment; massive devaluation of the real exchange rate and high swings in the value among key currencies. Second, how can the rise in government debt almost certainly not be stopped in the longer run ? The answer is: through a burst of inflation, even when it is largely unanticipated, because the demand for base money is now too small relative to public domestic debt; nor through domestic and foreign default unless the government runs a substantial primary surplus (what is mostly not the case) and can credibly commit not to default again (which is unlikely). Third, what are the possible remedies? The paper provides calculations of the required non-interest surplus which the governments have to run to stabilize (and then to reduce) public debt ratios and make their budgets consistent with other macroeconomic targets. It also discusses how fiscal adjustment can foster growth, while minimising real depreciation of the exchange rate and reducing the cost of domestic public debt.

SELF-FINANCED BUY-BACKS AND ASSET EXCHANGES

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Buy-backs of external debt that are financed by the debtor through asset sales generally result in unchanged or lower market prices for remaining debt. The contractual value of debt is reduced by some multiple of the market value of assets sold. The use of assets as collateral for new debt that is exchanged for old debt has effects equivalent to buy-backs financed by sales of the same assets.

THE MARKET-BASED MENU APPROACH IN ACTION: The 1980 Brazil Financing Package

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On June 22, 1988 Brazil and its Bank Advisory Committee reached an agreement on a Financing Package for 1988 - 1989, which formally terminated the moratorium declared by Brazil in February 1987. This was the first financial package structured along the lines of what has been called the market-based menu approach to sovereign debt workouts. This approach was first advocated by US Secretary of Treasury J. Baker and by Brazil's Finance Minister Dilson Funaro in April 1987. This approach consists on tailoring the forms of participation in the package to the different needs and preferences of different banks. The development and the mechanics of many of the options in the menu, including most of the options in the Brazilian package are discussed in Cline (1987), The World Bank (1988) and Bouchet and Hay (1989).

The 1988 Brazilian Financing Package has three basic components:

- the restructuring of US$62 billion of outstanding debt into a single Deposit Facility in Brazil's Central Bank.
- 5 New Money Facilities which amount to US$5.2 billion (3 of these facilities include some type of World Bank involvement).
- the renewal of trade and interbank credit lines.

The package also includes an exit option, which may substitute for both the restructuring and the new money. Each component of the package was structured to allow for many different options, referred to as "bells and whistles", which are attractive to different groups of banks.

The package was well received by creditor banks; over 90% of the new money was committed in less than one month. The creditors' favorable response may be due to the wide variety of instruments and options in the package, which are tailored to the regulatory and tax needs of banks in different jurisdictions. In addition, the disbursement of new money is linked in differ-

ent forms to actions by the World Bank and the IMF, which banks expect will enable them to treat the new money differently from the old. Given its success and comprehensiveness, the Brazil package is likely to become the model in future negotiations.

This paper describes the structure and main components of the 1988 Brazilian Financing Package. It analyzes the economic and financial effects of those instruments and facilities in the package that may be relevant in structuring packages for other debtor countries. It is important to notice that the inclusion of each clause and option in any agreement is negotiated between the debtor and its creditors. Hence, the fact that we show that the inclusion of a particular option in the package had a negative effect on the debtor does not imply that the debtor erred in allowing such an option. In order to assess whether the inclusion of the option was an error it is necessary to compare the costs related to the option with the benefits that the debtor may have received in compensation. This assessment requires an analysis of the bargaining process, which, however, is beyond the scope of this paper.

The paper is structured in the following manner. Section II summarizes the elements of the refinancing and new money packages. The effects of currency switching and interest retiming on Brazil and on the creditor banks are discussed in more detail in subsequent sections. Sections 5 and 6 study the relending and the debt conversion programs, respectively. Finally, section 7 analyzes the role and pricing of exit bonds.

BEYOND THE DEBT CRISIS:
Alternative Forms of Financing Growth

Donald Lessard, MIT

This paper examines the potential benefits of, and obstacles to, the inclusion of alternatives to general obligation finance such as direct investment, portfolio equity investment, quasi-equity investment, and commodity-price indexed debt in the external financing of LDCs. The advantage and obstacles are first considered for a country starting with a clean slate, then for a country suffering from a debt overhang in the context of both concerted and voluntary exchanges.

REVIEWING THE THIRD WORLD DEBT STRATEGY

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Statement before the Subcommittee on International Finance and Monetary Policy of the Banking Committee of the US Senate

February 8, 1989

President Bush's timely request for a review of strategy toward Third World debt has been widely welcomed. I am pleased to have this opportunity of participating in the debate that this request has provoked.

Third World debt now poses much less threat to the international banking system than it did when the debt crisis first broke in 1982. The banks have made good use of the intervening period to strengthen their balance sheets and many have also reduced their exposure. Unfortunately the position of the debtor countries has not shown a comparable improvement. The ratio of interest obligations to export revenue, and more recently of debt to exports, has shown some improvement. But the continuing negative transfer from the debtor countries needed to pay accruing interest obligations with minimal offsetting capital inflows remains a major impediment to the restoration of growth and the mastery of inflation, and hence a continuing threat to political stability.

Thus I assume that a principal objective of the review of the debt strategy will be to reduce the negative transfer to a level

that the debtor countries can live and grow with. It is particularly important that countries that have made a serious effort at policy reform should now be given the opportunity of escaping the financial constraint on profiting from that reform by resuming robust growth. (In Latin America I have in mind Bolivia, Chile, Colombia, Costa Rica, Mexico, and Uruguay as countries that have implemented extensive policy reforms.) I doubt whether it is either feasible or advisable (because of the rapid escalation of debt that would be implied) to seek the total elimination or reversal of the negative transfer, but I would suggest an objective of reducing it from its recent level of $20 billion to $30 billion per year to perhaps $10 billion.

For several years it has been taken for granted that the aim of the debt strategy should be to restore the debtor countries to a position where creditors will voluntarily lend them enough to reduce the negative transfer to a tolerable level. It seems to me that maintaining that objective risks pushing resolution of the debt crisis forward into the next century. We should instead aim to reduce and restructure the debts (at least of those countries that have made a serious effort at policy reform) to a point where they can expect to grow while fulfilling their contractual obligations, and eliminate the constant hassle of debt renegotiation.

A Strategic Choice

Everyone is now familiar with the "free rider problem": the incentive that each individual bank has to avoid making concessions to a troubled debtor even when it recognizes that collective concessions are in the best interests of both creditors and debtors, in the hope that other creditors will make the concessions and it will still reap the benefits. The initial reaction to recognition of this problem was to try and ensure that all banks acted in the same way (notably by participating in involuntary new money packages). More recently the trend has been to offer the banks a "menu" from which they can choose an option suited to their particular circumstances. If all of the options carry a roughly similar benefit to the debtor, the latter will not lose from banks acting differently provided that all of them choose one of the options. The hope is that the availability of an option tailored to its own circumstances will encourage each bank to participate rather than act as a free rider.

The same strategic choice between an attempt to get all banks to make the same concessions and the offer of a range of options will arise in designing a revised debt strategy. I strongly favor offering the banks a range of options. One reason is the sheer difficulty of persuading all banks (headquartered in a dozen or more different countries) to agree to the same terms, given the high probability that any attempt to legislate debt forgiveness would be held unconstitutional by the courts as a violation of the

principle of sanctity of contract. Another reason is the danger of provoking a long-term estrangement between the debtors and the banks.

In particular, I believe that the options from which the banks should be expected to choose should include both debt reduction and debt postponement. There are two reasons for wanting to see options in both categories. One is that the differences between the positions of different banks are sufficiently great to need options in both categories if there is to be any hope that all banks would find it preferable to accept one of the options rather than trying to insist on maintenance of the original contract (i.e. freeriding). The other is that a combination of options from the two categories can enable debtors to improve their short-run cash-flow without the level of debt exploding out of control. The debt reduction provided by one group of banks would do little to relieve cash flow for some time (see below), but it would reduce the level of debt. That would permit interest capitalization (or some alternative form of debt postponement) to alleviate the short-run cash flow without an unacceptable increase in the total level of debt.

Debt Reduction

Voluntary debt reduction (which is the same thing that I called "voluntary debt relief" in my study Voluntary Approaches to Debt Relief published by the Institute for International Economics last year) is now widely endorsed--by the banks, the US Treasury,

and the other G-7 authorities, as well as the debtors. Helpful as debt reduction is, however, it will almost certainly need supplementing by some form of formal debt postponement. Let me spell out the limitations of debt reduction.

First, debt-equity swaps. This has so far been the principal mechanism employed, with perhaps $15 billion swapped in 1988. A debt-equity swap typically involves a bank selling debt on the secondary market to a foreign company, which in turn sells the debt to the central bank of the debtor country in return for local currency with which it makes an equity investment in the local economy. This changes the form of the foreign claim on the debtor's economy from debt to equity, which may have some attractions in terms of improved efficiency consequential on foreign management and also generates a time-stream of payments obligations that is more responsive to the state of the domestic economy. But it has only a modest effect in reducing the debtor's net international liabilities--an effect that is dependent on the central bank paying less than 100 cents on the dollar for the debt that it buys back (i.e., splitting the secondary market discount with the foreign investor). Thus $15 billion of swaps may have made a dent of no more than $3 billion in foreign liabilities (some 1 percent of the debt to the banks).

Moreover, in some countries, notably Brazil, the pace of debt-equity swaps was excessive last year. Unless the foreign investor buys a newly privatized asset (a phenomenon that was important in

Chile), the central bank has to increase the monetary base in order to provide the local currency to the foreign investor. (In principle the government might issue local currency debt instead, but this is distinctly unattractive in countries where the real interest rate far exceeds the real interest cost of foreign debt.) Some observers believe that the magnitude of debt-equity swaps played a big role in driving Brazil to the verge of hyperinflation, which explains why the program has now been dramatically scaled back. In the future I would expect debtors (supported by the IMF) to be more cautious and seek to limit the volume of debt-equity swaps to a level that the economy can afford.

Second, buybacks. In March 1988 Bolivia bought back almost half its bank debt (using money specially donated by friendly governments) at a price of 11 cents on the dollar. In September Chile got permission from its bank creditors to use a part of its windfall gains from the high copper price to buy back debt on the secondary market, and proceeded in November to buy back some $300 million at a 44 percent discount. A part of the academic literature argues that buybacks are a mistake from the debtor country's standpoint because they involve the use of money that a country could spend on itself in order to eliminate debts that will not be paid in any event. I regard this analysis as nonsense: debts that are not being fully serviced are an obstacle to full participation in the world economy, a constant source of embarrassment, and a potential disincentive to adjustment. When

they can be bought back cheaply because some banks are anxious to exit from the lending process at almost any cost, it is foolish not to exploit the opportunity.

The problem is that buybacks require cash, and--almost by definition--troubled debtors are short of cash. Hence a solution to the debt crisis that relies on buybacks to reduce outstanding debt is liable to take a long time. Buybacks are likely to increase in importance relative to debt-equity swaps, because it is more attractive to the debtor to allow inward foreign investment over the foreign exchanges and then, when it seems desirable, to use the proceeds to buy back a part of its debt on the secondary market. This has two attractions: it allows the debtor to capture 100 percent of the discount rather than share it with the foreign investor, and it gives the debtor a continuing choice as to whether to amortize debt or increase imports (or reserves). Hence, as banks become accustomed to granting waivers to facilitate buybacks and as the need to subsidize inward equity investment wanes, I expect to see debt-equity swaps largely displaced by buybacks. But that will not change the conclusion that both these techniques together could only reduce the debt slowly--unless, at least, some substantial new source of money became available to finance buybacks. One could, for example, establish a special IMF facility for this purpose, financed primarily by major surplus countries like Japan (as suggested by C. Fred Bergsten in testimony before the House Banking Committee on January 4, 1989).

The other way of making more rapid progress might be through debt-debt swaps. The precedents here are the Mexico/Morgan deal, and the exit bonds issued by Argentina in 1987 and Brazil in 1988. Unfortunately none of these precedents is particularly encouraging: banks proved unwilling to swap on terms and/or a scale that would have achieved substantial debt reduction. The reason is straightforward: the quid pro quo the banks seek for substantial debt reduction is more rapid and/or more secure exit from their sovereign risk, whereas what they were offered was largely continued country risk.

The security sought by the banks could be provided in three ways: by collateralization, by subordination, or by guarantees. The disadvantage of collateralization is that, like a buyback, it requires the debtor to use its reserves. Indeed, reserves cannot be expected to buy more debt relief per dollar if used in collateralization than in buybacks (which poses a problem for the Miyazawa Plan, at least in its original form). Subordination of existing debt to exit bonds looks attractive until one learns that the required waiver would require unanimity on the part of the banks, which makes its feasibility extremely doubtful. Hence I conclude that a major role for debt-debt swaps would require the provision of guarantees for exit bonds by some public sector agency; the World Bank seems the natural choice for this role.

The authorities of the G-7 countries have up to now opposed the extension of guarantees. I sympathize with their aversion to

guaranteeing "new money" that the banks put in involuntarily, since this could provide a way for the banks in the long run to reduce their exposure without loss at the expense of the public sector (i.e., a "bailout"). However, a (partial) guarantee that bought debt reduction from the banks is a totally different proposition. Such a guarantee would apply only where a bank agreed to a large reduction in its claim, and could not make a doubtful claim whole at public expense. And the return expected from such guarantees would be attractive: a guarantee that allowed a debtor to swap outstanding debts with a 10 percent interest rate for exit bonds at a 50 percent discount would yield a real return of 20 percent, entirely in foreign exchange.

Debt Postponement

Debt reduction (other than debt-for-charity swaps, whose scale is miniscule) is not an efficient way of providing cash-flow relief. Debt-equity swaps do bring some short-run relief, but little or none in the longer run once the time-limit on dividend remittances expires. Buybacks and debt-debt swaps provide little short-run relief, since the debtor has to find the cash for a buyback or to service the new debt involved in a debt-debt swap. To complement such programs and provide an early easing of the debtor's cash-flow position one needs options that postpone the obligation to service debt.

Up to now, postponement of debt service has been accomplished through repeated reschedulings and new money packages. The process

of negotiating and gaining approval of these is time-consuming and wearing on creditors and debtors alike. Its perpetuation is not consistent with the objective of eliminating the hassle of constant debt renegotiation and allowing debtors to return to a situation where they fulfill their contractual obligations. A method of debt postponement that formalizes obligations is badly needed.

One approach would involve adapting the past approach by introducing multiyear new money agreements. Such an agreement would promise the provision of specified sums of "new money" over a number of years, perhaps on a decreasing scale. For example, it could provide for new money equal to 60 percent of interest due in a first year, 50 percent in a second year, and so on, decreasing to zero in the seventh year.

A second approach would involve interest capitalization. This could be designed simply to replicate a multiyear new money agreement, but with an indefinite term it could also secure a more permanent solution. For example, a country's interest obligation could be divided into two parts on the basis of an estimate of ability to pay. One portion, equal to an estimate of ability to pay in some base year plus an agreed proportion of the increment in export value over that in the base year, would be payable in dollars. The balance would be added to principal. As a country's export revenue grew over time, the proportion of interest capitalized should tend to fall. If and when ability to pay

exceeded interest due, the excess would be used to amortize principal.

A third approach, involving a commodity link, might be suitable for debtors that rely heavily for export revenue on a particular primary commodity whose price they are unable to control. For example, banks might agree to grant Mexico a concessional interest rate as long as the price of oil remains low, but with a provision for full interest payment as and when the oil price returns to a specified threshold, and a premium if the oil price went higher still.

In my opinion the second or third approaches would be more satisfactory than the first. The problem with a multiyear new money agreement is its inflexibility: it assumes one can be sure that the debtor will be in position to return to normal market access at the end of its multiyear term. If that proves overoptimistic, then one will in due course be faced with the need to negotiate a successor agreement. The only way to minimize this danger would be to capitalize such a large proportion of interest for so many years as to jeopardize the acceptability of the proposal to the banks.

An attraction of the second approach is that it would be relatively easy to deal with free riders. Provided that a two-thirds majority of the bank syndicate agreed to restructure the remainder of the debt (i.e. that not dealt with by debt reduction) to capitalize interest above the agreed formula, individual banks

that declined to sign could be paid interest prorata with those that had agreed to capitalize. They would then accumulate the excess as arrears, which would have the same effect as though they too had agreed to capitalize. Since they would be receiving interest on the same basis as the other banks, they would have no basis to sue them under the sharing clause.

Interest capitalization has up to now been strongly resisted by US banks. This was partly explained by a fear that once interest capitalization was instituted it would become too easy for a debtor to announce a unilateral increase in the proportion of interest to be capitalized. Such a fear would not seem very relevant in the context of an agreement that specified ex ante a formula to determine the extent of capitalization. Banks may also have been reluctant to let debtors off the "short leash" provided by the need for negotiations over new money. This may still be a relevant consideration where debtors that have not yet instituted adequate policy reforms are concerned, but it is surely time to let the countries that have made serious reforms off the "short leash". One suspects, however, that the major reason that US banks have always been so much more hostile to interest capitalization than many foreign banks is that the accounting and regulatory treatment of interest deferred though capitalization is so much more harsh. It is surely time to equalize the treatment of interest that is received by virtue of a bank's participation in a new money package and interest that is deferred by capitalization.

The Role of the Public Sector

The major role of the public sector in the proposals developed above is to facilitate the process of debt reduction, either by creating a special facility to finance buybacks at the IMF or by arranging for the World Bank to guarantee exit bonds (or both). In addition, the US authorities should equalize the treatment of capitalized interest with that which a bank pays itself when it participates in a new money operation. But there is a third role of the public sector that is particularly unsatisfactory at the present time: its role as creditor.

My colleague William Cline has recently drawn attention to the depressing and little known fact that the principal reason that the negative transfer has proved much larger than called for by the Baker initiative is that the public sector has fallen seriously short of providing an additional $3 billion per year net lending. A part of the problem is that the multilateral development banks increased their lending by only $300 million rather than $3 billion per year. The other part of the problem is that the Baker initiative did not make allowance for the large turnaround in IMF lending, from an inflow of $6.5 billion in 1983 to a repayment of $1.1 billion in 1988. (See William R. Cline, "The Baker Plan: Progress, Shortcomings, and Future Evolution", paper presented to a World Bank conference on January 16, 1989.) I also heard the Finance Minister of one of the debtor countries recently complain

that his most intransigent creditors were not the commercial banks, but the Paris Club.

In fact, the Toronto summit already agreed to an important initiative so far as the poorest countries, primarily in sub-Saharan Africa, are concerned. Each of the participating countries agreed to choose one of three options for restructuring its outstanding official lending to those least developed countries. The simplest option is to forgive one-third of the debt; the other two options are supposed to be broadly equivalent. This initiative is welcome but still inadequate. Ideally one might wish to see the simple solution of greater forgiveness. Failing that, it might be worth considering conversion of a further one-third of the official debt into local currency terms. This debt could bear interest at the rate of local inflation plus 3 percent (say), with the expectation that at least the real interest component would be spent on causes like conservation and education that require local-currency finance and are (hopefully) of mutual interest to creditors and debtors. In conjunction with the Toronto initiative, this would cut the debt service burden of the least developed countries by two-thirds, but with one-half of the relief taking a form that would enable the creditors to support initiatives that they regard as important but that many debtors have had to cut back on during the years of austerity.

It would seem appropriate to consider some relief on bilateral (Paris Club) debts for the middle-income debtors as well as the

poorest countries. This might take the form of conversion of a third of the debt to local-currency terms, just like the additional relief for low-income debtors suggested above. In terms of cash flow, however, the major impact will have to come from larger new lending. The minimal aim should be to achieve the Baker target of $7 billion net disbursements by the multilateral development banks.

Summary

The debt crisis has now lasted for 6 1/2 years. In that period a number of the debtor countries have pursued major reforms of the sort that have been urged on them by Washington, but a country like Mexico still cannot look forward to being able to resume robust growth without the need for further debt renegotiation or the danger of financial constraints. Whatever else the current review of the debt strategy may bring, it should ensure that countries that have made serious reforms and continue to pursue prudent policies should have their obligations restructured to match their ability to pay consistent with continued growth. It seems to me that the most promising strategy to that end would present the banks with a choice between debt reduction--aided by an IMF facility to finance buybacks and/or World Bank guarantees of exit bonds--and debt postponement, in the form of interest capitalization and/or a link between interest obligations and the price of major primary commodity exports. The public sector should support that strategy both by authorizing the IMF and/or the World Bank to facilitate debt reduction and by

reducing its own foreign exchange claims on troubled debtors, as well as increasing the flow of lending by the multilateral development banks.

Subcommittee on International Finance and Monetary Policy
Senate Banking Committee

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February 8, 1989

I. Introduction

Mr. Chairman, and members of this committee, I am very pleased to be here to today to discuss the issue of developing country debt, at a time when the U.S. Administration is undertaking a review of policies in this area. This review is, of course, long overdue, as is painfully clear from the profound economic crisis and growing political instability in almost all of the democracies in Latin America.

Indeed, the need for such a review was already/clear back in May 1986, almost three years ago, when I was asked to give testimony about the newly enunciated Baker Plan. At that time I stressed that[1]:

> By attempting to secure full interest servicing of interest on Latin American debt, the current strategy is: threatening democracies throughout the region; imposing an undue burden of adjustment on the debtor countries; hurting U.S. exporters by excessively squeezing import demands from the region; provoking high inflation and capital flight throughout Latin America; and, ironically, reducing the long-run value of the creditors' claims on the debtor countries, by discouraging adequate structural adjustments in the debtor countries.
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> Peru is an example of a country in need of debt relief. The economy is in a state of collapse due to the combined pressures of falling export prices, fifteen years of poor economic management, and the heavy weight of debt servicing. Per capita GNP has declined by 15 percent since 1980, and real wages have fallen by an incredible 40 percent. The social fabric is crumbling. . .

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[1] Testimony to the Subcommittee on International Trade, Senate Finance Committee, May 13, 1986, pp. 2-3.

> Where the strategy goes wrong is in its refusal to contemplate partial and selective debt forgiveness by private and official creditors in cases where the debtor country is crumbling under the weight of the debt burden, or where debt forgiveness might provide an important spur towards positive adjustment. It would be fatuous to destroy fragile democracies in order to collect the last cent on interest due to the commercial banks, particularly when much of the debt in Latin America is already written down in the books of the U.S. commercial banks, and in their stock market values, though almost none has been forgiven by the banks in their negotiations with the debtor country governments.

Mr. Chairman, these thoughts continue to apply today, with even more urgency, though today the quotation should be altered to use the more felicitous expression "debt reduction" rather than "debt forgiveness". Not only has the market value of the debt declined precipitously, from a value of about 75 percent of par in 1986 to a value today of about 40 percent of par, but the economic and political situation in Latin America has become truly alarming.

Today's facts are broadly known. What appeared to me in May 1986 to be a risk of social collapse in Peru has now occurred: annualized inflation rates of recent months are no less than 30,000 percent; real GNP will likely fall by 15 to 25 percent in the 12 months from September 1988 to September 1989; and radical terrorism has come in full force to the urban centers of Peru. In Argentina, the infrastructure has collapsed so completely that blackouts are the daily norm in Buenos Aires, and the telephone system in parts of that great city typically break down during rainstorms. Brazil too is headed towards a hyperinflation, with inflation exceeding 2,000 percent, and with a sharp political lurch towards to the left. And in Mexico, the vaunted political stability provided for decades by the PRI is now at a

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point of collapse. For anyone that cares to look, that country is at risk in the next few years of a drift into open class warfare.

Much of this was predictable, Mr. Chairman, and indeed was predicted. But our government's strategy was to ignore these trends, in order to give our commercial banks time to rebuild their capital base. Unpleasant facts in Latin America were simply buried by an unrelenting publicity barrage from the money-center banks that Latin American recovery was just around the corner, and by the message that Latin America's crisis resulted only from policy mistakes within Latin America and not from the heavy burden of debt combined with a collapse of primary commodities prices. From my perspective as a policy advisor in Latin America, I can report that is both dire and worsening.[2]

It must be appreciated how completely the debtor-creditor relations have broken down in the past two years. There is a tendency to focus only on the top three debtors (Argentina, Brazil, and Mexico), so let's begin instead with the other 39 countries engaged in commercial bank debt restructurings. For these other 39 countries, there was <u>not a single penny of new bank lending during 1987-88 in the so-called "new money" packages widely advertised under the Baker Plan</u>.[3] There were two attempts to put together very modest (and very inadequate) "new money" packages, for Ecuador and Ivory Coast. Both

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[2]In addition to my academic research on the debt crisis at Harvard University and the National Bureau of Economic Research, I am an advisor to the United Nations Development Program, currently working in Bolivia, Ecuador, and Venezuela.

[3]The term "new money" package is itself a misnomer, since the "new money" is always less than the interest due. These lending packages to refinance part of the interest due are also known as "concerted lending" programs.

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attempts failed. More than a dozen countries are in long-standing open arrears, including Bolivia, Costa Rica, Dominican Republic, Ecuador, Honduras, and Peru in Latin America.

For the larger countries, Argentina is deeply in arrears to the banks, and will only get out of arrears if it is bailed out in the next month or two by the IMF and the World Bank.[4] The Brazilian new money package signed last September, and widely tauted by the banks, is on the verge of breakdown after only three months, as that economy races towards hyperinflation.

Mercifully, the process of rebuilding the banks' capital base relative to Latin American exposure is now complete. This point was driven home a few weeks ago by Mr. William Seidman, Chairman of the FDIC, in testimony to the House Banking Committee[5]:

> Moreover, even in what surely could be considered a worst-case scenario, each of the nine money-center banks could write-off 100 percent of their outstanding loans to these six [largest debtor] countries and, on an after-tax basis, each of these banks would remain solvent. (emphasis in original)

This basic fact is underscored further by the all-time record profits

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[4]To its enormous credit, the IMF is resisting signing a phony deal with Argentina for the sole purpose of bailing out the banks. The IMF is attempting to maintain real standards of conditionality vis-a-vis Argentina. For this stance, the IMF is taking a lot of heat from the banking community (and friends at the Wall Street Journal), who see the IMF as a ready source of credit that Argentina could use to pay commercial bank interest. Argentina desparately needs real debt reduction (as President Alfonsin has repeatedly stated), not merely a new IMF program that can be recycled into commercial bank interest payments.

[5]Testimony of Mr. L. William Seidman to the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, January 5, 1989.

of the U.S. money-center banks in the fourth quarter of 1988.

Debt reduction is now an economic imperative for Latin America, and a foreign policy imperative for the United States. In fact, significant debt reduction is now emphatically in the long-term interests of the banks themselves, since debt reduction will improve the economic performance of the debtor countries and thereby the ultimate value of repayments that the banks will receive. The problem is that even though extensive debt reduction is in the collective interests of the banks, it will not occur by itself, for the same reason that bankruptcy can't occur without bankruptcy law and bankruptcy courts. Debt reduction, like bankruptcy, needs an institutional setting to bring it about. Otherwise, the individual interests of particular banks come to dominate the collective interests of all of the parties in this crisis.

It is not hard to envision the proper institutional setting: an International Debt Facility (IDF), under the official supervision of the IMF and the World Bank, to intermediate the process of debt reduction. Mr. Chairman, I believe that you were the first in the U.S. Senate to call for such a facility, and time has greatly bolstered the case for such a policy. This policy proposal is now widely admired and supported, not only in the Omnibus Trade Act of 1988, but also in related variants by the Japanese and French Governments, leading commercial banks such as the American Express Bank, and the debtor countries themselves, in the recent declarations of the Group of Eight democracies in Latin America.

In my judgment, this policy initiative is now close to being

implemented, as long as policymakers in the creditor and debtor countries keep their eyes on fundamental issues, and do not get distracted by the phony importunings of a few money-center banks. A few of the largest banks continue to pin their hopes on a mix of official bailouts (through increased IMF, World Bank, and Japanese lending), debt-equity swaps (despite their profound damage to the debtor countries), and debt relief granted by the smaller banks. This wish list of the largest banks is sometimes sold under the heading of "voluntary" debt reduction, which I will argue, holds as much chance for long-term success as "voluntary" bankruptcy.

The debt facility proposal is typically attacked along several well-rehearsed lines, none of which withstands scrutiny. It is said that the facility would be: (1) a bailout of the banks; (2) too costly for the taxpayers; (3) an abandonment of the case-by-case approach; (4) inimical to policy reform in Latin America; (5) harmful to the restoration of new private lending to Latin America; and (6) administratively unfeasible. I will urge later that all of these lines of criticism are unfounded, and are often based on a serious misreading of the debt facility proposal.

The remainder of my testimony will focus on two central themes. First, I will try to expose the profound shortcomings of so-called "voluntary debt reduction" schemes, as now supported by the commercial banks, and as championed for example in the recent statement of the Institute of International Finance on "The Way Forward for Middle-Income Countries". Second, I will outline the strong case for a debt facility, and try to clear away much of the underbrush of

misunderstanding that has slowed the adoption of this proposal.

II. The Illusion of Voluntary Debt Reduction[6]

It is now widely recognized that the overhang of sovereign debt is imposing major costs not only on debtors but also on creditors, by seriously disrupting the debtor economies. The costs of the debt overhang, combined with the recovery of the commercial banks, have led to a widespread acceptance of the need for a process of debt reduction, by the World Bank and others. The major commercial banks have, in rhetoric at least, started to advocate debt reduction as one step out of the current crisis.

While the banks advertise "more than $26 billion" of debt reduction,[7] the form of debt reduction has been almost uniformally of the wrong sort, and indeed inimical to the process of recovery in Latin America. The vast bulk of this amount is private sector conversions (approximately $8.0 billion), and debt-equity swaps and local conversions (approximately $16 billion), versus only about $2 billion of debt buybacks and exit bonds for public sector debt. Unfortunately, these measures have done little to reduce the public sector debt, where the crisis lies, and the debt-equity swaps have in fact done much to fuel inflation in the region.[8]

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[6]This section draws upon a more extensive study of debt reduction mechanisms, "Efficient Debt Reduction", presented at the World Bank Symposium on Dealing with the Debt Crisis", January 26-27, 1989.

[7]See the Institute of International Finance, op.cit., p. 21.

[8]See "Efficient Debt Reduction", pp.36-39 for a detailed critique of debt-equity swaps.

Debt reduction schemes should be measured against the standard of restored creditworthiness of the debtor country. Specifically, the debt reduction should be extensive enough to accomplish the following goals: (1) to allow the debtor country to service the external debt on the revised contractual basis without the need to refinance interest payments in new concerted lending packages; (2) to allow the private sector in the debtor country to attract suppliers credits, trade credits, and project finance, on a decentralized basis. By this standard, "voluntary" schemes will not come close to solving the current problems. Under the current incentives, voluntary debt relief is bound to mean no more than a continuing nibbling away at the edges of the debt overhang, without real relief for the debtor or real benefits for the creditors. We need instead a much more ambitious program of "concerted" debt reduction, in which all of the creditor banks, on an equal basis, participate in debt reduction.[9]

There are several barriers to adequate debt reduction through

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[9] By "voluntary" debt reduction, it is usually meant that each bank should be able to decide whether to participate in a debt reduction scheme (e.g. each bank chooses whether to accept a given exit bond in a swap for the existing debt). In contrast, with "concerted" reduction, All of the banks jointly participate in debt reduction on an equal basis. It has long been recognized that in the case of new money packages, or commercial bankruptcy, a "concerted" arrangement rather than a "voluntary" arrangement is needed. The same is true with respect to debt reduction for the developing countries.

A simple mechanism exists to bring about concerted debt reduction: interest rates on the existing debts should be renegotiated to sub-market rates, in line with an assessment of the country's ability to pay. The reduced interest payments should then be partially or fully guaranteed by official creditors. This mechanism could be managed on a country-by-country case by a new international debt facility, under the auspices of the IMF and the World Bank, as is described later in the testimony.

"voluntary" means (e.g. buybacks, exit bonds, and debt-equity swaps). These barriers are: (1) the inherent collective-action barrier to comprehensive debt reduction; (2) the problem of precedents; (3) the problem of public sector bailouts; (4) the distorted incentives of the large banks; (5) the structure of the bargaining cycle.

Collective Action Barrier

Consider first the collective action barrier. There is a fundamental paradox with "voluntary" schemes. If the scheme is effective enough to restore creditworthiness, then each bank should hold on to its original claims, which will rise in market value (back to par) as the other banks give the relief. Thus, each bank has the strong incentive to hold back from such schemes, letting the other banks give up their claims.

The fundamental distortion of voluntary debt reduction schemes is recognized by the banks, even though they fail to understand its implications for the failure of the voluntary approach. The IIF has recently written that "the cost [of debt reduction] is the discount incurred in exchanging old assets for new assets, but the benefits accrue to all creditors and to the debtor country because its external debt servicing costs are reduced. Thus, particular creditors benefit if other creditors can be induced to reduce their claims." This externality is praised by the IIF as an added benefit of voluntary debt reduction, rather than as the profound barrier to efficient debt reduction that it is in fact.

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The problem of precedent

Among the banks and the U.S. Treasury, almost the entire debt process is conceived of in terms of no more than five countries: Argentina, Brazil, Mexico, the Philippines, and Venezuela. While there are at least 42 countries that have rescheduled their commercial bank debts in recent years, the five main debtors account for about 80 percent of the exposure of the nine money-center U.S. banks to all 42 countries! The top three countries (Argentina, Brazil, and Mexico) alone count for 64 percent of the total exposure of the money-center banks to the problem LDCs. Importantly, however, from a humanitarian and geopolitical point of view, the five countries count for only 40 percent of the population of the entire group. In the debt management process, there has been little serious attempt to address the problems of the smaller debtor countries for fear of setting adverse precedents for the larger countries.[10]

The expectation of public sector bailouts

The third major reason why comprehensive debt reduction is unlikely is the continuing signal from the official community that public money will come to the rescue of the faltering

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10 Countries such as Bolivia, Dominican Republic, Ecuador, and Peru, among others, cannot pay their bills, and are in no condition to expect a return to commercial bank lending for general balance of payments support for many, many years to come. And yet for these countries, as much as for Argentina, Brazil, and Mexico, comprehensive debt reduction has been off the agenda.

renegotiation process. To the extent that the banks limit new lending or debt reduction, they know that the official community will make up at least part of the difference in official landing to the debtor countries. This is because the official creditors have an important stake in maintaining political and economic stability in the debtor countries, and thus are willing to put money into the process if the banks do not.

This infusion of public money acts as a tax on debt reduction schemes, because it reduces the incentives of the banks to agree to debt reduction schemes. The process of public sector bailouts is increasingly evident, as I have shown elsewhere.[11]

The distorted incentives of the large banks

Despite all of the biases against debt reduction (e.g. the advantages of waiting for *others* to give relief; the problems of precedent; the prospects of an official bailout), most banks are now prepared to accept significant losses on the debt in return for ridding themselves of the problem. This is evidenced by the fact that the regional U.S. banks are now divesting of their entire LDC debt portfolios on the secondary market at a remarkable rate, with losses reaching 50-60 percent of the face value of the portfolios. It is a few money center banks, not the vast bulk of small and medium size U.S. banks, that are resisting comprehensive writedowns of their portfolios. Note in Table 2 that while most

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[11] See "New Approaches to the Latin American Debt Crisis", Harvard University, September 1988.

U.S. banks are reducing their exposure, the non-money center banks are reducing their exposure at a much faster rate.

It is important to analyze why the large banks are less willing to sell off their portfolios, since that also helps to explain why the large banks have so vigorously resisted concerted debt reduction arrangements. There are basically three reasons for the resistance of the largest banks. First, the large banks are resistant to writedowns because of the greater LDC exposure relative to capital. This matter can be handled, however, through appropriate regulatory policies in support of comprehensive debt reduction arrangements.[12] Second, the large banks have superior

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The key point is that regulatory oversight of the banks is based on the book values, not market values, of the banks' assets and liabilities. This means that heavily exposed banks may sometimes have the incentive to avoid book losses on their portfolio even if they represent market gains. A bank with a large exposure of LDC debt relative to bank capital might satisfy capital-adequacy requirements when measured at book values, but fail to satisfy them when measured at market value. In this case, the bank might turn down participation in a debt reduction scheme, even if it raises the market value of the LDC exposure, if at the same time it causes a book loss on the bank's claims that pushes the bank out of compliance with the regulatory guidelines on capital adequacy.

This kind of distortion arises because of faulty accounting procedures. In the U.S., the banks are not required to mark-to-market the valuation of LDC claims, so that the vast bulk of the claims is kept on the books at 100 percent of face value, despite a secondary market value of around 40 percent of face value. Banks are willing to absorb some losses on their LDC claims in order to clean up their portfolios, but only if such losses do not jeopardize the bank's plans for meeting the guidelines on capital adequacy, which are based purely on book values.

The solution to this problem is to require banks to mark their exposure to market, at least for those banks that refuse to participate in a comprehensive debt reduction scheme. For participating banks, the regulatory authorities can exercise forebearance, and allow for gradual writeoffs over a period of several years.

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access to debt-equity swaps than do the small banks. In general, these debt-equity swaps offer a less costly way of divesting debt than does the secondary market. Thus, the big banks resist comprehensive agreements in order to maintain their options to pursue debt-equity swaps. Unfortunately, from the point of view of the debtor country, the debt-equity swaps tend to be highly deleterious.

Third, the large banks recognize that by slowing their own debt reduction process, they also gain by having the smaller banks "cash in", and accept losses via exit bonds, secondary market sales, and so forth. Since any creditor is made better off if another creditor voluntarily makes a concession to the debtor (since the remaining debt increases in value), the large banks have an added incentive to let the small banks get out at a large loss. John Reed, Chairman of Citicorp, was quite explicit on this point in a recent speech:

> What is happening right now is that some banks, like our own, are converting debt into long-term investments [i.e. debt-equity swaps]. At the same time, some smaller banks that have very different interests are selling out at prices that, frankly, are quite convenient to those of us who are going to stay in for the long haul, and quite convenient for the countries. (emphasis added).[13]

The waiting game imposes costs on the creditors as a whole (by allowing a continuing economic deterioration in the debtor countries), but these costs are borne by the smaller banks (who

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[13] See John S. Reed, "Opportunities for the New Administration", remarks at the National Foreign Trade Council, New York, New York (October 18, 1988) and the Los Angeles World Affairs Council, Los Angeles, California (October 27, 1988).

sell their debts at exceptionally discounted prices), not by the larger banks which impose the obstacles to concerted debt reduction.

III. The International Debt Facility

The voluntary approach, at least as now conceived, is unlikely to succeed in its central purpose: to restore the creditworthiness of the debtor countries in order that they may achieve renewed growth and political stability. Debt reduction should be comprehensive to achieve this goal, and for that we need a new approach. A real debt settlement requires the concerted participation of the banks. To the extent that there remains a "menu of options" for the banks, this menu should only include alternative ways of accomplishing debt reduction. In other words, banks should not have the luxury of opting out of the debt reduction process entirely, for that frustrates the whole process.

The simplest way to achieve a comprehensive reduction of debt is through a reduction of interest rates to sub-market levels on the existing debt. This mechanism is nearly ideal: it is administratively straightforward (the contracts merely have to be rewritten to include interest rates of say, a fixed 4 percent, rather than LIBOR plus 13/16); it is comprehensive; it is equitable in its impact across banks; it avoids the adverse consequences of debt-equity swaps; it is a standard mechanism for debt workouts in the domestic context; and it may even obviate the need for large, immediate writedowns of capital under U.S. banking

regulations.[14] Furthermore, it is easy to combine interest rate relief with credit enhancement, since the reduced interest rates can be guaranteed by the official creditors, e.g. the World Bank, as part of the restructuring process.

Achieving a comprehensive debt reduction for a particular debtor country will require several steps on the part of the official creditor community (especially the IMF and World Bank):

1. An explicit recognition by the IMF and World Bank that the debt burden of the country should be permanently reduced (conditional on the commitment of the debtor country to pursue appropriate macroeconomic policies);

2. An official policy that the banks should share equally in the debt reduction. A "menu of options" may still be used in recognition of regulatory differences facing different banks, but in economic terms, all banks should participate equally in the debt reduction mechanism.[15]

3. An official policy against debt-equity swaps as a significant component in debt reduction, except for the handling of private sector debt or the case of privatisation of a public-sector firm.

4. The design of official lending programs (e.g. standby programs and structural adjustment lending) based on debt-servicing targets that take into account the necessary debt reduction.[16]

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[14]Under FASB 15, a debt restructuring which preserves principal, but which reduces interest rates, does not in general require a capital writedown.

[15] As an example, some banks might prefer to take debt reduction by a cut in principal, while others would prefer to maintain principal while accepting a sub-market interest rate level. These differences should be accomodated in a menu of options, but all banks should be required to choose among the menu. New money, or longer maturities and grace periods, definitely should not be equated to debt reduction in the menu.

[16]In other words, if a country has a huge overhang of debt, the IMF and World Bank programs for the country should be designed on the assumption that the debt will eventually

5. An official policy that IMF and World Bank programs can go forward despite arrears to the commercial banks in circumstances in which the IMF determines that the debt should be reduced, but in which the banks have not yet agreed to a comprehensive debt reduction mechanism.

6. Regulatory support for debt reduction, with regulators requiring writedowns of debt to market values for those countries for which debt reduction packages are not concluded. At the same time, a stretching out of writedowns in the cases that comprehensive debt agreements are reached.

7. The use of official money to "enhance" the interest stream of debt for cases in which the countries and the commercial banks have agreed to a comprehensive debt reduction scheme. The official institutions can provide partial or complete interest payment guarantees, depending on the precise economic circumstances of the debtor country, and the nature of the debt reduction agreed to with the commercial banks.

8. Strict conditionality on official lending for all countries negotiating debt reduction programs, and for all countries seeking programs in the face of commercial bank arrears.

9. A policy that sustained interest arrearages on payments <u>after</u> debt reduction has taken place should trigger cross-default provisions with other IMF and World Bank lending. This is especially important in cases in which there are official guarantees of the interest payments that have been missed.

10. An official policy of support for debt reduction through the mechanism of <u>sub-market interest rates</u>, as the simplest, fairest, and administratively easiest form of comprehensive debt reduction.

These steps could best be accomplished in the context of an international debt facility, that would be in charge of: (1) organizing the comprehensive package; (2) linking the debt reduction package to policy reforms in the debtor country; and

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be reduced in negotiations between the debtor and the banks.

(3) providing official guarantees on the reduced interest payments that are due after the debt reduction package is put into operation.

This solution, which is quite straightforward, is often opposed on misleading grounds. Let me conclude my testimony by touching briefly on several of the "myths" surrounding an international debt facility.

Myth 1. A debt facility is a taxpayer-financed bank bailout

This is real whopper. A debt facility is the most effective and orderly way for insuring that the banks accept losses on their bad loans, rather than pawning them off onto the taxpayer via new lending from the IMF, World Bank, and creditor governments. A debt facility would require a concerted acceptance of bank losses for the first time in this crisis.

Myth 2. A debt facility is too costly for the taxpayer

This, no doubt, is the preeminent myth that has forestalled any action on the proposal. With the popular press fond of quoting a developing country indebtedness of more than $1 trillion, opponents of the debt facility are able to instill the notion that real relief would require hundreds of billions of dollars of taxpayer funds.

This is wrong on several points of view. The target of the facility is <u>medium-and-long-term debt of the public sector of troubled debtor countries</u>. This amounts to about $240 billion,

with a secondary market value of the debt of about $90 billion. Other kinds of debt (e.g. debt owed to the IMF, World Bank; short-term debt; debt owed by the private sector; etc.) would not be part of the plan. Moreover, it is the banks, not the taxpayer that would assume the bulk of the losses under the debt facility. Roughly speaking, the debt would be cut from approximately $240 billion to $90 billion (in steps, and assuming that all countries eventually qualify for debt reduction, by undertaking adequate adjustment programs). The facility would guarantee the payments of part or all of the $90 billion due. The taxpayers would be liable only if the debtor countries could not manage to carry the burden of the $90 billion, and would be liable only for that part which remains unpaid by the debtor countries.

The U.S. share of the guarantees could be quite modest. In another detailed study, I have illustrated the very small amounts at stake by assuming that the Japanese would cover one-third of the guarantees, and the U.S. would cover one-fourth.[17] The result is that the U.S. ends up guaranteeing about $22.5 billion in liabilities of the facility. If paid-in capital is about 10 percent of the amount of the guarantees, the U.S. contribution would come to approximately $2.3 billion. This could be distributed over five years, with an annual budgetary burden of about $470 million.

Thus, for somewhat less than each year's foreign aid

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[17]See "New Approaches to the Latin American Debt Crisis", Harvard University, mimeo, September 1988.

disbursement to El Salvador, the U.S. would be able to fund its participation in an international debt facility that could effectively solve the commercial bank debt crisis for the 30 largest debtor countries. This comparison should certainly put in perspective the very modest sums involved!

If the political will is still stuck, then the Committee might reflect on the fact that the $90 billion of secondary market value of the developing country debt is equal in value to about 60 acres of land in downtown Tokyo. A modest sale of Japan National Railway land holdings in Tokyo could readily finance the entire international debt facility. (And remember, the cost to Japan is not the price of the debt that is guaranteed, but only the cost of the guarantees if some of the reduced payments are not met).

Myth 3. A Debt Facility is contrary to the Case-by-Case Approach

This myth reflects a simple misunderstanding. Advocates of a debt facility do not advocate an across-the-board writedown of debt. Rather, comprehensive debt reduction would be available on a case-by-case basis, depending on the willingness of the country to undertake economic reforms. In each case, the extent of reform would be tailored to the economic needs of the country in question. Those needs could be ascertained based on a professional assessment of the weight of the debt burden, the solvency of the public sector, the extent of past losses in GNP as indicative of the growth potential of the economy, and so

forth.

It might turn out that only a few countries would qualify for debt reduction supported by the debt facility. But at least the option would be universally available for all debtor governments that are willing to attempt a program of economic reform.

Myth 4. The Debt Facility is Inimical to Economic Reform

This notion is simply backward. The debt overhang itself is the greatest barrier to economic reform, because it destabilizes governments in Latin America, and thereby deprives governments of the political base to pursue sustained programs of reform. Moreover, it is virtually impossible to sell a program of economic reform in Latin America today, because the political opposition is only too quick to point out that under current arrangements, the benefits of reform accrue to the international banks, rather than to the domestic citizenry.

Two countries, Bolivia and Costa Rica have already achieved a measure of de facto debt relief. These two governments have, indeed, among the most successful programs of reform now underway in the region in large part because of the breathing space offered by the easier terms on debt servicing.

The real harm with the current policies is that politicians friendly to the United States in the region will find themselves increasingly undermined by opponents who attack the U.S. (and the rest of the creditor world) as the agents of oppressive debt

collection.

Myth 5. Debt Reduction would be harmful to new lending

The banks have long argued that Latin America should be drained of approximately 5 percent of GNP per year in net interest payments, since to give relief would somehow restrict the access of the countries to "new lending". Since no real net lending is in fact available, the point has always seemed to me to be unreal in the extreme.

But more fundamentally, there is an enormous confusion about the linkage of debt reduction and new lending. In bankruptcy, for example, the reduction of debt is seen as vital to restoring creditworthiness. It is common in a bankruptcy action that once the existing debts are reduced, the bankrupt firm may immediately return to the credit markets for new financing based on a cleaned-up balance sheet. Similarly with sovereign debt, it is the debt overhang itself that prevents the return of the sovereign to the loan market, and the most effective way to revive lending for trade financing and fixed capital formation is to reduce the debt burden to a level that can be serviced by the debtor.

Those who argue against debt reduction because of an alleged adverse effect on future lending confuse the effects of two kinds of actions on the debt. A unilateral and hostile suspension of payments by a debtor may indeed delay the debtor's return to the

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capital markets.[18] Contrariwise, an agreed and negotiated reduction of debt can speed the return of the sovereign to the capital market. Note, for example, that Indonesia had access to commercial market borrowing just four years after Indonesia's debts to foreign governments were substantially reduced in 1970. The alleged reputational onus against a government that failed to honor its debts simply did not exist in this case. If the creditor banks are truly worried about a sovereign's future access to lending, then the banks should strive to reduce the debt burden via negotiation, rather than cornering the debtor into the need for unilateral actions.

Myth 6. The Debt Facility is Administratively Unfeasible

A final myth is that the debt facility is unworkable because the banks might choose not to participate. And if the debt facility enters the secondary debt market to try to buy up the debt, the price will be driven too high to make a debt repurchase feasible. Once again, this myth reflects an enormous naivete over the actual workings of the loan market. The debt facility would not "go into the market" to buy debt. Instead, the banks as group (negotiating via the steering committee) would have to reach a comprehensive agreement with the country in order to qualify for assistance from the debt facility.

Since the major banks hold most of the debt, and since the

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[18]It may still make sense as a measure of last resort, however.

vast majority of the banks would be only too happy to be relieved of their exposure in an organized manner, the debt facility can be made to work with the cooperation of a very small number of U.S. banks, including Citibank, Bank of America, Chase Manhatten, Chemical Bank, and Morgan. There are many carrots and sticks to induce participation, including regulatory changes, official guarantees, support from the IMF and the World Bank, etc. Moreover, it is highly unlikely that any of these banks would stand in the way of a reasonable settlement at risk of interfering with a matter of significant foreign policy concern of the United States.

Unanimity would not be required, moreover, since under the existing bank agreements, qualified majorities may change the terms of lending agreements for the entire group of creditors. David Finch, a long-time senior manager of the IMF, and one of the wisest observers of the debt issue in the world, has summarized the question of participation as follows: ". . . there is no question that the creditor governments have it in their power to give substantive legal protection to a majority settlement".[19]

100% agreement for certain changes, inc. lower int.

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[19]See C. David Finch, "IMF -- The Record and the Prospect", Institute of International Economics, Washington D.C., mimeo, 12-30-88.

The Baker Plan: Progress, Shortcomings, and Future Evolution

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ABSTRACT

Global economic conditions were broadly favorable to debt management under the Baker Plan (late 1985-1988), except for the collapse of oil prices. Major Latin American debtors achieved important reductions in interest/export ratios. While the banks provided new money that was one-third lower than the Baker Plan target, the multilateral development banks raised net flows by only one-tenth of the targeted $3 billion annually. If the IMF and bilateral export credit agencies are included, net capital flows from official sources to the highly indebted countries actually fell, from $9 billion annually in 1983-85 to $5 billion annually in 1986-88.

Political fatigue is evident in major debtor countries. However, their recent growth stagnation has been caused primarily by internal economic distortions (high fiscal deficits and inflation), not the debt burden. Of the six large Latin American debtor countries, the three with the largest outward transfer of resources relative to GNP (Chile, Colombia, Venezuela) achieved the highest growth and lowest inflation in 1986-88, indicating that external debt does not explain high inflation or low growth in Argentina, Brazil, and Mexico.

While the basic international debt strategy remains valid, intensified policy efforts are necessary. Banks should provide multi-year new money packages. Banks should confer senior status on "exit bonds," and the World Bank should then guarantee these instruments, to make viable substantial voluntary debt reduction by interested banks. Bilateral and multilateral creditors should raise annual net capital flows to the highly indebted countries by $10 billion annually and the banks by $5 billion to cut the outward resource transfer from these countries in half over the next three years. The central determinant of success in emerging from the debt crisis, however, will have to be sound economic policies in the debtor countries themselves.

The Baker Plan:
Progress, Shortcomings, and Future Evolution

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January, 1989

Origins

From the suspension of Mexican debt payments in August of 1982 through 1983, the debt problem was addressed on a basis of short-term crisis management. All four parties were expected to act: the banks, through rescheduling payments and providing new loans; the countries, by adopting adjustment programs; the international financial agencies (especially the IMF), by providing leadership to the banks and funding as well as policy guidance to the countries; and the industrial countries, through reschedulings of export credits in the Paris Club and bridge loans. The objective was twofold: to avoid a collapse of the international banking system and to permit adjustment and renewed development in the debtor countries.

Extremely high interest rates and severe global recession had played a major role in precipitating the debt crisis. Buoyant recovery by 1984 (with industrial country growth at 5 percent) and a reduction of interest rates (as LIBOR ebbed from 19 percent at its 1981 peak to 11 percent) led to considerable optimism in that year that the debt crisis was on its way to resolution. Indeed, key debtors ran large current account surpluses, and economic growth in Latin America again turned positive (3.7 percent, versus -1.2 percent in 1982 and -2.6 percent in 1983).

By 1985 the mood began to swing once again toward pessimism.

Latin American policy-makers were facing intensifying political pressure as the lagged effect of severe recession in 1983. Moreover, they were beginning to conclude that bank lending could be expected to remain frozen over the near term, despite adjustment progress. Governments had shifted from military to civilian rule in Argentina and Brazil, and in both countries there were initial breaks with the formula of IMF-led adjustment that had dominated the initial response to the debt crisis.

In US policy circles, economic leadership had shifted in an activist direction under new Treasury Secretary James Baker, as illustrated by his Plaza Agreement in September 1985 to reduce the value of the overly-strong dollar to avoid a protectionist outbreak. In debt, Mexico in particular provided reason for this Texan's concern, as that country experienced fiscal erosion, rising inflation, weakening oil prices, and a devastating earthquake. It was evident that Mexico would once again need to borrow from the banks as its large 1984 current account surplus evaporated with a partial recovery in imports and lower oil exports. Yet the banking community was in no mood to renew lending.

Design

Although Mexico was an important catalyst, the Baker team prepared a broader attack on the debt problem that amounted to a global indicative plan.

STRATEGY AND TARGETS -- The new initiative called for banks to extend new lending amounting to approximately $7 billion annually ($20 billion over three years), or 2-1/2 percent of existing

exposure each year, to 15 major developing countries with debt difficulties. The implication was that this target was conceived of as a net disbursements concept, above and beyond amortization of principal (but not net of interest payments). The announcement of this goal for bank lending served notice that the absence of major new money programs in 1984-85, which had been possible because of the greater than expected increases in trade surpluses of debtor countries, could not be expected to continue over the medium term.

The plan called for structural reform by the debtor countries. It stressed three areas: trade liberalization, the liberalization of policies toward direct foreign investment, and reform of the state enterprise sector, including through privatization.

Industrial countries were to provide more support through an increase in net loan disbursements of multilateral banks (MDBs) by $3 billion annually ($9 billion over three years). Secretary Baker indicated that successful implementation of the plan by all parties would serve as the condition for US support for a substantial increase in the capital of the World Bank, a measure which, however, US authorities were not yet prepared to endorse at the time. Added to the 1985 base of net disbursements by MDBs, the expansion meant total net capital flows (excluding interest) of approximately $7 billion annually from these agencies, or almost the same three-year magnitude as the $20 billion asked of the banks. Private bank/ public sector symmetry thus seemed present.

The Baker Plan essentially provided a more concrete

formulation of the existing strategy on the debt problem. It did not change the fundamental assumptions of that strategy. In particular, from the outset the debt strategy had rejected a bankruptcy approach in which major portions of existing debt would be forgiven on a coerced basis. The plan's architects judged that forced forgiveness would "admit defeat" and cut off borrowers from capital markets for many years to come.

Instead, the plan continued the policy premise that the principal debtor countries could grow their way out of the debt problem, and in a non-hostile world economy could expand their exports enough over time to reduce their relative debt burdens to sustainable levels compatible with a return to more normal credit market access. The new initiative also continued the principle of financial support by foreign official and bank creditors, matched by adjustment effort in the debtor countries.

STRENGTHS -- The plan did make an important shift in emphasis. It stressed that the official community recognized the debt problem was one that would take a long time to address, and that it was foremost a problem of economic development. This thrust of the plan was widely interpreted to signify a move away from short-term balance of payments stabilization, particularly through programs that could have contractionary effects, to longer-term development objectives. The implicit institutional shift was from the IMF to the World Bank as the lead institution in debt management. In view of the costly recessions of 1982-83, this new emphasis was timely.

The plan was also correctly oriented in its intent of

encouraging new bank lending. From the outset of the debt problem it had been apparent that the free rider problem, in which individual banks could seek to avoid new lending yet would benefit from the strengthening of the country's ability to ride through the crisis resulting from new loans by other banks, could cause bank lending to grind to a halt, and that orientation from a central force was necessary to deal with this externality. The IMF had provided this direction early in the crisis; the Baker Plan targets sought to do so over the medium term.

The initiative was also positive in its implicit confirmation that the industrial country governments recognized a responsibility to participate in the solution to the debt problem. Public sector action was to occur primarily through the MDBs. This commitment was important in an environment of the facile and popular political critique that the public sector should not bail out the banks.

The plan was even broadly correct in its selection of the priority structural reforms in debtor countries. Excessive protection and import-substituting industrialization carried to an inefficient extreme had played a large role in the vulnerability of Latin America to the debt problem, as this development strategy had left an export base much weaker than that developed in the East Asian NICs. Similarly, the fiscal fragility that had given rise to much of foreign borrowing owed much to chronic deficits of state enterprises. The emphasis on direct investment was also logical given the need to reverse the pendulum in its extreme swing in the 1970s from risk capital inflows to borrowing abroad.

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WEAKNESSES -- The Baker initiative did not address the difficult problem of the transition from "concerted" (or "involuntary") lending through "new money packages," in which all banks were pressured to lend additional amounts in proportion to their exposure at the outset of the debt crisis, back to voluntary capital flows. Indeed, the more pressure applied in pursuit of the bank lending targets, the more resentment there was likely to be and the longer the delay of voluntary lending. At the same time, the official sector lacked means other than moral suasion to ensure that the private sector met the lending targets in the indicative plan.

The initiative appears to have been somewhat misleading in its capital flow targets for the public sector by not taking an integrated approach to all official lending, and in particular by remaining silent on the role of the IMF. As discussed below, the shift of the IMF from an extremely active new lending role early in the debt crisis to a posture of minimal or negative new lending meant that the widely publicized targets for expansion of lending by multilateral development banks overstated the net capital contribution that could be expected from the international institutions as a whole. From the bureaucratic standpoint it was natural to argue that the IMF was not a "development agency" and thus could not be expected to continue indefinitely its initial high level of net lending; but from the standpoint of the broader development objectives of the Baker plan itself, a comprehensive view of public sector financing for the debt problem needed to be

taken. The same observation applied to bilateral export credit agencies, which had provided considerable financing before the debt crisis but cut back much like the private banks after its onset.

There was an awkwardness in the seeming interventionism of the industrial country governments into what could be considered the internal affairs of the debtor countries. While liberalized treatment of imports and foreign investment and slimming of the state sector were in practice desirable in many of the debtor countries, in principle adjustment and growth could have been carried out through other means of fiscal correction and improved efficiency at the choice of each country according to its political tradition. There were delays in the mobilization of new lending efforts in early 1986 as each major debtor waited for another to bear any taint that might be associated with being the first to sign up in the program, thus appearing to accept foreign conditions in areas more fundamental than the macroeconomic guidelines familiar in IMF programs.

There was also considerable doubt about the adequacy of the capital flow targets of the Baker Plan. From 1981 to 1985 the net transfer of resources (capital inflow less net payments of interest and profits abroad) to the highly indebted countries identified in the Baker Plan fell from $18.3 billion to -$26.5 billion,[1] a decline of almost $45 billion. The 1981 flows had been seriously

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[1] World Bank, World Debt Tables: External Debt of Developing Countries, 1988-89 Edition, Vol. I (Washington: World Bank, 1988), p. xvii. Hereafter referred to as World Bank Tables 1988.

exaggerated by excess demand in some key countries such as Mexico, and the 1985 flows had been artificially small because of transitory high current account balances in major debtor countries such as Mexico and Brazil that meant they were not asking for new money. Nonetheless, reversal of only one-fourth of the decline in resources transfers (through an increase of $10 billion annually between the banks and the multilateral development banks, MDBs) appeared to be too modest a policy goal, and many analysts argued that the objective should be at least twice as large. There was, of course, an inherent tension between the scale of new lending and the speed of reduction of the debt burden to more sustainable levels, which many critics of the Baker Plan who attacked both the lending target as too low and the debt buildup as too high failed to recognize.

Mid-term Evolution

Brazil's moratorium in early 1987 triggered widespread loan-loss provisions by US banks, and both events led to an erosion in market psychology that drove secondary market prices for the debt of major Latin American countries from the range of 60-80 cents on the dollar to the 40-60 cent level. An increasing number of banks, especially regional banks that had been involved in Latin American lending for a relatively brief period in the late 1970s, simply wanted to be rid of their portfolios of loans to debtor countries. Lengthy delay in mobilization of the $7.7 billion new money package for Mexico in late 1986 had led many to question whether there could be any further new lending programs.

At the annual meetings of the IMF and World Bank in September of 1987, Secretary Baker suggested a further evolution of his initiative, which called for a "menu approach" to tailor the forms of bank participation in support of debtor countries to the varying interests of the individual banks. The approach included more attractive vehicles for new money (bonds to confer implicit seniority, rights to convert new loans into equity) as well as alternative options for banks desiring to exit from the new-money process ("exit bonds").[2] Secretary Baker backed the new approach more concretely when the US Treasury subsequently gave its blessing to Mexico's exit bond, designed with Morgan Guaranty, which used Mexican reserves to purchase zero-coupon US Treasury bonds as collateral for 20 year bonds paying LIBOR plus 1-5/8 percent. The Mexicans hoped banks would convert existing claims at close to the secondary market price of 50 cents on the dollar in return for this more secure instrument, and some did; but the total volume exchanged was limited ($3 billion) and so was the discount (which turned out to be 30 percent rather than 50 percent), because the bonds had a guarantee only for distant maturity and none for ongoing interest payments. In addition, the banks credited the menu approach with the relative success in mobilizing a package of $5.2 billion in new lending for Brazil in 1988, although when

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[2] Several of these options as well as alternatives such as discounted debt buybacks were examined in my Mobilizing Bank Lending to Debtor Countries (Washington: Institute for International Economics, Policy Analyses in International Economics No. 18, June 1987).

Brazil launched its new anti-inflation program in January of 1989 its negotiators informed the banks that some of the attractive features ("relending" and debt-equity conversion) would have to be suspended or scaled back temporarily.

Results of the Strategy

By the end of the three-year time horizon of the original Baker Plan, its results as the core international strategy for dealing with the debt problem were mixed, but considerably more positive than the widespread image of failure conveyed by some of the media, some entities representing developing countries, and some academic, legislative, and business figures (including Senator Bill Bradley and the President of American Express, James Robinson). An evaluation of the results of the strategy requires special care in attributing a causal role to external debt, and within debt, a causal role to the Baker Plan. With this cautionary note in mind, the results of the Baker initiative may be reviewed according to several criteria.

ECONOMIC GROWTH -- The bottom line of the Baker Plan was supposed to be a restoration of economic growth in the debtor countries. Ironically, their growth rates were higher in the two years immediately before the plan than during its duration. Thus, Latin America as a whole achieved growth of 3.7 percent in 1984 and 3.6 percent in 1985. While the rate was approximately the same at 3.9 percent in 1986, the region's real GNP growth decelerated to 2.5

percent in 1987 and only 0.7 percent in 1988.[3] However, the argument is developed below that the primary source of this decline was not the external debt problem, but the adverse growth effects of high domestic inflation. As discussed below, those countries that did achieve favorable performance on domestic adjustment were able to obtain relatively high growth in the Baker Plan period (1986-88).

INTERNATIONAL ENVIRONMENT -- An assumption of the Baker Plan was that the international economy would not collapse and make it impossible for the debtor countries to increase their exports and "grow their way out" of the debt problem. The industrial countries more than fulfilled this prerequisite. Thus, average growth in industrial countries in 1986-88 stood at 3.3 percent, comfortably above the range of 3 percent (or, after LIBOR subsided to single digits, 2-1/2 percent or lower) that had been considered necessary for progress on debt.[4]

International interest rates also remained in a range compatible with emergence from the debt problem. For 1986-88 as a whole, LIBOR averaged 7.3 percent, less than half the level of 1981-82. Although the rate rose by 200 basis points from the fourth quarter of 1987 to the fourth quarter of 1988 (when it stood

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[3] Economic Commission for Latin America, Balance Preliminar de la Economia Latinoamericana: 1988 (Santiago: ECLA, December 1988). Hereafter referred to as ECLA 1988.

[4] IMF, World Economic Outlook, October 1988, p. 59; William R. Cline, "International Debt: Analysis, Experience and Prospects," Journal of Development Planning, No. 16, 1985, pp. 25-56.

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at 8.9 percent), in part because of attempts to stabilize the dollar, US inflation was also up (from -3 percent in 1986 and +2.6 percent in 1987 to 4.1 percent in 1988, wholesale price index) so that real international interest rates were not much changed at the end of 1988 (and were lower than in 1986).

International prices of commodities and especially oil were the principal area in which the world economic environment caused serious difficulty during the Baker plan period. As figure 1 shows, the dollar price of oil fell by half in 1986, and after a modest recovery in 1987, in 1988 was not much higher than the weak level of 1986. Several debtors among the 15 countries identified in the indicative Baker Plan depend heavily on oil, especially Mexico, Venezuela, Nigeria, and Ecuador. Because oil is a smaller share of imports for such oil-importing debtors as Brazil than it is of exports for the oil-exporting countries, it is fair to say that the collapse of oil prices during the Baker Plan period was the most severe blow to the strategy from the international economy.

Other commodity prices were weak but less dramatically so. Figure 1 shows an index of nominal dollar prices for six commodities weighted by their shares in Latin America's exports.[5] The prices of these raw materials had shown promising recovery from

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[5] Coffee (32.6 percent), soybeans (25.8 percent), copper (22.8 percent), corn (9.1 percent), sugar (5.9 percent), and beef (3.9 percent). Price series are from International Financial Statistics; trade shares calculated from Inter-American Development Bank, Economic and Social Progress in Latin America: 1987 Report (Washington: IDB, 1987), pp. 474-5.

the initial debt crisis year of 1982 to 1984, as they rose by 9.1 percent. But from 1984 to 1987 these commodity prices fell by 15.8 percent, dominated by excess supply in world grains trade and coffee. Dollar commodity prices had been expected by many economists to rise once the dollar fell, and signs of this process began with higher copper prices by 1987. By 1988 there was a much broader commodity price increase, as the index for the six raw materials rose by 30 percent from 1987 and stood 10 percent above the 1984 level. US drought spurred grains prices, and a world boom in production and trade added more generalized upward pressures.

DEBT INDICATORS -- In a world economic environment that was generally hospitable, with the most notable exception of oil prices, by 1988 the debt indicators for the major debtor countries were showing significant improvement. Figure 2 shows the most important single indicator of the debt burden, the ratio of interest payments to exports of goods and services, for the six largest Latin American debtor countries, which account for 69 percent of external debt of the Baker-15 countries. By 1988 the interest/exports ratio was lower than its highest past year in all six countries. From their peak levels for the 1980s, the interest/export ratios had declined from 57.1 percent to 29.7 percent in Brazil, 47.3 percent to 29.1 percent in Mexico (despite the collapse of oil prices), 58.4 percent to 40.4 percent in Argentina, 31.1 percent to 26.4 percent in Venezuela, 49.5 percent to 22.6 percent in Chile, and 26.7 percent to 20.8 percent in

Colombia. By 1988 the interest/export ratio was not only lower than in the debt crisis year of 1982 but also either lower than or equal to the ratio in the pre-crisis year of 1981 for Brazil, Mexico, Chile, and Colombia. For Latin America as a whole, the ratio stood at the same level in 1988 (28 percent) as in 1981, and well below the peak 1982 level of 41 percent.[6]

Even the absolute level of debt, and the ratio of debt to exports and goods and services (which fails to take account of the sharp decrease in the price of debt, the interest rate) showed moderating trends by 1988. As indicated in figure 3, in 1988 the dollar value of total external debt for Latin America as a whole fell (from $410 billion to $401 billion) as the consequence of debt-equity conversions and substantial discounted debt buybacks in the private sector. In real terms (deflating by US wholesale prices), by 1988 debt for the six countries stood only 13.5 percent above the 1982 level, for average annual growth of only 2.1 percent. And the ratio of debt to exports of goods and services declined from its 1986 peak for the six countries at 424 percent to only 339 percent, a level moderately lower than in 1982 (354 percent) and not far removed from the pre-crisis 1981 level (331 percent).

In view of these absolute and relative trends, the summary view presented in the World Bank's 1988 debt report was misleading:

> .. most of the indebted countries are still no better off than in 1982 -- when the debt crisis erupted. Debt disbursed and outstanding has doubled, and debt service

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[6] ECLA 1988, table 17.

payments on a cash basis are one-third higher.[7]

By aggregating debt for all developing countries, the statement seriously obscured the progress in the major Latin American debtor countries that had been and remain the central core of the debt crisis as a systemic problem. Thus, it may be seen in table 1 that the increase in debt in the 17 Highly Indebted Countries (HICs), or the original Baker 15 plus Costa Rica and Jamaica, was far smaller than in other developing countries (34.8 percent versus 63.2 percent). Moreover, of the large volume debt increases in other developing countries, the bulk occurred in countries well capable of carrying debt; indeed, had they not been, the debt would not have increased as it did. The largest absolute and percentage increase in debt occurred in China. Other large absolute increases occurred in Greece, Hungary, India, Indonesia, Malaysia, Thailand, and Turkey, all countries that have remained outside the locus of the debt crisis (and indeed, Turkey overcame its earlier crisis to achieve new access to credit).[8]

In short, for the major Latin American debtors at the center of the debt crisis, there has been much more improvement in the key debt indicators than is generally recognized. Large increases in debt of such countries as China, India, Greece and Portugal

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[7] World Bank Tables 1988, Vol. I, p. xi.

[8] The World Bank data, which only extend through 1987, do not capture the reduction in Latin American debt that occurred in 1988, as discussed above. Note also that the World Bank data show larger 1987 debt than does the Economic Commission for Latin America (table 1).

should be construed as a continued functioning of the capital market for developing countries despite the Latin American problem, rather than as evidence that the world debt problem has grown worse.

CAPITAL FLOWS -- A widespread view is that the private banks fell far short of their lending targets under the Baker Plan. In fact, the banks did lend less than the plan called for, but the shortfall was limited to about one-third. A much less recognized pattern is that on a consolidated basis, capital flows from the public sector to the Baker countries actually fell by approximately $4 billion annually, rather than rising by $3 billion annually as implied by the Plan. The main reason for the public sector shortfall was that decreases in IMF and bilateral (mainly export credit agency) lending were not offset by increases in lending by multilateral development banks.

Table 2 reports capital flows (net disbursements) to the Baker countries during the Plan years, 1986-88. For the private banks, the figures refer to the actual disbursements under the agreed "new money packages." Because outstanding principal was typically rolled over in this period, net disbursements are approximately the same as gross disbursements.[9] For the IMF, net flows are

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[9] The major exception is for Venezuela, where there were repayments of principal of about $1 billion annually. However, the Venezuelan government chose to repay principal rather than enter an IMF adjustment program, the condition the banks insisted on for complete rescheduling and new money. In any event, overstatement of the effort made by the banks from the standpoint of not deducting Venezuelan repayments is approximately offset by understatement from the standpoint of commitments undertaken by the banks but not disbursed because of changes in circumstances.

calculated by multiplying the change in the number of SDRs in outstanding "use of Fund credit" at the end of each year by the average dollar/SDR exchange rate for the year.

The table shows that the banks achieved capital flows of approximately $14 billion over the Baker Plan period, or about two-thirds of the target $20 billion for these countries. It is clear, however, that the flows were concentrated in the major countries. The smaller countries typically were unable to mobilize new money packages. This pattern reflected the greater importance of the large debtors to the banks, and implicitly the greater bargaining power that these countries had in new money negotiations.

Table 2 also shows that the multilateral development banks achieved average net disbursements of $4.2 billion annually during the Baker Plan period. This outcome represented a massive shortfall from the target set under the Plan, according to which annual net disburements were to rise by $3 billion. Considering that the annual average for 1983-85 stood at $3.86 billion (table 3), the actual increase achieved amounted to only about $300 million annually, one-tenth of the target.[10]

The outcome was worse in IMF lending. For the 1986-88 period,

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Thus, the banks pledged up to $7.7 billion to Mexico in the 1986-87 new money package, but because oil prices recovered the full amount was not activated.

[10] The World Bank made net disbursements to Latin America amounting to $1.8 billion in its fiscal 1988. This rate was below the institution's average of $2.4 billion annually in FY84-88. For its part, the Interamerican Development Bank faced paralysis in net lending as the result of an impasse with the United States over US veto power.

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the IMF was a net taker of funds from the Baker countries, for a total of $2.7 billion. The largest net repayments were from Brazil and Yugoslavia, but of the 17 countries in question, 11 had negative capital flows from the IMF over the period.

Table 3 summarizes the capital flows under the Baker Plan and before. The disbursements from banks averaged $4.6 billion annually in 1986-88, modestly lower than in 1985 but less than half the rate of the early debt crisis years of 1983-84 ($12 billion annually) and even further below the more than $20 billion annually in 1981-82. Nonetheless, as noted the banks met approximately two-thirds of their new lending target under the Baker Plan.

For the public sector, capital flows to the Baker countries averaged $5.2 billion annually in 1986-88, sharply lower than the average of $9.3 billion during 1983-85. The main reason for the decline was the reduction in IMF flows (from $6.5 billion in 1983 to -$1.1 billion in 1988, a swing of $7.6 billion). Flows from the bilateral credit agencies averaged $1.9 billion annually in 1986-88, and thus showed a significant recovery from the lowpoint of less than $700 million in 1987 (although the 1986-88 average still remained below the $2.5 billion annual rate in 1981-83). Overall, the failure of multilateral bank lending to rise by the target amount, and the only limited recovery of bilateral lending, meant that the large decline in net IMF lending placed the consolidated official sector lending in the Baker Plan period sharply below the average levels of the preceding three years.

There were of course good reasons for part of this decline.

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Countries such as Brazil that chose not to enter an IMF program faced large repayments of earlier IMF credits. And in the very design of the Baker Plan, the IMF was regarded as a "revolving credit" agency rather than an aid institution, and international officials did not necessarily regard the reflows to the IMF as inappropriate. The broader problem, however, was that the original design of the Baker Plan failed to treat the official sector on a consolidated basis. The increase of lending targeted for the multilateral banks should have taken account of any expected reflows to the IMF and any decline anticipated in bilateral lending. Expression of the official sector contribution to the Baker Plan as limited to multilateral development banks sent a misleading signal. Unfortunately, not even that target was achieved.

The central implication of the record on capital flows to the Baker countries in 1986-88 is that both the private and public sectors fell short of their goals. The public sector shortfall was considerably greater than that of the banks, especially if the IMF and bilateral institutions are included. This record suggests that calls for increased official sector financing to deal with the debt problem are not inappropriate.

STRUCTURAL REFORM -- There has been a significant amount of structural reform under the Baker Plan, although presumably less than its authors envisioned. The most far-reaching reforms have come in Mexico, probably because that country faced one of the largest fiscal and external shocks (from the collapse in oil

prices) and has a political regime with relatively high control from the top. In 1986 Mexico broke with long tradition and became a member of the GATT. By the end of 1988, it had cut its maximum tariffs to 20 percent (and average tariffs to 10 percent) and reduced the share of imported products under quantitative restrictions from virtually 100 percent in 1982 to only 23 percent. In the state enterprise sector, the Mexican government reduced the number of state firms from nearly 1,200 in 1982 to fewer than 500 by 1988. Although many of the privatizations or closures involved small entitities, by late 1988 the government had privatized such large enterprises as the airline Aerovias de Mexico and the copper firm Mexicana de Cobre. There was also progress toward trade liberalization and privatization in Argentina (where by late 1988 the government planned to sell 40 percent of the state telephone company to a Spanish telephone entity and 40 percent of Aerolineas Argentinas to Skandinavian Airline Systems). Even in Brazil, where import protection had remained relatively unchanged and there was a tradition of strong state enterprises, in late 1988 the government announced the freeing of half of some 2,500 import categories under import prohibition, and in early 1989 the government's new anti-inflation plan included a pledge to cut back government employment by tens of thousands.[11]

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[11] William R. Cline and Riordan Roett, Latin American Economic Outlook, No. 88-3, December 31, 1988. Note that the close timing of Mexico's acceleration of privatizations in late 1988 and the October announcement by US authorities of a $3.5 billion credit line to Mexico suggested that linkage of financial support to structural reform under the Baker Plan had concrete content. Similarly, there have been large World Bank loans to Argentina and

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BANK VULNERABILITY -- From the onset of the debt crisis in 1982, a major policy goal was to avoid a severe disturbance to the world economy from a crisis in international banking. By the time of the advent of the Baker Plan, the locus of the debt problem had already shifted away from bank vulnerability toward the need to restore sustainable growth in debtor countries. By the end of 1988, the international banking system had become even less vulnerable to the debt problem. European banks had generally set aside large provisions on Latin American debt. US banks had continued to build capital and, after Brazil declared its moratorium in early 1987, had set aside sizeable loan loss reserves. By late 1988, US banks had reduced the ratio of their exposure to the 15 Baker countries to primary capital from 136 percent in 1982 to 58 percent. For the nine money-center banks, the ratio of total developing country loans to primary capital fell from 191 percent in 1982 to 85 percent in 1987. Bank regulators testifying before Congress in early 1988 indicated that third world debt was no longer a proximate threat to the banking system.[12]

POLITICAL FATIGUE -- By the end of its initial three-year horizon, the Baker plan had failed to dispell the political perception in key debtor countries that the debt problem was

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Mexico for trade sector reform.

[12] Thus, the Comptroller of the Currency testified that "the vulnerability of the US banking system to LDC debt performance has lessened significantly," while the Chairman of the Federal Deposit Insurance Corporation stated that "at this time we cannot foresee any bank failures resulting from LDC exposure alone." Washington Post, January 6, 1989; New York Times, January 6, 1989.

condemning their economies to stagnation. Elections were to be held in 1989 in both Argentina and Brazil. The front-runner in Argentina, Peronist Carlos Menem, spoke of a five-year moratorium on debt payments (sometimes using the qualification "negotiated"). Two leading presidential candidates in Brazil, leftists Leonel Brizola and Luis Inacio da Silva (the labor leader "Lula"), called for a moratorium on debt payments. Ever in Mexico, the new president Carlos Salinas de Gortari had faced unprecedented domestic opposition in considerable part over the debt question, and his statements on taking office emphasized the need for debt reduction (but not through moratorium or confrontation). And the new president of Venezuela, Carlos Andres Perez, had similarly seemed to take a tough line on debt (and the country found itself compelled to suspend a large portion of principal payments at the end of 1988 as its non-gold reserves fell precariously low).

Political debt fatigue is easy to understand. In Mexico, real wages in 1987 stood almost 30 percent below their 1980 level. Inflation reached unprecedented dimensions in Latin America in 1987-88. Per capita income for the region in 1988 stood 6.6 percent below its 1981 level.[13] The understandable but simplistic reaction was to blame external debt for all of these economic ills. An equally simplistic and dangerous tendency was to infer that some form of radical debt relief would mean renewed high growth and price stability.

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[13] ECLA 1988, table 3.

Yet the region itself had already generated two major lessons indicating that at least confrontational attempts to reduce the debt burden were counterproductive. In Peru, a unilateral ceiling on debt payments had been followed by a short-lived boom and then recession and extremely high inflation, and by 1988 the country was compelled to adopt harsh austerity measures and seek renewed ties with the IMF. In Brazil, a moratorium on debt during 1987 was subsequently characterized as a mistake by the President and the Finance Minister, and the loss of credit lines alone cost the country at least $1-1/2 billion.

The Debt/Inflation/Growth Nexus

The proper reading of the experience of major Latin American debtors in the past six years is not that debt condemns them to stagnation and inflation, but instead that the countries which have adopted appropriate economic policies have shown the capacity to achieve economic growth, relative price stability, and reductions in relative debt burdens. The principal cause of stagnation in 1987 and 1988 was from domestic policy distortions and high inflation in particular, not the debt problem. Nor was inflation caused primarily by the debt burden.

RESOURCE TRANSFERS AND GROWTH -- The analytical framework that might suggest the opposite is of course the relationship of resource transfers to growth. Under a traditional, simple development model (Harrod-Domar), growth is determined by the resources available for investment. These resources equal domestic saving plus saving from abroad. As capital inflows fell far below

interest payments on external debt after the debt crisis, foreign saving shifted from positive to negative, and the traditional saving/investment model suggested lower growth would result. Similarly, in the "two-gap" model in which there can be a special role for foreign exchange available for critical imported inputs and capital goods, the reduction in net foreign exchange availability can slow growth.

The "resource transfer" argument becomes less relevant, however, when production is below full capacity, as has been true in many instances in recent years in debtor countries. Output can be expanded for a time without large new investment. Similarly, where domestic savings rates are abnormally low, correction of domestic policies to boost saving can substitute for foreign saving. At the same time, export expansion can serve as an engine of growth for the economy, so that ironically high exports and thus high outward transfer of resources may be associated with high growth. The extraordinary trade surpluses of Taiwan and Korea, coexistent with their high growth rates, are vivid examples.

The six major Latin American debtor countries provide a laboratory for testing the hypothesis that the outward transfer of resources imposed by the debt crisis has caused a collapse in growth. Figure 4 plots average real GNP growth in the Baker period 1986-88 against average outward transfer of resources as a

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percentage of GNP for these countries.[14] If the resource constraint were binding, one would expect the countries with the highest ratio of outward transfer of resources to GNP to have the lowest growth rates. As indicated in figure 1, just the opposite appears to be the case. During 1986-88, Colombia, Venezuela, and Chile had the highest ratios of outward resource transfer to GNP among the six large Latin American debtor countries (an unweighted average of 4.6 percent of GNP), yet they had relatively favorable growth rates (averaging 5.2 percent annually). In contrast, Argentina, Brazil, and Mexico had lower outward resource transfers (an average of 2.4 percent of GNP) but nonetheless had lower growth as well (an average of 1.9 percent annually). While few would conclude that larger outward resource transfers generate faster growth (although the notion of export-led growth tends in that direction), the data do contradict the view that it is outward transfers of resources that are causing economic stagnation in Latin America.

RESOURCE TRANSFERS AND INFLATION -- The obvious explanation for low recent growth in countries such as Brazil and Argentina is the adverse impact of their inability to control inflation. Truly high inflation, in the range of several hundred percent annually, is inimical to growth. It makes investment decisions difficult by making economic projections highly unstable. Figure 5 provides support to the idea that high inflation is a major cause of

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[14] The resource transfer estimates refer to the excess of net payments of interest and profits over net inflows of capital. The data are from ECLA 1988.

stagnation. The figure shows that among the six largest Latin American debtor countries, those with the lowest inflation in 1985-87 had the highest growth in 1986-88. Thus, in Chile, Colombia, and Venezuela, where inflation averaged 23.5 percent annually in 1985-87, economic growth averaged 5.2 percent annually in 1986-88. In contrast, in Argentina, Brazil, and Mexico, inflation averaged 177 percent annually in 1985-87 while growth was only 1.9 percent on average. Few would dispute the role of high inflation in causing slow recent growth in major Latin American countries.

There is, nonetheless, both a popular perception and an analytical argument that high inflation has been caused by the debt problem, so that in the end economic stagnation in the area is indeed attributable to the debt problem. The popular perception goes little further than the notion that debt has been the major cause of all economic disturbances. The analytical argument is two-fold. First, attempts to adjust externally have required sharp devaluation of the exchange rate, and devaluation boosts cost-push inflation. Second, the debt crisis suddenly thrust governments into a fiscal crisis because they could not mobilize the internal transfer of resources from the private sector to the public sector needed to replace the former inward transfer from foreign creditor to the domestic public sector. The internal transfer problem thus necessitated a higher inflation tax, the argument goes.

The best case for debt-imposed inflation can probably be made for Mexico. There the government adopted sharp exchange rate devaluation in 1986 when oil prices collapsed, and the devaluation

played an important role in the acceleration of inflation from the range of 65 percent to, by 1987, 160 percent. In Argentina and Brazil, however, inflation in the high triple digits has been essentially the consequence of a combination of high domestic fiscal deficits (on the order of 4 to 8 percent of GNP in real terms and over 30 percent in Brazil in nominal terms), on the one hand, and indexation mechanisms that perpetuate each successive plateau of inflation, on the other. Thus, the real exchange rate was almost constant in Brazil from 1983 through 1987, and actually appreciated by some 10 percent in 1988. Similarly, although there was a large real devaluation of the Argentine currency in 1982 after major overvaluation at the beginning of the 1980s, the real exchange rate in 1986-88 was not much different from the 1982 level.

The internal transfer argument is more ambiguous, but the essential issue is whether it would be appropriate for countries to sustain large fiscal deficits over several years, whether financed from abroad or domestically. Virtually all of the governments of major Latin American countries have by now come to the conclusion that high fiscal deficits are incompatible with growth and acceptable inflation, and it would seem to stretch a point to imply that if the debt crisis had not arisen, countries could have continued high fiscal deficits with high foreign financing over long periods of time.

Once again, the evidence for the Baker Plan period does not support the critique that the debt problem caused inflation.

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Instead, there were major debtor countries that were able to achieve relatively low inflation and (usually) fiscal adjustment despite relatively high debt burdens. Figure 6 shows that Colombia, Venezuela, and Chile, with high outward transfers of resources (averaging 4.6 percent of GNP in 1986-88) managed to achieve relatively moderate inflation (averaging 22.9 percent annually for the same period), while Argentina, Brazil, and Mexico with relatively lower outward transfers of resources (an average of 2.4 percent of GNP) encountered extremely high inflation (an average of 245 percent annually for 1986-88). Indeed, as the figure shows, the relationship was almost exactly inverse rather than positive: the highest inflation was in Brazil, which had the lowest outward resource transfer, with successively lower inflation rates for each respective country at successively higher outward transfer levels. In short, cross country evidence suggests that it is possible to control inflation despite the debt burden, if proper domestic policies are pursued.[15]

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[15] A variant of the inflation argument warrants further attention. In Brazil, the Finance Minister has complained that the need for the central bank to buy up a large trade surplus has led to excessive money expansion. And there has been great criticism of the bank package for Brazil because of its use of debt-equity conversions, under the perception that these feed excessive money expansion and thus inflation. But the central bank could reduce money growth from the trade surplus by permitting exporters to sell foreign exchange to firms seeking to buy back external debt at a discount, instead of requiring that all of it be turned in to the central bank in exchange for local currency (and it could afford to do so because the trade surplus in 1988 well exceeded the amount required to service debt). As for debt-equity conversion, the amounts in Brazil in 1988 that passed through formal operations and thus potentially affected the money supply amounted to less than 3 percent of total money and quasi-money including overnight holdings of government paper, hardly the

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The Next Phase

Because there has been considerable improvement in the key debt indicators, and because countries that have achieved domestic adjustment and moderate inflation have been able to sustain growth despite relatively high debt burdens, there is no reason to change the central strategic premise of the Baker plan: that the major debtors can achieve renewed growth while continuing to manage their debt on a market-related basis, and that resort to forced forgiveness of debt or interest is in most cases unnecessary and would be counterproductive for the future growth of the countries themselves. However, there is a need for a more intensified effort under a Baker-II (or Brady) Plan for the next few years.

For the banks (and the capital markets more generally), the next phase in the debt strategy should involve a three-track approach: multi-year new money programs, voluntary debt reduction, and return to voluntary lending based on more attractive instruments. For the public sector, the objective must be considerably higher actual net lending, at the least full realization of the increase for the public sector as a whole that had been implicit in the original Baker Plan targets. For the debtor countries, the objective must be actual achievement of adjustment programs, centered on fiscal balance for domestic stability and appropriate real exchange rates for export growth.

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source of quadruple digit inflation.

In 1981 and 1982, the net resource transfer to the fifteen Baker countries amounted to an annual average inflow of $8.9 billion.[16] In the first three years after the debt crisis, the resource transfer averaged an annual outflow of $38.4 billion. During the three years of the Baker Plan (1986-88), the outward transfer of resources from these countries averaged $28.6 billion annually. Despite the evidence that domestic destabilization rather than outward transfer of resources has been the primary cause of recent stagnant growth in some major debtor countries, it is time for a more determined international effort to increase net capital flows to the debtor countries. With domestic stabilization and renewed growth, excess capacity would eventually be exhausted, and higher resource inflows can contribute to future growth even though stagnation in Latin America in 1988 was not primarily attributable to external debt or outward resource transfers.

Complete elimination of the outward transfer would be too ambitious over the next three to five years, as it would mean a sufficiently more rapid buildup in debt that progress in debt indicators could be halted prematurely. However, a reasonable goal would be to cut the outward transfer of resources in half, to some $15 billion annually over the next three years. This objective

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[16] Estimated as the difference between the current account deficit (assumed equal to capital inflow, abstracting from reserves change) and net payments of interest and profits. Calculated from International Monetary Fund, World Economic Outlook, October 1988 (Washington: IMF, 1988), p. 104.

would require increasing net capital flows from foreign private and official creditors to the debtor countries by $15 billion annually over the average achieved under the Baker Plan.

MULTI-YEAR NEW MONEY -- Debtor country governments would have much more certainty in planning if banks would agree to new lending programs over three year or even five year periods.[17] Ideally the levels programmed for new bank money would decline over time (for example, from a benchmark in the first year equivalent to say half of interest due to perhaps 30 percent by the third and 10 percent by the fifth), with the objective of a progressive shift to voluntary private capital and to official lending sources. To the extent possible, countries should make new money options attractive to banks (debt-equity conversion rights, relending rights, new money bonds) to facilitate mobilization (as in the Brazil 1988 program). Moreover, those banks (primarily in Europe) preferring for tax or regulatory reasons to participate by capitalizing some interest due rather than making new loans could usefully be permitted to do so, although such banks would have no basis for insisting that all other banks also capitalize (and that outcome would be adverse because it could initiate a transition to unilateral insistence by the country that specified fractions of

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[17] Thus, President Carlos Salinas of Mexico stated as one of his four principles on debt that the country should be assured multi-year access to new loans. His three other principles were: reduction of the outward resource transfer, reduction of the stock of debt to closer to its secondary market value, and reduction of the debt/GNP ratio during his regime. Wall Street Journal, Dec. 2, 1988.

interest be capitalized each year).

VOLUNTARY DEBT REDUCTION -- By the end of the initial three-year horizon of the Baker Plan, perhaps the major change from what its authors anticipated was the low value of the debt in secondary markets, on the one hand, and the related activity in debt-equity conversions and discounted debt repurchases, on the other. Secondary market prices for Argentine debt were in the range of 20-25 cents on the dollar; for Brazil, 40 cents; Mexico, 44 cents; Chile, 58 cents; and Venezuela, 42 cents.[18]

Low secondary market prices offer the opportunity for mutually beneficial voluntary debt reduction operations between the countries and those banks desiring to exit. The banks are not monolithic, and many of the smaller banks in particular are prepared to accept 50 cents on the dollar or less if the asset they receive is secure, even as other banks (particularly those with long experience and, in many cases, local branches, in the countries) anticipate eventual recovery of the countries' economies and consider the true value of their claims much closer to face value than indicated by the secondary market. Yet the banks with the more favorable long-term expectations typically are not in a position to buy up the debt from the banks seeking immediate exit because they must be careful of their own exposure limits in the countries.

Much debt reduction has already occurred. Mexico has reduced

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[18] Salomon Brothers, International Loan Trading, Dec. 22, 1988.

its private sector debt from $22.5 billion in 1983 to $10 billion at the end of 1988, largely through debt-equity conversions and repurchases of outstanding debt on a discounted basis. The Institute for International Finance estimates that $26 billion in external debt of the Baker-15 countries has been extinguished by voluntary debt reduction, with $17 billion occurring in 1988 alone.[19] The organization estimated that approximately three-fifths of this amount had occurred in debt-equity and local currency conversions, one-third in private sector restructuring with a relief component, and a small portion in debt buybacks and debt exchange into "exit bonds."[20]

Countries with adequate reserves can make discounted repurchases of debt, as Chile did in late 1988 with its windfall gains from higher copper prices. Other countries can conduct debt-equity conversion programs, although the experience of Mexico and by early 1989 Brazil suggests that sensitivity to monetary expansion under these programs can limit their dimensions.

The most promising instrument for debt reduction would be an "enhanced exit bond." The concept of this instrument is that it converts the bank's existing claim into another asset which has a value closer to the secondary market price. The benefit for the country is alleviation of its debt. The benefit for the bank is

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[19] Institute for International Finance, The Way Forward for Middle-Income Countries (Washington: IIF, January 1989), p. 22.

[20] However, much of the "local currency conversion" also amounts to debt buybacks, as recipients then use the local currency to purchase dollars on the parallel exchange market.

greater security of the asset, combined with the understanding that the bank will no longer be expected to provide additional lending as part of any future concerted new lending packages.

The small magnitudes of both the early 1988 Mexico-Morgan Guaranty exit bond (which converted some $3 billion into long-term bonds with principal but not interest guaranteed by US Treasury zero-coupon bonds, and sold at a price of 70 cents on the dollar) and the 1988 Brazil exit bond (which converted about $1 billion into bonds paying 6 percent over 25 years) indicates that the real problem with these instruments so far has been their lack of blue-chip security. In particular, creditors continue to doubt that even the reduced instruments will be fully honored by the government. Thus, the Mexico-Morgan bond sold at a price that attributed full confidence only to the zero-coupon-backed principal but continued to discount unguaranteed interest at the going secondary market rate for Mexican obligations.

One of the most important potential changes in the debt strategy over the medium term would be joint action by the banks and the public sector in industrial countries to provide effective guarantees to exit bonds. If these instruments were fully reliable, it is conceivable that banks representing some 30 percent to 40 percent of the claims on debtor countries would be willing to accept them at a value of 50 cents or less on the dollar to make a clean exit from the debt problem.

So far the public sector has been unwilling to issue guarantees to back exit bonds. The political concern has been that

to do so would appear to be "bailing out the banks." It is time to discard this false argument. Any bank that accepted an exit bond worth say 50 cents or less on the dollar would by definition already be absorbing massive losses up front. It would not be meaningful to say that the public sector by guaranteeing the instrument would be making good the losses that the bank should otherwise absorb.

Two measures would make exit bonds gilt-edged. First, the banks themselves should agree that exit bonds have seniority over the other claims of banks. Here the idea would be that even those banks choosing to retain their full claims would benefit from the reduced burden on the country accorded by the banks chosing to exit at a cost. For this purpose, serious consideration should be given to new legislation that permits a two-thirds majority of bank creditors of a sovereign nation (by value of claims outstanding) to grant senior status over their own existing claims, to specific new instruments to be issued by the country. The legislation would provide for carefully controlled conditions, such as the presence of a program approved by the US Treasury and the International Monetary Fund. Moreover, the banking community as a whole would presumably authorize such instruments only up to specified amounts and over specified periods. The point, however, is that once it became unambiguous that exit bonds stood at the head of the que, the instruments would have a high degree of reliability.

Because the bulk of Latin American debt is under contracts that specify New York as the jurisdictional area, it might be

sufficient for US law alone to make this change, although a similar law in the United Kingdom would cover the jurisdiction of most of the rest of the debt. While initially such laws could not be iron-clad assurance against constitutional challenge by a dissident bank, and while issues of extra-territoriality could arise, the fact that the class whose interests could be injured by the granting of such senior status, namely the banking community itself, would by the law be directly represented in the decision (and on a two-thirds majority basis) would throw into question the standing of such a plaintiff. In this regard, the conferal of seniority by a high majority of banks would differ sharply from attempts to legislate mandatory debt forgiveness, because the affected parties would (in their majority) approve in the first case and disapprove in the second.[21] Moreover, there is precedent in domestic bankruptcy law for joint action by a class of creditors that supersedes claims of dissident individual members.

The second step to make exit bonds secure instruments would be, in addition to conferral of seniority by the banks themselves, the issuance of guarantees by the World Bank (and Inter-American Development Bank).[22] Because the senior status accorded by the

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[21] Thus, the Institute of International Finance has recently warned that mandatory cancellation of debt would be "unconstitutional taking of property" and "would be contested in the courts." Institute of International Finance, The Way Forward, p. 20.

[22] See John Williamson, Voluntary Approaches to Debt Relief (Washington: Institute for International Economics, Policy Analyses in International Economics No. 25, September 1988).

banks would already make the instruments relatively secure, it would be appropriate if necessary to count only a fraction (such as 20 percent) of the value of the exit bonds against the capital of the institutions, rather than require one-for-one capital backing as is the usual case for lending by these institutions.

The structure of the exit bonds would usually need to be relatively long-term (such as 20 to 25 years). Otherwise, the payments on the instruments would be as high as the interest payments on existing bank claims.[23] Yet for most countries voluntary debt reduction needs to make a contribution to near-term cash flow as well as long-term balance sheet improvement.

In September of 1988 Japanese authorities proposed the establishment of a window at the IMF that would take deposits of reserves from debtor countries for use in providing collateral for exit bonds, and the Japanese apparently had in mind parallel lending from industrial countries to the debtor countries that would provide the reserves required for this purpose. This proposal was moving in the direction of official support to enhance exit bonds. While industrial country officials have disavowed the use of World Bank guarantees for this purpose, a reconsideration of this position is in order, especially under the condition that the banking community would be prepared to minimize the potential

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[23] For example, 7-year bonds bearing 9 percent interest would involve cash outflow equal to 23 percent of face value in the first year. Even if the face value were set at one-half the original loan, the resulting payments would stand at 11-1/2 percent of original loan value, higher than interest payments on the original claims (with all principal rolled over).

risk to the World Bank by granting seniority to the instruments.

The World Bank and other official lenders could in principle also contribute to voluntary debt reduction by making policy-related (non-project) lending available for the purpose of country repurchases of debt from the secondary market at a discount. However, any such lending would have to be truly additional to official flows that would otherwise occur. If lending for buybacks were not additional, the net effect for the country would usually be a negative cash-flow impact for the first five years or so.[24]

A major push for voluntary debt reduction (VDR) by the banks and the international financial institutions would have the potential to reduce the debt owed to banks by perhaps 15 to 20 percent (that is, a reduction by half in the value of the debt held by banks accounting for 30 to 40 percent of bank debt). This reduction would be important economically and perhaps even more important politically, as it would enable leaders in debtor countries to point to an important supportive shift by creditors. If the debt problem were as intractable as many believe, this

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[24] Thus, suppose that in case A the country would receive fast-disbursing policy lending which it would use for general purposes, while in case B it would dedicate the same funds to debt buybacks. In case A there would be one dollar of freely available foreign exchange for each dollar of World Bank policy lending. In case B, the country would spend the dollar to repurchase two dollars' worth of debt owed to the banks. The interest on the two dollars debt would be some 20 cents for the current year. The net effect on cash flow for the country would thus be one dollar in case A but only 20 cents in case B. Indeed, unless the secondary market price falls to as low as the interest rate (that is, 10 cents on the dollar), buybacks have negative cash flow in the first year.

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amount of debt reduction would not be enough; more thorough-going relief of a bankruptcy nature would be required. But as analyzed above, at least for the major debtors the progress on debt to date is compatible with the moderate alleviation that voluntary debt reduction offers rather than requiring more radical measures.

One important side effect of more energetic voluntary debt reduction would be an increase in the secondary market price. The secondary market is extremely thin, and VDR would boost the demand substantially. Sometimes officials and analysts in debtor countries express concern that debt-equity conversion and other VDR measures would raise the secondary market price; their implicit fear is that somehow the country would lose the opportunity to cancel the debt at low prices such as 30 to 50 cents on the dollar if the secondary market price rebounded to the 60-80 cent level. The flaw with this reaction is that in the absence of conversion the debt continues to accrue interest at the full face rate regardless of its low secondary market price, so that the seeming lost opportunity is in fact not a loss at all. Instead, the proper way to view the rising secondary market price likely to follow VDR is as a sign of restored health and return toward creditworthiness. Until the secondary market price returns far closer to the 80 cent - 100 cent range, it will be difficult to reestablish truly voluntary capital flows.

NEW VOLUNTARY LENDING MECHANISMS -- The third track for capital flows in the near term should be a range of instruments designed to revive voluntary lending even as the secondary market price

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rises. Direct investment is a crucial component of these flows. Control of high domestic inflation and a return of domestic economies toward more normal conditions would help spur renewed interest of foreign investors, but in addition the liberalization of restrictions (in such countries as Mexico) could help.

For existing bank creditors, it would make sense to supplement new money packages that involve all creditors (except those choosing exit bonds) with club loans involving a more limited number of large players. These loans would ideally have elements to make them attractive in their own right so that they would not have to be coerced. One example would be the issuance of bonds convertible into commodities as the instrument for club deals. Banks could thus anticipate some chance of profit, while actual convertibility (for example, into oil at $20 per barrel if the current price is $15) would provide an inherent in-kind guarantee (in this example, equivalent to 75 cents on the dollar, well above the secondary market price for standard obligations of the country). It would be desirable to bring new actors into the club operations, such as insurance companies.

PUBLIC SECTOR LENDING -- Beyond these approaches for bank lending, it will be necessary in the next phase of the international debt strategy to make good on the promise of increased official support implicit in the original Baker Plan. As indicated above, with the period 1983-85 considered as a base, net capital flows from the consolidated public sector (IMF, multilateral development banks, and bilateral export credit agencies) fell from $9.3 billion

annually to only $5.2 billion annually in the Baker Plan period (1986-88). The public sector could well seek a goal of increased net disbursements to the large debtors in an amount of some $10 billion annually, of which half would be merely returning to the levels of 1983-85. Private capital flows could then pick up the other $5 billion of the $15 billion increase in net flows to the highly indebted countries identified above as the increment required to cut their outward transfer of resources by half.

CAPITAL FLOW OBJECTIVES -- Table 4 shows an illustrative set of capital flow objectives for the period 1989-91 for the highly indebted (Baker Plan) countries. Net disbursements by multilateral development banks could double to approximately $8 billion annually; export credit and other bilateral agencies could increase net flows to $4 billion annually (with perhaps an especially large rise by the Japanese). The private banks would double the new-money equivalent of their lending and debt-reduction efforts, returning their net flows to slightly below the 1983-85 average. Some further expansion in direct investment would be expected, bringing the total increase to the $15 billion needed to cut outward resource transfers by half. These objectives are feasible, although they would require an intensified commitment to the multilateral agencies (but not necessarily immediate increases in capital, except for the Inter-American Bank) as well as increased dynamism in new money arrangements, voluntary debt reduction, and club loans as well as other voluntary finance from the banks.

Above all, however, it will be the pursuit of sound economic

policies in the debtor countries themselves that will determine the feasibility of such a program. With poor policies, official donors will be unprepared to move ahead, and banks may allow arrears to build and set aside more reserves rather than provide additional new money or voluntary debt relief. With sound policies in debtor countries, there is every reason to believe that financing in the ranges shown in the table could be mobilized, and more broadly that most of the debtor countries will be able to achieve politically acceptable economic growth and moderate inflation while continuing to make progress in restoring external creditworthiness.

Table 1
Total External Debt, 1982 and 1987
($ billions and percentages)

	1982	1987	Percent Change
All Developing Countries	781.2	1,167.1	49.0
Highly Indebted	391.2	527.3	34.8
Other	392.1	639.9	63.2
of which:			
Algeria	16.7	22.9	37.1
China	8.4	30.2	259.5
Egypt	26.2	40.3	53.8
Greece	11.2	23.1	106.3
Hungary	9.0	19.0	111.1
India	25.6	46.4	81.2
Indonesia	26.5	52.6	98.5
Malaysia	11.3	21.7	92.0
Pakistan	11.6	16.3	40.5
Poland (a)	31.0	42.1	35.8
Portugal	13.6	18.2	33.8
Thailand	12.2	20.7	69.7
Turkey	19.7	40.8	107.1
Subtotal	223.0	394.3	76.8
Latin America			
World Bank	332.8	442.0	32.8
ECLA	331.0	410.5	24.0
Latin America-6 major			
World Bank	281.2	363.3	29.2
ECLA	285.1	331.3	16.2

a. Initial year is 1985.
Source: Calculated from World Bank, World Debt Tables 1988, Vol. II; ECLA, Balance Preliminar de la Economia Latinoamericana, 1987 and 1988.

Table 2
Capital Flows Under the Baker Plan: 1986-88
($ millions)

	Banks(a)	Public Sector				Total
		Multilateral	Bilateral	IMF	Total	
Argentina	2,607	1,680	716	844	3,240	5,847
Bolivia	0	555	230	111	896	896
Brazil	4,000	1,556	-385	-2,032	-861	3,139
Chile	215	1,132	87	-3	1,216	1,431
Colombia	1,957	952	286	0	1,238	2,195
Costa Rica	0	134	-17	-146	-29	-29
Cote d'Ivoire	0	502	357	-226	633	633
Ecuador	0	858	264	-39	1,083	1,083
Jamaica	0	154	110	-327	-63	-63
Mexico	5,472	2,190	2,301	1,166	5,657	11,129
Morocco	0	949	553	-495	1,007	1,007
Nigeria	0	1,009	704	0	1,713	1,713
Peru	0	314	180	-52	442	442
Philippines	525	355	928	-185	1,098	1,623
Uruguay	0	174	-9	-113	52	52
Venezuela	0	145	-215	0	-70	-70
Yugoslavia	0	-59	-280	-1,171	-1,510	-1,510
Total	13,776	12,601	5,809	-2667	15,742	29,518

a. Disbursements under new money packages.

Source: World Bank, World Debt Tables 1988, Vol. I, p. ixliii; Vol. II; IMF, International Financial Statistics, January 1989; and World Bank, by communication. Estimates include bank lending of $4 billion to Brazil completed in late 1988.

Table 3
Capital Flows to Highly Indebted Countries, 1981-88
($ millions)

	1981	1982	1983	1984	1985	1986	1987	1988
Public Sector								
Multilateral	2,719	3,881	3,069	4,522	3,997	5,150	3,370	4,082
Bilateral	3,158	1,719	2,539	1,525	697	1,158	1,919	2,738
IMF	1,213	2,110	6,517	3,334	1,686	-206	-1,384	-1,077
Total	7,000	7,710	12,125	9,381	6,380	6,102	3,905	5,743
Banks (a)	20,205	23,263	13,575	10,427	5,345	3,455	4,931	5,450
Total	27,205	30,973	25,700	19,808	11,725	9,557	8,836	11,193

Source: World Bank, World Debt Tables 1988, Vol. I, pp. xliii, 30-31 and by communication; table 2.

a. For 1981-82: net disbursements from "financial markets". For 1983-88: disbursements under new money packages.

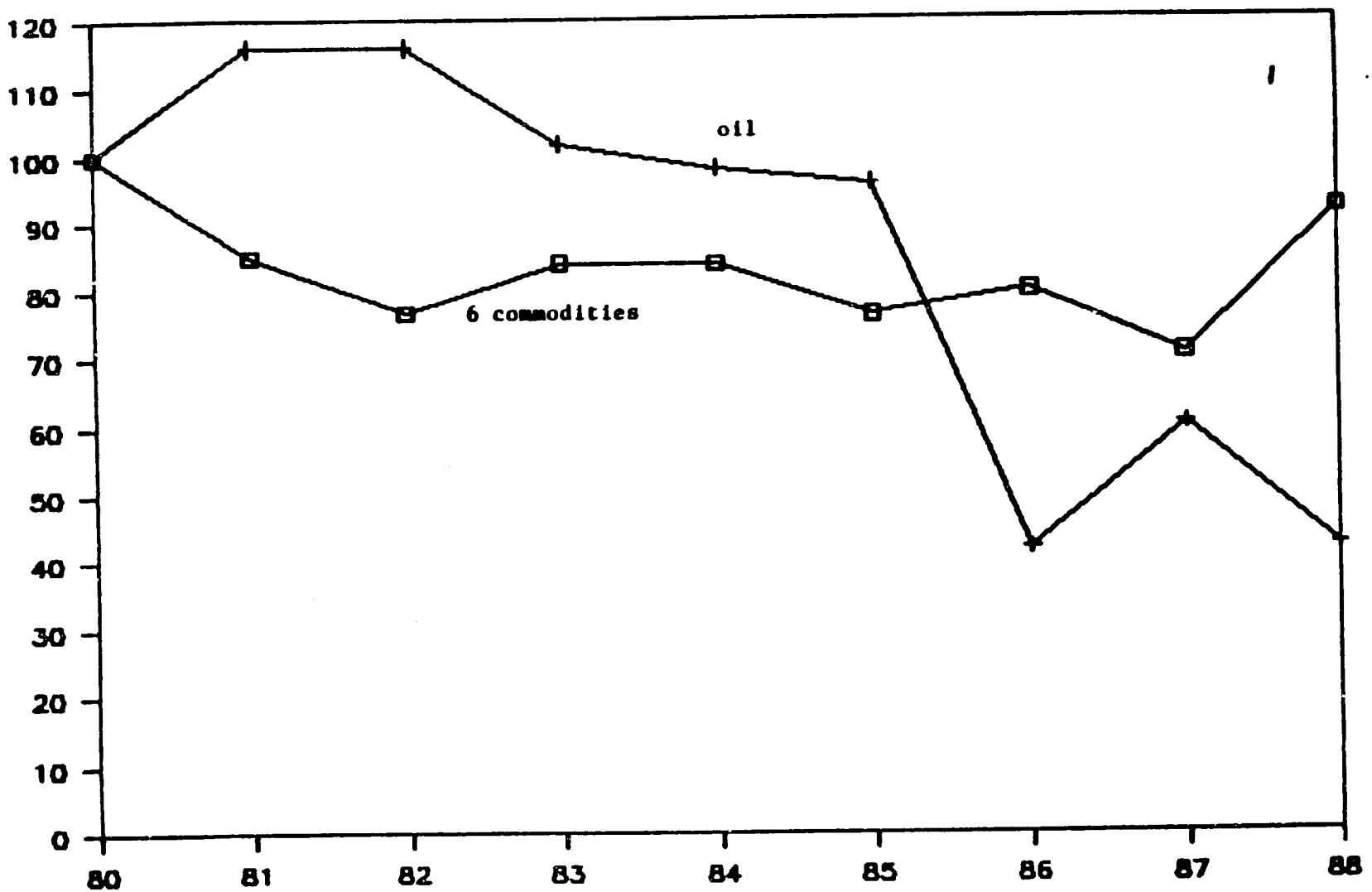

Figure 1

Commodity Price Indexes for Latin American Exports
(1980=100)

Table 4

Annual Average Capital Flows to Highly Indebted Countries by Period, 1983-91
($ billions)

	1983-85	1986-88	1989-91
Public			
Multilateral Banks	3.9	4.2	8
Bilateral	1.6	1.9	4
IMF	3.8	-0.9	2
Total	9.3	5.2	14
Private			
Banks	9.8	4.6	9
Direct Investment	14.5	8.1	10
Total	33.6	17.9	33

Source: Table 3; IMF, World Economic Outlook October 1988, p. 115 (for "non-debt-creating" flows).

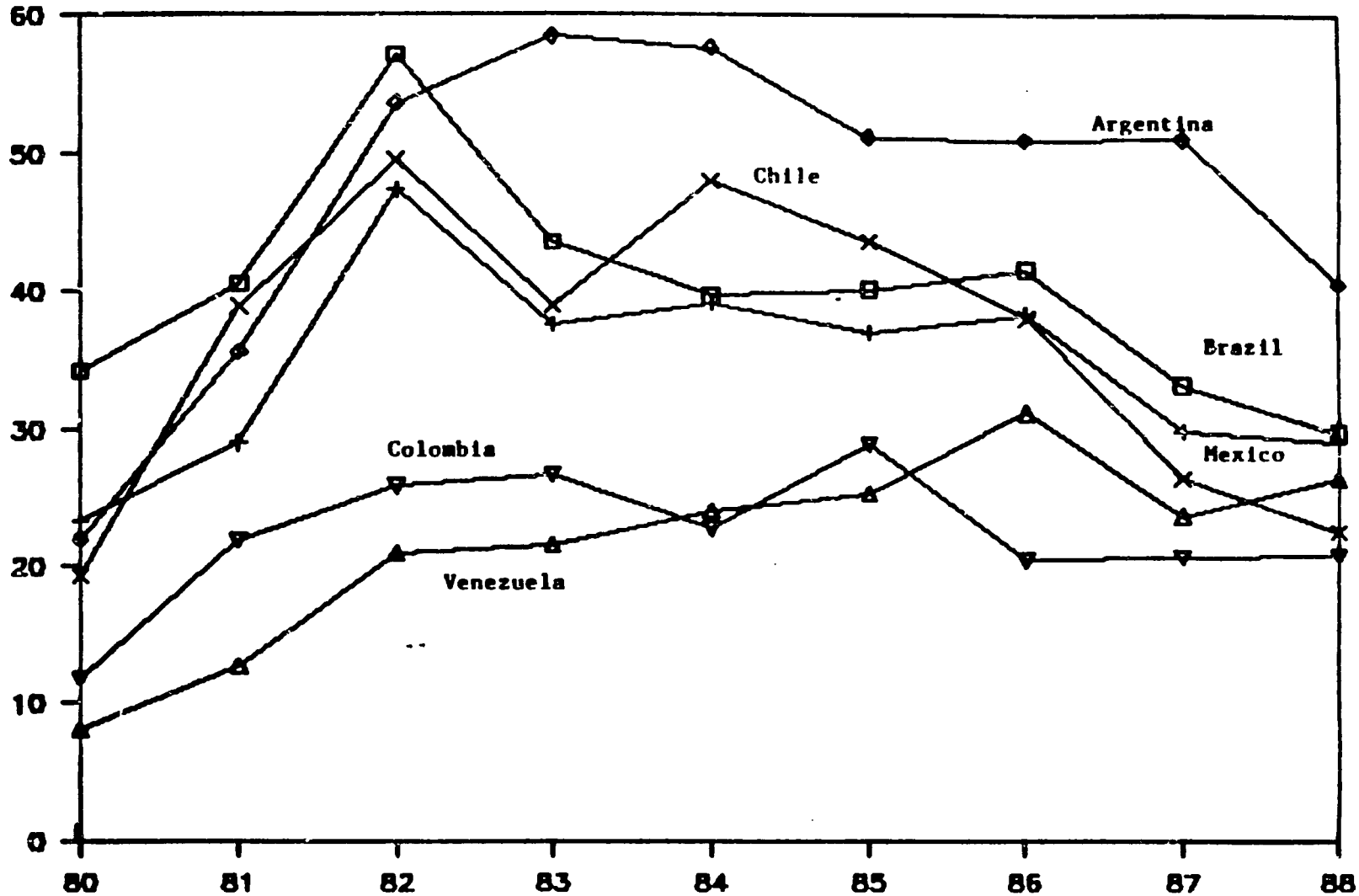

Figure 2

Ratio of Interest Paid (Accrual Basis)
to Exports of Goods and Services
(percentages)

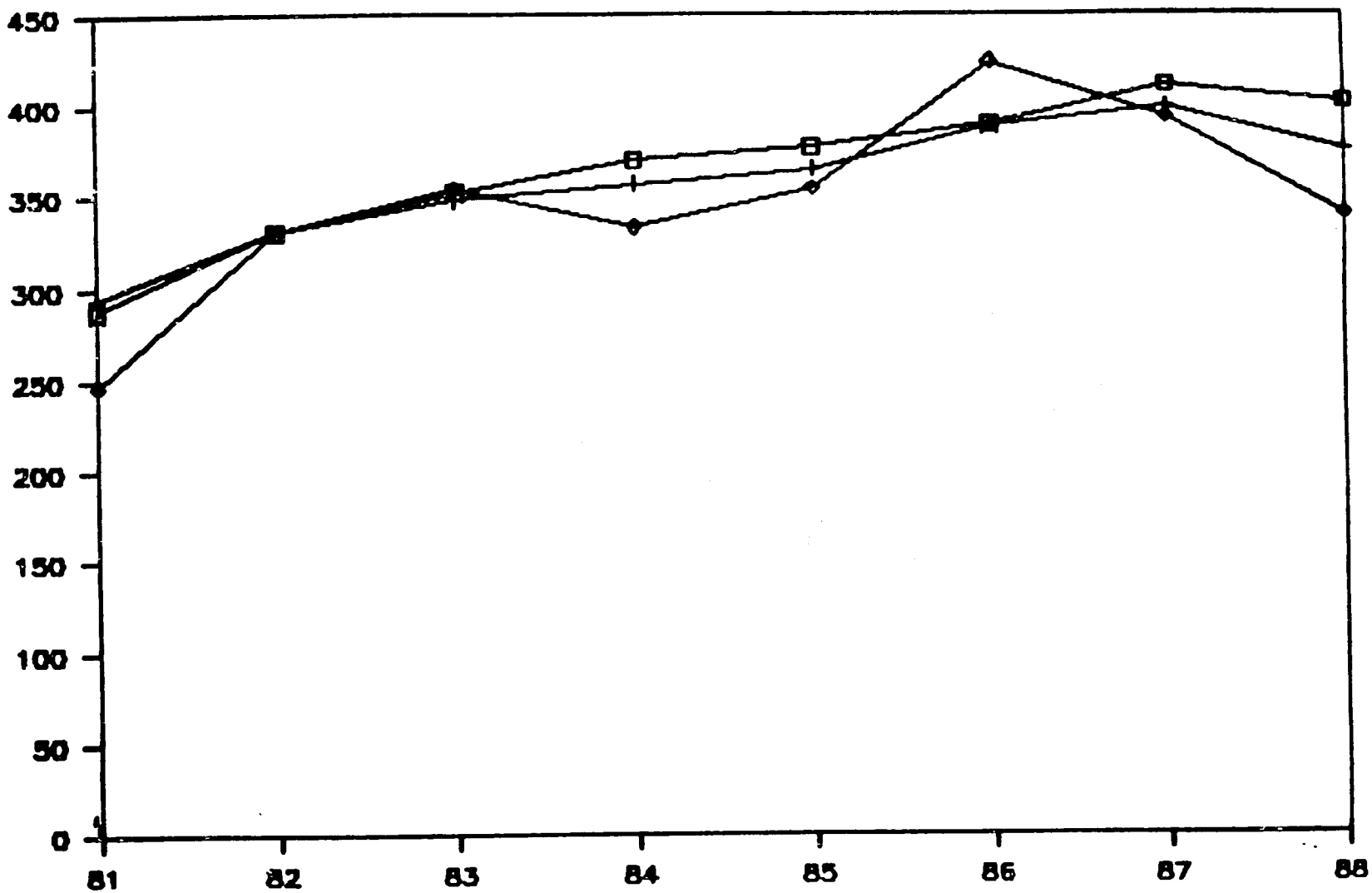

Figure 3
Latin America: Total and Relative Debt

- Nominal External Debt ($ billion)
- Real External Debt ($ billion, 1982 prices)
- Debt/ Exports of Goods and Services (percent)

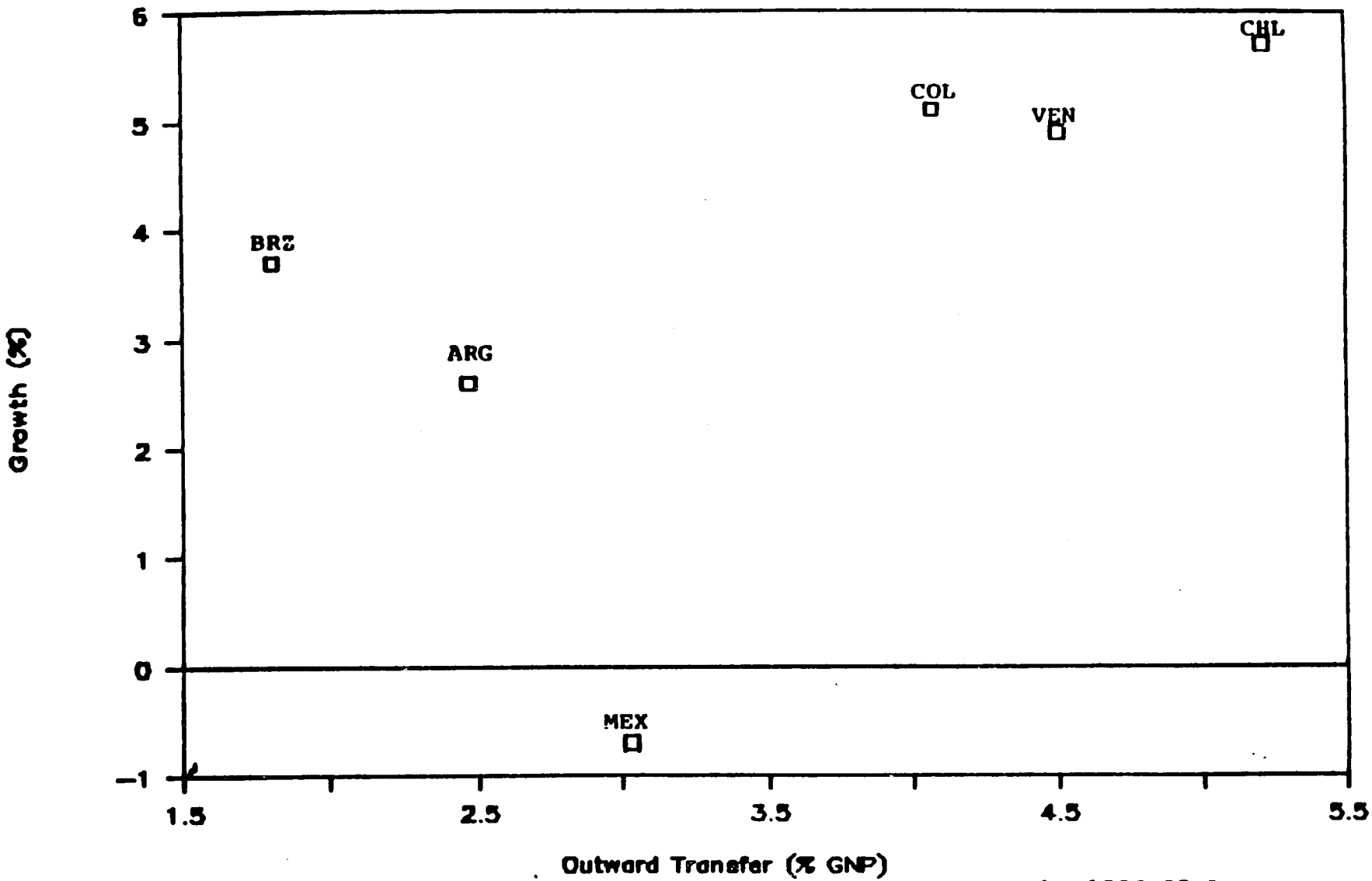

Figure 4 Outward Resource Transfers and Economic Growth, 1986-88 Averages
Six Latin American Countries

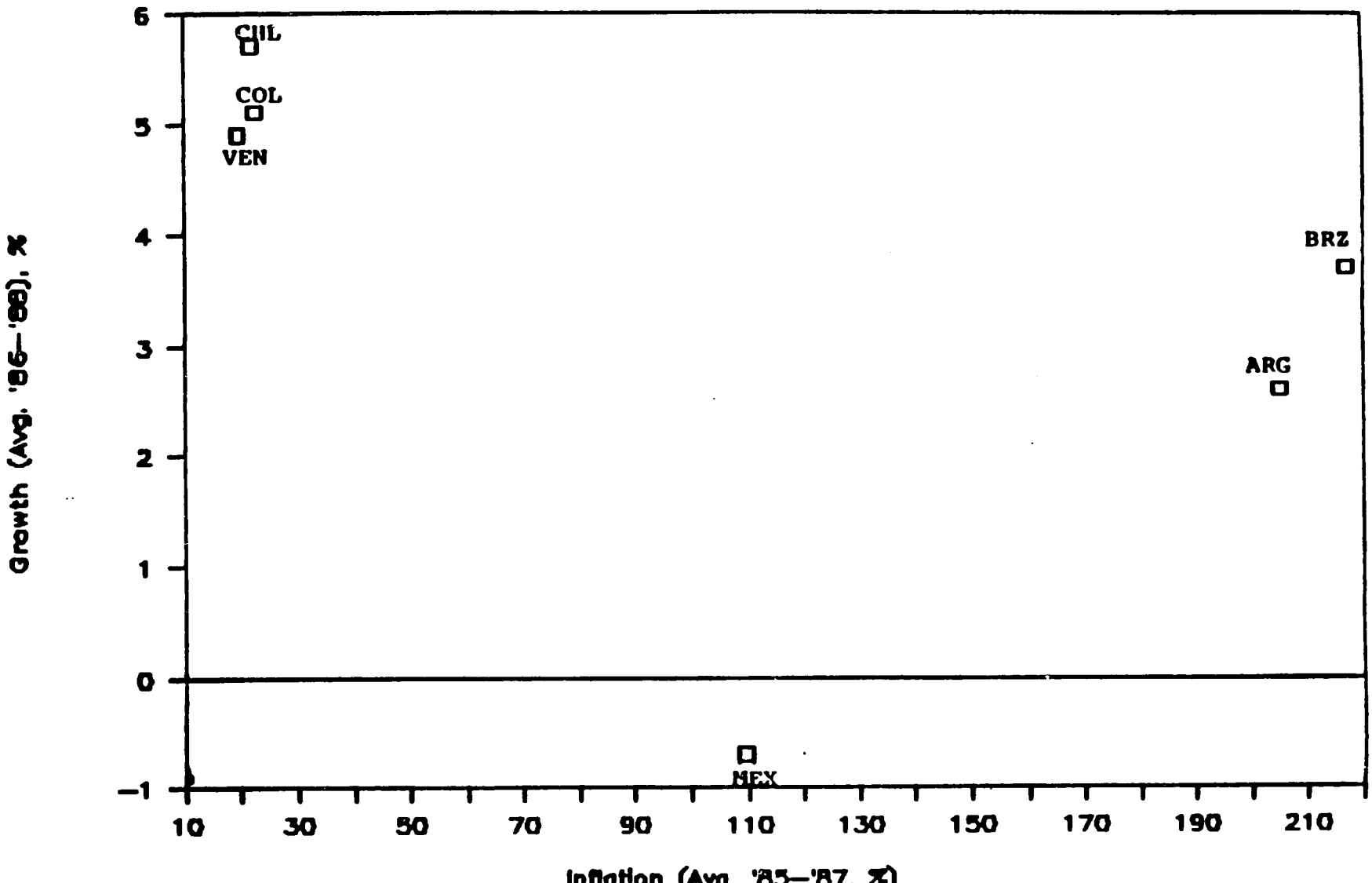

Figure 5 Average Inflation and Average Growth One Year Later, 1985-87
Six Latin American Countries

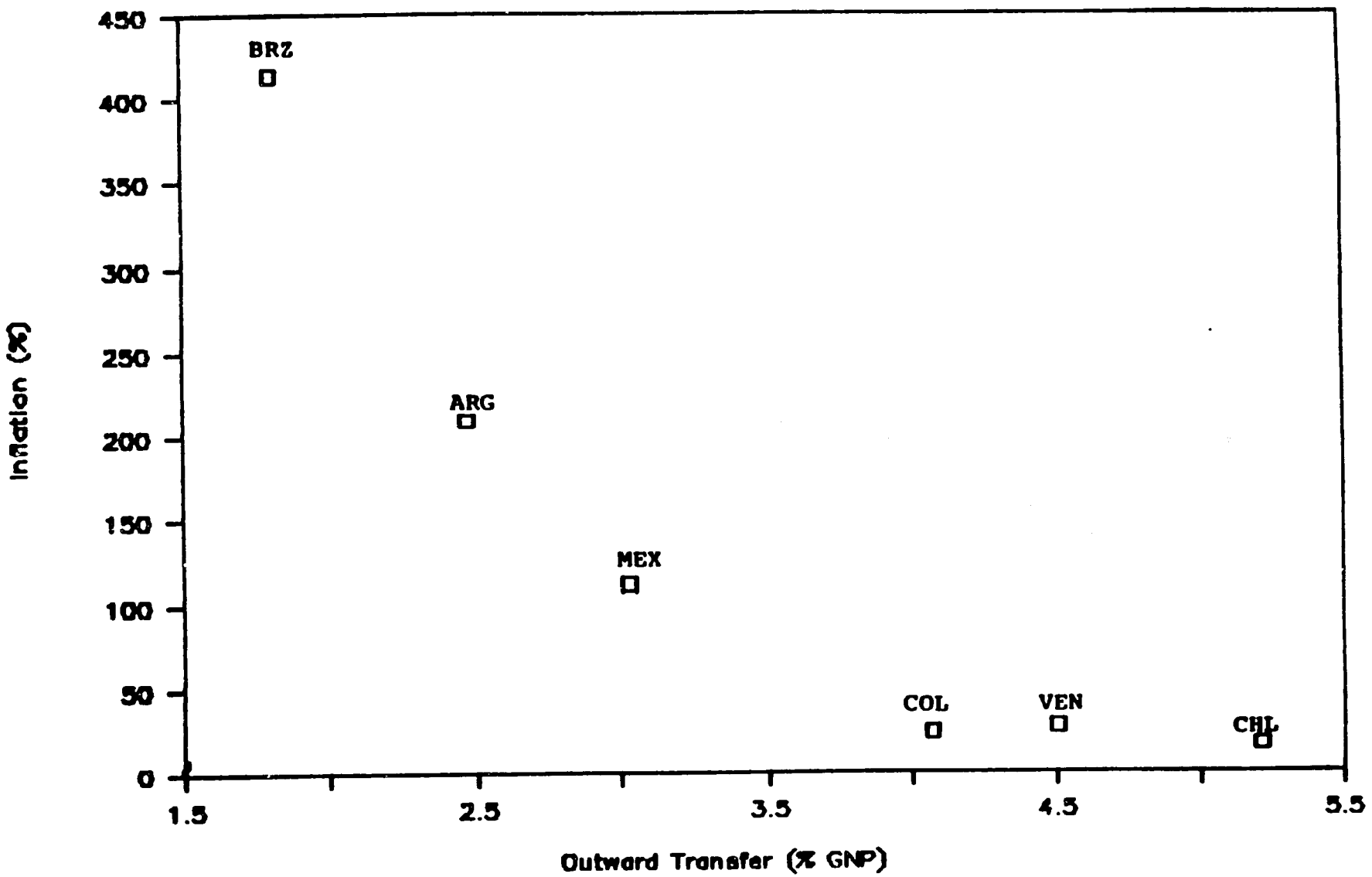

Figure 6 Outward Resource Transfers and Inflation, 1986-88 Averages
Six Latin American Countries

CHAPTER 1

THE EXTENT AND CAUSES OF THE DEBT CRISIS OF THE 1980s*

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1/13/89

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Abstract

Chapter 1

THE EXTENT AND CAUSES OF THE DEBT CRISIS OF THE 1980s

by

John T. Cuddington
Georgetown University

This paper describes the growth in external lending to developing countries in the 1970s as well as the emergence and extent of the debt servicing problems encountered in the early 1980s. In doing this, Part I analyzes the movements in LDCs' debt/GDP and debt/export ratios, which are often used as indicators of creditworthiness. It also considers differing views on the relative importance of various underlying causes of the developing-country "debt crisis." Contributing factors include shocks that are external to the LDCs involved, as well as policy choices in the LDCs themselves.

Part II describes the macroeconomic and financial environment in which the debt build-up occurred. Changing patterns of international capital flows are identified and the movements of key macroeconomic variables are examined to determine the extent to which the experience of the 1970s and early 1980s should be considered atypical. In an environment characterized by numerous sources of uncertainty, it is often difficult to determine whether individual borrowers and lenders acted in a manner that should ex ante have been judged to be imprudent, or whether their current problems are more accurately attributed to "bad luck." Some risk-taking is obviously desirable. Policy makers -- both borrowers and lenders -- must assess the nature of various risks in order to act in their constituents' best interests.

Part III turns briefly to policy choices of LDCs in the face of various external shocks. This topic is covered in greater detailed by other papers in the volume, notably Easterly (1989).

The paper is, for the most part, a restatement of ideas already in the literature. Its primary objective is to put the remaining papers in the volume into an appropriate historical perspective. It concludes that, although the threat to the stability of the international financial system has gradually subsided, the crisis of restoring sustained economic growth in developing countries remains. Their debt servicing problems are large in magnitude and have been very persistent. It is now clear that the debt problem is not just a short-term nuisance that a couple of years of strong worldwide economic growth can eliminate -- contrary to optimistic expectations in the early years of the crisis. Hence, the need for new policy initiatives by official institutions and the "international community" at large is likely to be the single most important issue in global economic development policy for the 1990s.

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THE EXTENT AND CAUSES OF THE DEBT CRISIS OF THE 1980s

This paper first describes the growth in external lending to developing countries in the 1970s and the emergence and extent of the debt servicing problems encountered in the early 1980s. It goes on to review various causes of the developing-country "debt crisis." Contributing factors include shocks that are external to the LDCs involved, as well as policy choices in the LDCs themselves.

Part I of the paper describes the emergence of the debt crisis in the 1980s. The movements in LDC debt/GDP and debt/export ratios are analyzed and the deeper underlying causes of the crisis are reviewed.

Part II considers the macroeconomic and financial environment in which the debt build-up occurred. Changing patterns of international capital flows are described and the movements of key macroeconomic variables are examined to determine the extent to which the experience of the 1970s and early 1980s should be considered atypical. In an environment characterized by numerous sources of uncertainty, it is often difficult to determine whether individual borrowers and lenders acted in a manner that should ex ante have been judged to be imprudent, or whether their current problems are more accurately attributed to "bad luck." Some risk-taking is obviously desirable. Policy makers -- both borrowers and lenders -- must assess the nature of various risks in order to act in their constituents' best interests.

Part III turns briefly to the policy choices of LDCs in the face of various external shocks. This topic is covered in greater detail by other papers in the volume, notably Easterly (1989).

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The paper is, for the most part, a restatement of ideas already in the literature. Its primary objective is to put the remaining papers in the volume into an appropriate historical perspective. It concludes that, although the threat to the stability of the international financial system has gradually subsided, the crisis of restoring sustained economic growth in developing countries remains. Their debt servicing problems are large in magnitude and have been very persistent. It is now clear that the debt problem is not just a temporary difficulty that a couple of years of strong worldwide economic growth can "solve" -- contrary to optimistic expectations in the early years of the crisis. Hence, the need for new policy initiatives by official institutions and the "international community" at large is as pressing as ever. Dealing with or coping with the LDC debt crisis is likely to be the single most important issue in global economic development policy for the 1990s.

I. The Emergence of the Debt Crisis

Concern over the growing external indebtedness of developing countries and its possible implications for borrowing nations, their creditors, and the financial system as a whole had been voiced with varying degrees of intensity at least since the early 1970s. For example, one commentator on LDC debt, Gordon Smith (1979, p. 289) commented in 1979 that "...by 1970, there were sufficient signs of trouble on the horizon for Charles R. Frank, Jr. [1970] to characterize the debt situation as 'alarming.'" Quoting Frank, "If present trends continue, the problem for a number of them [LDCs] threatens to reach crisis proportions as the flow of debt repayments is reaching an unmanageable level." [Frank, 1970, p.1]. Even by the late 1970s, however,

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the consensus view was one of cautious optimism regarding the burden of the debt.

In a 1979 book, Cline observed that, "For some time now public attention has focused on the first aspect [the viability of the ongoing composition and pace of developing-country external borrowing, especially from commercial sources], as journalists and legislatures have sounded the alarm about the possibilities of developing-country defaults on debt and of resulting strains on the U.S. banking system." (p.32) He goes on to provide an excellent overview of two opposing views (one pessimistic, the other optimistic) on the viability of the current process of developing-country borrowing, and concludes that: "Over the near term, it would appear that the optimists have the weight of the evidence on their side. There is more uncertainty over a horizon of five or more years [i.e. by 1982 or so]. Gordon Smith suggests... that there may be problems of bunching of repayments at the turn of the decade. The Lissakers report [1977] is even more emphatic about the bunching problem..." (p. 34). These comments turned out to be very prophetic indeed. From a historical perspective, they also suggest that the debt crisis did not erupt as a complete surprise in 1981 or 1982. Some analysts had repeatedly emphasized the potential systemic risks facing the international financial markets.

There were a growing number of seemingly isolated debt servicing problems in the 1970s. It was the problems of Poland in 1981 and, especially, of Mexico in 1982, however, that heightened fears of systemic weakness and dramatically altered the international financial community's perceptions of LDCs' creditworthiness. Poland's quasi-default revealed the fallacy of assuming that East European countries' hard currency debts had an

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implicit guarantee of any sort by the Soviet Union. By implication, not only the Polish debt but whose of other East European countries had to be reassessed. "Credit quickly became scarce for the region, pushing Romania into rescheduling and placing pressure on other governments in the region. Thus, the net exposure of Western banks in Eastern Europe declined from $46 billion in 1980 to $42 billion by mid-1982." [Cline, 1984, p. 17] In short, systemic risks and the potential importance of shifts in market psychology were rapidly becoming apparent.

Most observers would date the beginning of the generalized debt crisis of the 1980s as August 1982 when the Mexican finance minister announced that Mexico was unable to service its public sector's external debt obligations as originally contracted. Mexico's debt servicing moratorium was noteworthy because of the sheer magnitude of Mexico's external liabilities. [1/] In addition, the large exposure of commercial banks, especially those in the United States, as opposed to official creditors, served to focus attention squarely on the systemic risks.

Even by early 1983, disagreement remained regarding the nature of emerging debt servicing problems. It is noteworthy that at that time the World Bank, with its characteristic optimism, argued that: "There is no generalized debt crisis; rather, the mutual difficulties of developing countries in servicing foreign borrowing and of commercial banks in obtaining service payments on foreign lending are an outgrowth of the broader economic problems" growing out of three years of global disinflation, which began

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[1/] According to the World Debt Tables, total external debt by DRS reporting countries was an estimated $672 billion at the end of 1981, of which approximately $78 billion was incurred by Mexico.

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toward the end of 1979. [2] The report goes on to emphasize the importance of restoring economic growth in order to overcome these transitory difficulties. Echoing a widespread view, the Bank argued that the global disinflation, which was pushing many high-debt countries into debt servicing crises, was the consequence of deliberate policies on the part of the major financial powers (as well as many other countries, including LDCs) to limit aggregate demand growth following the second oil shock.

What ensued was more than a typical cyclical downturn in the world economy. It was indeed a "crisis," not only for Mexico, which had to engineer massive external adjustment of its economy, but also for a number of other heavy borrowers in Latin American and Africa. The massive exposure of North American and European commercial banks in these regions caused legitimate fears about the stability of the international banking system. The real threat was that cascading sovereign debt problems, coupled with high interdependence of international banks, would trigger a "meltdown" of the financial system of the sort encountered in the 1930s. Fortunately, collapse of the financial system was averted.

It is important to distinguish between debt servicing problems of the 1980s and a full-blown financial crisis or collapse. In their study of financial instability, Eichengreen and Portes (1987) suggest the following definition:

> A financial crisis is a disturbance to financial markets, associated typically with falling asset prices and insolvency among debtors and intermediaries, which ramifies through the financial system, disrupting the market's capacity to allocate capital within the economy. In an international financial crisis, disturbances spill over national borders, disrupting the market's capacity to allocate capital internationally. (p.10)

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[2] World Debt Tables, 1982-83 edition, p. vii.

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> Our definition implies a distinction between generalized financial crisis on the one hand and bank failures, debt defaults and foreign-exchange market disturbances on the other. This distinction is the presence of linkages...These linkages within the body economic give the essential anatomy of financial crisis. (p.11)...Debt default need not give rise to financial crisis. But if, on the contrary, debt default heightens the commercial banks' susceptibility to failure, the danger of a generalized crisis is intensified. (p.12)

It was, of course, the prospect of a generalized financial crisis in the early 1980s that triggered the intense concern and sense of urgency among policy makers in the major industrial nations to deal with the debt crisis. Over the ensuing six years, these fears have largely subsided as the IMF and central bankers stood ready to prevent a collapse of the banking system. The commercial banks have gradually strengthened their balance sheet positions by increasing reserves for problem loans and by retaining earnings to increase their capital. In 1987, commercial banks followed the lead of Citibank in a much more aggressive write-down of the book value of their LDC loans. At the same time, their positions in negotiations with problem debtors tended to harden. In a recent analysis of the current vulnerability of US and foreign banks, Harry Huizinga (1988, p. 38) concludes that "the stability of the international financial system is no longer threatened by the LDC crisis "

Even as the vulnerability of commercial banks has declined, the number of developing countries encountering debt serving problems has grown. It is hardly encouraging that virtually none of the troubled debtors has regained access to the private credit markets. The 1986-87 World Debt Tables (p. viii) claims: "Of the countries that have rescheduled debts since 1982, only Côte d'Ivoire and Uruguay have been able to raise long-term loans from financial markets outside the context of a formal restructuring agreement. In each case, new lending by commercial banks was part of a cofinancing

arrangement with the World Bank." Even countries that have not experienced debt problems have found their access to external funds greatly reduced.[3]

What remains after six years of intensive effort to restructure external debts and restore growth, however, is indeed a debt servicing crisis when viewed from LDCs' perspective. In many cases they continue to service external obligations only at a very high cost in terms of foregone economic growth and drastic declines in per capita consumption, with little prospect of a return to voluntary lending in the foreseeable future. In short, the debt crisis has become a crisis of restoring the momentum of economic development achieved in the 1960s and 1970s. As a number of observers have emphasized, the decade of the 1980s has become a "lost decade for economic development," as per capita income levels in a number of regions have fallen to their levels as of 1960, before the economic growth miracle of the 1960s and 1970s began.

On Causes of the Debt Crisis

On "causes" of the debt crisis, there is no shortage of commentary. Rudiger Dornbusch and Stanley Fischer (1986), for example, conclude:

> The question of the origin of the 1982 debt crisis is easily answered. Imprudent borrowing policies in the debtor countries and imprudent lending by commercial banks had a chance encounter with extraordinarily unfavorable world macroeconomic conditions that exposed the vulnerability of the debtors and the creditors.

Mario Simonsen, formerly Finance Minister of Brazil, on the other hand, places much more emphasis on systemic factors, and their inevitable

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3/ Eichengreen and Portes (1985, 1987) have made the interesting observation that this drying up of external funding for problem and non-problem debtors alike also characterized the debt servicing crisis of the 1930s.

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consequences for debt dynamics:

> To sum up, neither the errors of the lenders nor those of the borrowers can explain the global debt crisis that emerged in late 1982. The central cause has already been indicated in the discussion on debt dynamics: the sudden and unanticipated change in sign in the difference between the growth rate of developing-country exports and international interest rates. From 1974 through 1980 a typical interest rate on developing-country loans, LIBOR plus 1.5 percent a year spread, averaged 10.7 percent. Meanwhile, exports of non-oil-exporting developing countries were expanding at 21.1 percent, overfulfilling the weak solvency test [that nominal export growth exceed the nominal interest rate]. In 1981-82 the interest rate soared to 16.3 percent a year, while the annual rate of growth of exports declined to 1 percent, challenging any solvency criterion. Even if balance of payments finance had been provided by a single central lender, such a change would have required drastic adjustment policies. Under competitive recycling, the result could be nothing but a crisis. (1985, p. 120)

William Cline (1984, p.1) also focuses on global macroeconomic considerations:

> The global debt problem stems from forces dating to the mid-1970s, and to the first oil price shock (1973-74) in particular. The intensification of the problem in 1982 derived primarily from the effects of global recession from 1980 to 1982, combined with adverse psychological shocks to credit markets caused by events in individual major countries. In a broad sense the problem is a consequence of the transition from inflation to disinflation in the world economy. Funds that were borrowed when inflation was high and real interest rates were low or negative are no longer cheap in an environment of lower inflation and high real interest rates.

While agreeing that global shocks were indeed important, Jeffrey Sachs (1985, p.526) stresses that country-specific factors, in particular their policy choices, were decisive in determining which LDCs escaped the "debt trap" and which did not:

> The debt crisis of the early 1980s was triggered by a combination of global economic events and domestic developments in the debtor countries. The best evidence for the contribution of global events is the simultaneous onset of the crisis in more than forty developing countries. The best evidence for the role of distinctively national developments is the success of many debtor countries in surmounting external shocks without an emergency rescheduling.

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While agreeing that external shocks and LDC policies were indeed important in bringing on the debt crisis, there are many students of the debt crisis (e.g. Swoboda (1985) and Guttentag and Herring (1985)) who place a good share of the blame of the shoulders of the commercial lenders and their regulators. Banks allegedly "overlent," aggressively expanding loans in the 1970s with insufficient attention to the creditworthiness of individual borrowers or the profitability of the projects being financed. Later, following the onset of the debt crisis, they abruptly cut back on sovereign lending, thereby greatly worsening the liquidity crunch. Guttentag and Herring (1985, pp. 129-130) focus on the excesses in the commercial banking system and the inadequacies of prudential and supervisory regulations:

> [t]he conventional story about the debt crisis places some emphasis on imprudent borrowing (or endogenous factors in the borrowing country), but most of the emphasis is placed on the deterioration in the world economy...We believe this conventional story is incomplete. Imprudent borrowing is usually impossible without imprudent lending. In several instances, commercial banks continued to lend in support of unsound economic policies long after the residents of the borrowing countries had demonstrably lost confidance in their government's policies. The consequence was a substantial amount of bank lending that was used to finance capital flight from the borrowing country.

They go on to develop three hypotheses about how and why overlending by commercial banks occurred: (1) banks were subject to what they call "disaster myopia," (2) banks underestimated risks because of inadequate information, and (3) banks took calculated gambles based on the expectation of official support in the event of adverse outcomes. In addition they express concern that "bank regulatory authorities were so ineffectual in constraining growing concentrations of country exposure in individual banks." (p. 130)

As the foregoing quotations suggest, there are lots of possible culprits to be considered if one's objective is to go on a "witch hunt," to use Mario Simonsen's (1985) colorful terminology for attempts to assess blame for the

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debt crisis. Possible pleasures of "witch hunting" aside, a thorough understanding of the causes of the current debt problem is presumably worth pursuing. "Much as the study of disease is one of the most effective ways to learn about human biology, the study of financial crises provides one of the most revealing perspectives on the functioning of monetary economies." [Eichengreen and Portes (1987, p. 10)]

Beyond this intellectual motivation are more pragmatic ones: First, an understanding of the causes of debt crises may indicate the need the systemic reforms to reduce the vulnerability of the world economy to similar problems in the future. Second, it may help us to predict incipient debt servicing problems and to take timely action to avert them. Third, it may suggest efficient and equitable solutions to the current difficulties. An equitable sharing of the among borrowing countries, commercial lenders, official institutions, and taxpayers in creditor and/or debtor nations may depend on perceptions of their relative blame or responsibility. Fourth, in addition to "fairness" considerations, there is the issue of efficiency -- maintaining or establishing appropriate economic incentives to prevent excessive borrowing and, in the extreme, a full-blown financial crises from occurring in the future. As Paul Krugman emphasizes, "the current debt strategy involves, de facto, an element of bailout of debtors by their creditors, on one hand, and bailout of both debtors and creditors by official agencies, on the other. If the problems of debtor countries basically reflected irresponsible behavior, such a bailout would provide encouragement for more such behavior in the future. If, on the other hand, the debt crisis can be viewed basically as an act of God (or his earthly manifestation, Paul Volker), this is not a concern." (p.391, his comment on Diaz-Alejandro, 1984)

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This is the so-called moral hazard issue. [4]

Debt Servicing Problems: Their Nature and Extent

Debt servicing difficulties vary greatly in terms of character and duration, not to mention the severity of the policy measures needed to restore external balance and the time it takes before market access is restored. In some cases these difficulties are isolated and country-specific. In others, as in the 1930s and the 1980s, they are widespread. Debt payment problems include a range of maladies: arrears on interest payments, arrears on principal repayment as well as interest, higher-tranche IMF arrangements, or requests to reschedule loans from private and/or official creditors. The study of debt servicing problems between 1970 and 1982 by McFadden et al. (1985, pp.186-87) contends that "Of these, arrears are likely to be the first symptom, or even a deliberate signal, of difficulties. Rescheduling or IMF arrangements come later as part of the resolution of problems after their presence is generally recognized." Their Table, reproduced here as Table I-1, shows the transition matrix for various types of repayment problems for their sample of 93 countries (which includes problem and non-problem debtors). This table confirms that "arrears are the most common problem, present in 73.4 percent of the years where any form of problem occurs. Furthermore, arrears are a strong one-year-ahead indicator of future problems: 83.3 percent of countries with arrears in year t have a problem in year t+1, while this is true for only 20.6 percent of countries

[4] Richard Portes has warned economic policy makers not to overestimate the practical importance of the moral hazard problem. In the current search for a resolution to the debt crisis, he argues, "hazardous moralizing" may be slowing progress much more than the potential complications caused by the moral hazard!

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without arrears in t." [5]

****** insert Table I-1 here (from McFadden et al (1985)) *******

The data in Table I-1, which cover the decade prior to the debt crisis, remind us that debt servicing difficulties are certainly not a new phenomenon in the 1980s, even if one considers only the post World War II period. What is unique about the experience of the early 1980s is how widespread debt servicing problems have become and how difficult it is to resolve them and restore voluntary lending.

The rash of rescheduling in the 1980s is clear from Table I-2, which shows the number of rescheduling operations involving official and private creditors for each year from 1975 through September 1987. The number of restructuring operations rose from one per year in 1975 and 1976 to 8 in 1980. It then jumped to 14 in 1981 and to a higher plateau of 30-40 after 1983. If one looks at the estimated dollar value of loans restructured, the big surge occurs in 1983, the year after the Mexican debt moratorium was announced. The high level of restructuring activity has continued since that time, reflecting the enduring nature of the crisis. Between January and September of 1987, 25 restructurings occurred. The estimated face value of the debt was over $102 billion, which represents fully 10 percent of the total outstanding external debt of the DRS countries as of year-end 1986.

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[5] These sorts of calculations, of course, assume that the individual country observations are independent. That is, they ignore the impact that one country's problems has in inducing problems elsewhere -- a phenomenon that typifies periods of generalized debt crises. It would be interesting to extent the analysis of transitions across various states of debt servicing difficulties to the post-1982 period -- noting cross-country interdependence -- to see if contagion effects are, in fact, detectable in the data.

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What Table I-2 does not reveal is that the vast majority of reschedulings have been concentrated in two regions of the world: Latin America and Africa. It also hides the fact that many of the countries experiencing debt servicing difficulties have had to restructure their debt obligations several times. Once debt servicing problems arise, they tend to dog the countries involved. This entails considerable time and negotiating costs for the LDC policy makers involved, not to mention the larger economic and political costs associated with debt problems.

Not surprisingly, these debt servicing problems have been accompanied by, and to some extent have caused, a severe deterioration in the financial markets' assessment of LDC creditworthiness. The timing and extent of this deterioration is suggested by several factors. First, spreads over LIBOR for individual borrowers jumped as debt servicing problems became imminent, as Fig. I-1 (from Carron (1982, p. 413)) shows. [6/] First came Brazil with a jump in its spread from less than 1 percent over LIBOR in late 1979 to over 2 percent by the end of 1980. In early 1981, the Falkland Islands conflict caused Argentina's loan rates to jump from less than 0.6 percent to 1.1-1.2 percent. For Mexico, the spread began to increase slowly in the latter half of 1981, after falling gradually in 1979 through early 1981. As debt servicing difficulties seemed inevitable in early 1982, the spread climbed sharply to 1.5 percent.

[6/] As the theoretical literature on sovereign debt and lending in the presence of informational asymmetries emphasizes, it is not always in the interest of the creditor to adjust spreads upwards as creditworthiness deteriorates, because higher spreads themselves increase the burden of the debt, thereby worsening servicing prospects. Once a country's debt servicing difficulties have reached the point where voluntary lending has ceased and concerted lending programs are being negotiated, a reduction in the spread may be considered mutually beneficial. This point has been stressed by Paul Krugman and Jeffrey Sachs, among others.

********** insert Fig. I-1 (Fig. 1 from Carron, 1982) **********

Edwards (1986) provides an interesting perspective on market perceptions of sovereign risks by analyzing data from the secondary market for LDC bonds. [7] Studying the risk premium on Mexican and Brazilian bonds implied by their yield differential via-à-vis a comparable-maturity World Bank bond (which has a triple A credit rating), reproduced here as Fig. I-2, he concludes that "the [bond] market anticipated by only a few weeks -- and only partially -- the Mexican debt crisis of August 20, 1982. As late as July of 1982, the spreads were negative, and not significantly different from the average for the preceding 18 months." (p. 582). Thus it seems that one gets quite a different impression of the extent to which financial market participants anticipated the debt crisis when one compares the bond market data in Fig. I-2 to the spreads over LIBOR on new bank loans shown in Fig. I-1.

********** insert Fig. I-2 (Fig.1 from Edwards (1986)) *********

Another indication of deteriorating LDC creditworthiness is the high discounts for which LDCs' bank debts are being traded on the secondary market. The magnitudes of these discounts over the last couple of years, shown in Table I-3, are particularly interesting in that they show just how far the current international environment is from the point where voluntary

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[7] A number of papers by Eichengreen and Portes have focussed on the LDC bond markets' assessment of sovereign risks in the 1930s. See their paper in this volume and the references therein.

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lending will be restored.

******* insert Table I-3 on values of debt in the secondary markets *****

A third indication of the severity and generality of the debt problem is the low level of commercial lending in recent years. Much of the new lending that has occurred has been "involuntary" in that it involves increased participation by existing creditors as part of rescheduling agreements. In 1985 and 1986, for example, there were significant resource transfer from LDCs to creditors as aggregate repayments have overtaken disbursements. This negative transfer is the result of large reflows to commercial banks in industrial countries which are only being partially offset by positive resource transfers from multilateral institutions. This pattern of net transfers shows up clearly even in the aggregate data in Table I-4a, which includes all DRS reporting countries. If one considers the major debtors and sub-Saharan Africa separately, the negative transfer begins in 1983, and is much more dramatic; see Table I-4b. [8]/

******* insert Table I-4a and Table I-4b ******

In summary, the evidence in this section makes clear that the debt crisis is severe indeed, especially in Latin America and in sub-Saharan Africa, and is likely to be very protracted -- contrary to the optimistic

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[8]/ Based on provisional data for the 1988 World Development Report, Versluysen (1989) comments that "despite numerous reschedulings and concerted lending by banks, [the seventeen largest debtor countries] have suffered a total resource drain of some $105 billion, or about 2 percent of their aggregate GDP during the last six years." (p.3 of the 1988 typescript).

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assessments in the international financial community in the early years of the crisis. The high costs that the enduring crisis of debt and economic stagnation is imposing on debtor countries makes the study of the relative role of various causes of the crisis worthy of careful attention.

Debt Trends and Creditworthiness Indicators

The total external indebtedness of the 109 countries included in the World Bank's Debt Reporting System (DRS) grew from $67 billion in 1970 to $579 billion in 1980, prior to the onset of widespread debt servicing difficulties. As Table I-5 shows, these figures represented roughly 16 percent of their collective GDP or 142 percent of exports of goods and services in 1970; they grew to 28 percent of GNP and 130 percent of exports in 1980. By 1986, total external debt had risen to over one trillion dollars ($1021 billion) or 48 percent of DRS countries' GNP and 227 percent of their exports of goods and services.

According to the bottom section of Table I-5, total external debt (EDT) grew at a compound annual growth rate of almost 27 percent between 1974 and 1980, after which time the growth rate fell sharply. 9/ Comparing the growth in total external debt to the long-term public/guaranteed debt component (DOD), on which more complete data is available over a longer time period, one can infer that short-term lending rose sharply in 1980, undoubtedly a precursor of the debt servicing problems to come. 10/

These aggregate data mask a number of important features of the debt

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9/ The series on total external debt jumps in 1977 because reasonably comprehensive data on short-term debt becomes available from that date forward

10/ Short-term debt data reported in the World Debt Tables for the years after 1977 confirm this inference.

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build-up. First, the growth in debt differed significantly across regions, and among individual countries within each region. Generally speaking, debt burdens are greatest in Latin America and Africa, with the developing countries in Asia and Eastern Europe being considerably more conservative. Of the World Bank's 17 highly indebted countries (HICs), only two (the Philippines and Yugoslavia) are located outside Latin America or Africa. [11]

Also hidden in Table I-5 is the pronounced shift in the relative importance of creditor sources towards commercial lenders and away from multilateral lenders, particularly for Latin American debtors. With this shift came higher average interest rates and shorter loan maturities, albeit with less in the way of "conditionality" or restrictive loan covenants than was typical on loans from multilateral lending institutions.

Debt/GNP, debt/export, and debt service ratios are widely used when studying the evolution of external debt. They are also used in informal as well as econometric assessments of creditworthiness. In limited dependent variable models that attempt to predict debt servicing problems (discussed briefly below), the debt service/export ratio and debt/export ratio are typically the most significant explanatory variables. More often than not, the debt/GNP ratio is not significant. Interestingly, this is consistent with the information in Sachs' (1985) recent comparison of Latin American and East Asian debtors, reproduced in Table I-7. He finds that the group of problems debtors he studied (primarily in Latin America) differed from the non-problem countries (which were concentrated in East Asia) mostly in terms of their debt/export ratios. Debt/GNP ratios, on the other hand, were rather

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11/ The other 15 HICs are Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Uruguay, and Venezuela.

similar across the two regions. Sachs attributes the lower debt/export ratios in Asia to that region's superior export performance.

**** insert Table I-6 (reproduced from Sachs, 1985, p.533) here *******

Given the widespread use of these ratios, it is useful to look more carefully at why and how they move over time. For example, are variations in the debt itself or fluctuations in the GNP or exports more important in bringing about changes in the principal debt ratios? Examining the growth rates for total external debt (EDT), long-term public/guaranteed debt (DOD), GNP, and exports of goods and services (XGS) in Table I-5, it is seen that EDT and DOD grew much more smoothly than either GNP or exports. This suggests that the major determinant of changes in either the debt/GNP or debt/export ratios are not the changes in the debt itself, but predominantly the fluctuations in GNP and exports respectively. Hence, one must consider the movements in these macro aggregates in order to predict deterioration or improvements in creditworthiness, at least as reflected by these indicators. 12/

Table I-5 indicates that external debt grew at an average rate of 21.9 or 24.4 percent per annum between 1971 and 1980, depending on whether one looks at EDT or DOD. As this was somewhat faster than the average growth rate in GNP of 17.5 percent, the debt/GNP ratio grew over the period. It is noteworthy that the abrupt climb in the ratio as the debt crisis emerged after 1980 reflected primarily the collapse in GNP growth, not a surge in the

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12/ The evidence that increases in a country's debt service ratio or debt/export ratio cause the probability of debt servicing problems to rise is summarized briefly below.

debt level.

In contrast to the debt/GDP ratio, the debt/export ratio actually fell slightly during the 1970s, because export growth outpaced the growth in external debt. All in all, the movement of the aggregate debt/GNP and debt/export ratios over the 1970s for the DRS reporting countries taken as a group would hardly have suggested that a debt crisis was imminent. These data, of course, hide widely differing trends in individual countries. (Appendix A shows similar data for the 19 major borrowers and the sub-Saharan African countries, respectively, and carries out a ratio analysis of the sort described in the following section using these data.)

A Way of Organizing Ratio Analysis

In an effort to systematize the use of the principal ratios of debt analysis somewhat and to relate the ratios to each other, two identities are proposed below for decomposing movements in the debt/export and debt service ratios and relating them to the debt/GNP ratio. [13]/ The first identity relates the debt/export ratio to the debt/GNP ratio and the export share of GNP:

(1) debt/exports = (debt/GNP) / (exports/GNP).

Identity (1) serves to emphasize the point that an increase in the debt/GNP ratio need not indicate an increasing debt burden as measured by the debt/export ratio if the rise in the debt/GNP ratio is accompanied by a

[13]/ The statistical insignificance of the debt/GNP ratio in many of the econometric models of debt problems, as well as the above-mentioned study by Sachs (1985), led me in this direction.

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rising export/GNP ratio.

Table I-7 shows the decomposition of the debt/export ratio (DOD/XGS). The bottom panel of the Table shows the movements in each term in percentage change form: the percentage change in the debt/export ratio equals the percentage change in the debt/GNP ratio minus the percentage change in the export/GNP ratio. Examining these percentage changes, it is easy to see that an improvement in DRS countries' debt/export ratio occurred between 1970 and 1980 even though the debt/GNP ratio rose, because of a rising export share in GNP. This is, of course, just a way of highlighting an observation of Balassa, Sachs and others: export growth that is rapid enough to raise the export share does indeed seem to be the key to maintaining the debt/export ratio in an "acceptable" range, i.e. a range considered indicative of creditworthiness. [14]/ The average percentage changes in the ratios and their respective standard deviations over the pre-crisis period 1971-80 are shown on the right side of the Table. They show that the debt/GNP ratio has risen rather smoothly over time, whereas the export/GNP ratio has trended upward but with greater volatility from year to year.

Between 1980 and 1986, on the other hand, the debt/export ratio rose sharply from 80.3 percent to 173.2 percent. The decomposition of this shift reflects a surge in the debt/GNP ratio as debt grew much more slowly, but nominal GNP growth collapsed. As the 1980-82 world recession materialized, the changes in the export/GNP ratio were modest. In contrast, the steep drop in the export/GDP ratio in 1986 contributed 7.8 percent to the 17.5 percent growth in the debt/export ratio in that year.

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[14]/ Some of the empirical work by these authors, in fact, uses the percentage change in the export/GNP ratio as a proxy for the orientation of trade policy, even though the ratio may change for other reasons.

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A similar decomposition exercise is carried out in Table I-8 for the total debt service (TDS) [to export] ratio using a second identity:

$$(2) \qquad TDS/XGS = TDS/DOD \times DOD/XGS.$$

The movements in the debt/export (DOD/XGS) ratio on the right hand side of (2) have already been decomposed above. The issue highlighted by (2) is whether movements in the aggregate debt service ratio reflect primarily changes in the debt burden as measured by the debt/export ratio or changes in the ratio of debt service to debt (the "amortization ratio"). Rewriting (2) in terms of percentage changes:

$$(3) \qquad \%\Delta\ (TDS/XGS) = \%\Delta\ (TDS/DOD) + \%\Delta\ (DOD/XGS),$$

yields the information at the bottom of the Table.

As Table I-8 shows, the debt service ratio fell from 11.7 percent in 1970 to 7.2 percent in 1974, primarily because of a declining debt/export ratio. From 1975 through 1978, on the other hand, the debt/export ratio rose consistently, more than offsetting modest improvements in the amortization ratio in 1974-76. Hence the debt service ratio deteriorated. The deterioration in the debt service ratio continued in 1978 and 1979, but it was driven by rising amortization ratios in these years. These changes in the amortization ratio reflect increases in the interest rate as well as shifts in the structure of principal repayments in particular years. [15]

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[15] A more detailed decomposition than that in Table I-8 can be obtained by disaggregating the amortization ratio into its two components: the interest ratio (interest/debt) and the net principal repayment/debt

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Although the debt service ratio for the DRS countries showed a gradual deterioration over the 1970s, one would have been hard-pressed on the basis of this aggregate information to conclude that a debt-servicing crisis was just around the corner. [Of course, the behavior of principle ratios varied widely across regions and across countries within those regions as our decomposition of debt data for the highly indebted countries and the sub-Saharan countries in Appendix A highlights.] The Table also indicates that the steep rise in the debt service ratio from 12.5 to 21.3 percent as the debt crisis materialized in the early 1980s reflects primarily the steep rise in the debt/export ratio as export earnings collapsed (albeit with a temporary surge in 1984). On the other hand, rescheduling activity, which pushes principal repayments into the future, undoubtedly explains a large part of the gradual decline in the amortization ratio between 1981 and 1986.

Finally, Table I-9 briefly examines the extent to which growth in outstanding long-term debt (DOD) is attributable to factors other than net flows of new lending. For example, year to year changes in DOD may reflect revaluation of the non-dollar denominated portion of the debt as the dollar exchange rate in terms of other key currencies fluctuates. The rolling over of short-term debt into long-term obligations may also explain part of the growth in debt if we are looking at long-term public/guaranteed debt (DOD) rather than total external liabilities (EDT). The assumption of private-sector external debt by the public sector can also cause DOD to grow more quickly than the net flow of new loans would dictate. These latter two activities became increasingly important in the mid-1980s as restructuring activity surged.

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ratio.

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The Table shows that for most years the growth rate of DOD is roughly equal to the percentage growth in DOD attributable to net flows, measured by net flows divided by DOD at the beginning of the year (DOD(t-1)) multiplied by 100. The 1984-86 period is the major exception to this rule, and presumably reflects both debt restructuring and sharp movements in the dollar exchange rate in those years.

Debt Dynamics

In judging the sustainability of LDC debt burdens, the relationship between export growth rates the interest rate on external liabilities has received considerable attention. [16]/ Like the ratio analysis above, this rule of thumb exploits simple arithmetic and accounting identities. The relation on which these discussions are based is obtained by rewriting the DOD/export ratio in terms of percentage changes:

$$(4) \qquad \%\Delta\ (DOD/XGS) = \%\Delta\ DOD - \%\Delta\ XGS.$$

Next, using a simplified version of the balance of payments identity, the growth in debt (%ΔDOD) in the above identity is replaced with the accounting identity relating changes in the debt (ignoring non-debt capital flows) to net interest payments (iD) and the non-interest current account deficit (CAD): $\Delta DOD = i\ DOD + CAD$ where i is the nominal interest rate on external borrowing. Using this identity, (4) becomes:

$$(5) \qquad \%\Delta\ (DOD/XGS) = (i - g) + CAD/DOD$$

[16]/ See Simonsen (1985) for a recent application.

where g is the export growth rate.

Taking the debt to export ratio as a measure of the debt burden, the relationship in (5) shows that, even if the non-interest current account is brought down to zero, the debt/export ratio will grow without limit if the nominal (dollar) interest rate on the debt exceeds the growth rate in the dollar value of exports. This explosive growth in the debt/export ratio is taken as an indicator that debt servicing problems will ultimately emerge unless corrective policies are implemented (by borrowers or lenders).

In the quotation in the Introduction, Mario Simonsen stressed that in his view it was the sharp rise in world interest rates coupled with the collapse in LDC export growth rates that brought on the global debt crisis. Fig. I-3, taken from Cline (1984,p. 9), shows just how abrupt the change in the relationship between interest rates and export growth rates was for non-oil LDCs taken as a group, and for Mexico and Brazil alone. It is interesting to note that although interest rates rose steadily from 1977 through 1981, it was the drastic turnaround in exports not the rise in interest rates that was primarily responsible for the collapse in the simple solvency condition (or rule of thumb, rather) that i-g be less than zero.

One gets a slightly different perception of the relative importance of interest rate increases and the collapse in export growth if one considers <u>real</u> interest rates and the growth in export <u>volumes</u>. To convert the relation $i-g<0$ to one about real interest rates $(i-\pi)$ and the real export growth rate $(g-\pi)$, one would have to choose an export price deflator and interpret "real" interest rates $(i-\pi)$ accordingly. The rule of thumb for debt sustainability then becomes: $(i-\pi) - (g-\pi) < 0$, where $r-\pi$ is the growth

in export volume. The jump in real interest rates after 1981 is indeed remarkable, as Fig. I-4 (from the World Debt Tables, 1986-87 edition, p.xii) shows. Of course, the inference from the information in Fig. I-3 and I-4 is that the growth in export volume must have collapsed after 1981 also. Thus the sharp turnaround in the simple solvency condition reflects both higher interest rates and lower export volumes, and hence leaves open the question of underlying "causes" of the debt servicing difficulties that emerged in 1982.

********** insert Fig. I-3 (Fig. 1.3 from Cline (1984) ****

********** insert Fig. I-4 on real interest rates from WDT ****

Predicting the Occurrence of Debt Servicing Problems

A number of researchers have proposed econometric models using financial and macroeconomic indicators of creditworthiness to predict or "explain" the occurrence of rescheduling problems using data on a cross-section or panel (i.e. cross-section time-series) of developing countries. The bulk of these statistical exercises have used discriminant or logit models and were carried out using data from the 1960s and early 1970s. In a few cases, the data extended through the early 1980s, but most studies do not include the period since 1982 when debt servicing difficulties took on systemic dimensions and a rash of reschedulings occurred. 17/

These studies provide a useful starting point for examining various "causes" of the debt crisis by examining the impact of various debt ratios

17/ An exception is the Berg and Sachs (1988) paper, which uses data from 1977 through 1985.

(such as those we examined above) in bringing on debt crises. Nevertheless, these variables are in most cases only proxies for more fundamental causes. As McFadden et al (1985) have noted, early studies also have a number of statistical shortcomings. For example, they generally ignore time effects (e.g. before and after 1982 when the debt crisis began) and country-specific effects. More importantly from a conceptual standpoint, the prediction models make no attempt to isolate the separate influences of factors affecting the supply-and demand for new loans to sovereign states. Thus, they are at best estimations of reduced-form models of some sort. Early models predicting debt servicing problems are summarized in Table I-10, reproduced from McFadden et al (1985).

The latter shortcoming has been remedied in recent work following Eaton and Gersovitz (1981) which applies the "regime-switching" econometric technique to allow for the possibility of disequilibrium credit markets. The underlying model assumes that interest rates, for various reasons, may not adjust continuously to equate the supply and demand for new credit. Two types of disequilibrium, or more precisely non-Walrasian equilibrium, can arise in the Eaton-Gersovitz model. In one, the borrower faces a credit-availability constraint at the prevailing interest rate (i.e. there is excess demand for funds); in the other regime, a borrower's demand for credit at the prevailing interest rate is completely met (and there may be an excess supply). In the process of estimating this two-regime model, the parameters of both the supply and demand schedules for external loans are estimated, as is the probability of facing a credit-constrained situation given a county's determinants of credit supply and demand.

The work of McFadden et al. (1985) and Hajivassiliou (1987) extends the

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two-regime model of Eaton-Gersovitz to three regimes, thereby allowing for the possibility of debt servicing problems. The Hajivassiliou paper improves on the econometric techniques used in his earlier work with McFadden and others by correctly allowing for the country and time specific effects in the (panel) data. He delineates the three separate regimes as follows. [18] In the first, there is an excess supply of credit so the borrowing country is not credit constrained; no arrears occur and there is no rescheduling. In the second, there is "moderate" excess demand for credit. Suppliers are on their notional supply schedules but the available credit is less than the borrower's demand at the prevailing interest rate. The Borrower responds by incurring arrears in debt service payments. By assumption, however, the level of arrears falls short of the country lending limit established by lenders, so they do not put pressure on the borrower to reschedule. In the final regime, there is a large excess demand. In particular, the borrower's excess demand for credit and hence the level of its arrears is so large that it exceeds the lender's country lending limit. Rescheduling occurs.

Under this approach, it is possible to estimate not only the supply and demand schedules for new loans but also a function specifying the allowable level of arrears (the country's credit limit) that creditors will tolerate before pushing for formal rescheduling. Hajivassiliou's estimation results are reproduced in Table I-11. He finds that the demand for new loans depends significantly and positively on the amount of debt service due relative to exports, and positively on the import to GNP ratio. The real GNP per capita had a statistically significant negative effect on new loan demand ceteris

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[18] See, especially, the technical appendix (pp. 224-5) in Hajivassiliou (1987).

paribus. The supply of new loans, on the other hand, depended positively on the debt/export ratio, while the export/GNP ratio was statistically insignificant. Indicators of IMF support, rescheduling, or arrears tended t reduce the supply of new funds ceteris paribus. Finally, the limit on arrears that lenders permitted was influenced significantly by two variables the debt service ratio entered with a positive effect, and the indicator of an IMF support or rescheduling had a negative impact on allowable arrears.

********** insert Table from Hajivassiliou (1987, Table 3, p. 219)

The regime-switching approach represents an important conceptual and econometric innovation in the explanation and prediction of debt servicing problems of varying degrees of intensity (arrears, IMF support, rescheduling). The approach has, to date, yielded useful insights into the sorts of financial and macroeconomic variables that affect the supply and demand for credit, as well as allowable arrears.

Most econometric models of creditworthiness and debt servicing problems typically include variables, such as the debt service ratio and the debt/GDP ratio as "determinants" of debt servicing problems. While these variables may be rough "indicators" of the likelihood of encountering debt problems, they are typically not the true underlying "causal" factors (for example, those alluded to by various authors cited in the Introduction).

In spite of this limitation, the financial indicator regressors used in most statistical models may reflect changing trends in debt servicing potential. Some of the variables, such as the export and GNP growth rates, enter discussions of "debt dynamics" (à la Simonsen, for example) and hence

are reflecting causes of the debt crisis at this more mechanical, but arguably less fundamental, level of investigation.

To date, the empirical analysis based on the three-regime disequilibrium model has not focussed specifically on the question of what internal and external factors were the most important causes of the debt crisis of the 1980s. They use data for the pre-crisis period. This is unfortunate, because the three-regime model using panel data (as in Hajivassiliou (1987)) is ideal for isolating the supply-side and demand-side factors, both those that are country-specific and systemic, that have contributed to debt crises. A thorough analysis would attempt to incorporate the effects of both global shocks and individual LDCs' policy choices outlined on the supply and demand for loans in the international capital markets. This appears to be a research topic worthy of future consideration.

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II. The Macro and Financial Environment of the 1970s

Policy decisions regarding foreign borrowing, exchange rate management, government expenditure and revenue raising must recognize the uncertain world environment in which LDCs operate. For students of the debt crisis, a critical question is: did individual LDCs experience debt servicing difficulties primarily because of "bad policies" or "bad luck?". That is, did they undertake policies that should have been considered suboptimal at the time they were undertaken, given the nature (e.g. the size and persistence) of various shocks to their economies? Alternatively, did they encounter problems in large part due to the extraordinarily adverse nature of the shocks encountered in the early 1980s?

One often hears that cyclical fluctuations in worldwide economic activity were particularly pronounced during the 1970s and early 1980s. The world economy was buffeted by "supply shocks" in the form of higher oil prices, sharp increases and decreases in the prices of various non-fuel primary commodities, surging real interest rates in the early 1980s, etc. Even though these shocks are exogenous from the point of view of most debtor countries, some of them might be considered more or less direct consequences of policy actions in the industrial world., For example, the sharp recession in the early 1980s was, according to most observers, induced by disinflationary aggregate demand policies in the major industrial nations and some developing countries. For example, the World Bank [1]/ pointed to this policy shift in outlining the sequence of events that brought on the debt servicing difficulties in a growing number of LDCs:

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[1]/ World Debt Tables 1982-83 edition, p. vii.

1. Excessive reliance on monetary restraint rather than on a balanced mix of monetary and fiscal policies led to very high and widely fluctuating real interest rates.

2. The change in operating procedure of US monetary policy toward control of monetary base and aggregates rather than interest rates led to increased interest rate volatility.

3. The resulting worldwide economic slowdown had a negative impac on LDCs' export growth.

Suppose policy shifts in industrial countries do indeed cause key macroeconomic variables in the world economy to move far from their normal values and that these developments bring on debt servicing problems in many LDCs, perhaps those LDCs that borrowed most aggressively or invest unwisely Under such a scenario, one might consider it "equitable" to have the industrial countries absorb some of the costs that the debt crisis subsequently imposed on debtor nations.

Before jumping to such a conclusion, however, it is obviously desirabl to briefly reexamine the macroeconomic and financial environment facing developing countries in the 1970s and early 1980s, the period over which th major build-up in external debt occurred. Just how atypical was this perio from a longer-term historical perspective? In answering this question, we consider several factors that impacted the supply and/or demand for externa funds in LDCs. First, the oil price shocks of 1973/74 and 1979/80 are highlighted as perhaps the two most significant events in the global macroeconomy during the period. Second, the real economic growth performances of the industrial countries and the developing world are reviewed, noting the different r rns in their real GDPs following the first and second oil shocks as well as the severity of the 1980-82 recession Third, trends in global inflation are discussed, again focussing on the different responses of countries after the two oil shocks. Fourth, movement

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in real and nominal interest rates are noted. Finally, the movements in non-oil primary commodity prices are examined, as these goods are major exports for many developing countries.

After reviewing the external shocks mentioned above, the resulting pattern of current account imbalances is examined, as are the various sources of balance of payments financing that were utilized.

The Oil Shocks

As the quotation by Cline in the introduction suggested, many analysts of the debt problem focus on the role of the oil price shocks in 1973/74 and 1979/80 as major causes of the debt crisis. There are several channels through which oil shocks might give rise to increased vulnerability of LDCs to debt servicing difficulties. The price hikes implied large real income losses for oil importing nations, although there is, of course, a corresponding gain for those nations that export oil. The impact that such income shocks have on domestic saving and investment, and hence the current account of the balance of payments, depends on at least two factors (i) the perceived degree of permanence of the oil price shock and (ii) the speed of adjustment of various categories of expenditure to the altered levels of income and relative prices.

Figure II-1 shows the history of real price of oil using the manufacturing unit value index as a deflator. Examining this Figure, it is clear that the size of the price hike of 1973/74 was indeed unprecedented relative to past movements in the time series. [2]/ LDC policy makers can

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[2]/ Cuddington and Urzúa (1987) have recently fit univariate time series to a number of real commodity prices before using the Beveridge and Nelson (1981) technique to decompose the price series into permanent and temporary

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hardly be faulted for not anticipating this "whammy" and taking preventative actions to reduce their countries' vulnerability to shocks of this sort. Such shocks are particularly difficult to cope with from a policy standpoint because of the high uncertainty regarding their duration. The past history of oil prices provides little guidance. Instead, one must rely on theoretical conjectures about the likely survival of cartels, etc. In these situations of acute "risk" (rather than statistical "uncertainty," to use Frank Knight's distinction), policies for coping with uncertainty per se, rather than reactive policies that attempt to distinguish "permanent" and "temporary" shocks are the best that can be hoped for. In the volatile external environment such as that following the first oil price hike, therefore, it is hardly surprising that policy responses in both industrial countries and LDCs varied widely. Some countries undertook contractionary aggregate demand policies to moderate the oil shock's inflationary impact. Others followed a more expansionary stance designed to reduce losses in output and employment.

********** insert Figure II-1 (real oil prices) **********

Fluctuations in World Economic Activity

Turning to movements in real GDP, Figures II-2 and II-3 show the behavior of world GNP and two groups of developing countries -- those in the IMF's "western hemisphere" (i.e. Latin American) and African groups, respectively -- from 1961 through the early 1980s as calculated and reported

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components. It is noteworthy that the oil price shocks of 1974 and 1979 had to be captured by dummy variables; they are indeed outliers.

by the IMF in International Financial Statistics. The behavior of world real GDP growth as measured by the IMF's index is indeed markedly different after 1973 than it was in the 1960s. Before 1973, it fluctuated rather narrowly between 3 and 6 percent. This was a period of relative stability for world GDP, although -- not surprisingly --the GDP of different regions and individual countries exhibited more volatility. After a drop from more than 5 percent in 1973 to less than 0.5 percent in 1975, GDP growth rebounded to five percent in 1976. Thereafter, the growth rate fell rather steadily through the trough of the worldwide economic slowdown in 1982.

It is noteworthy that the sharp drop in economic growth in 1974 as oil prices surged was felt more strongly by industrial countries than by either the Latin American or African LDCs (taken as regional aggregates). In Latin America, real growth continued relatively undisturbed by the adverse developments in the global economy. In fact, it wasn't until 1981 that their real GDP growth came to an abrupt halt. Presumably Latin America's growth rate was maintained largely by the heavy reliance on foreign borrowing in the latter half of the decade, although I know of no empirical work that attempts to disentangle this cause from other possible causes. Strong primary commodity prices in the mid-1970s undoubtedly also contributed to the moderate impact of the industrial country recession on a number of Latin American and African countries.

As Fig. II-3 shows, the African continent has experienced wide fluctuations in real GDP repeatedly over the last 25 years, although the continent's output growth reached new lows in the downturns of 1978 and 1982. The sharp downturn in 1978, at the time of the widespread drought, proved to be a mere preview of the persistent negative growth the region was to

experience in the post-1982 period when foreign loans dried up and primary commodity prices softened.

**********insert Figs. II-2 and II-3.**********

Inflation and Disinflation

Inflationary pressure in the IMF's Western Hemisphere and African country groups also differs significantly from the world aggregate. As Fig. II-4 shows, LDC inflation prior to the first oil shock was somewhat higher but otherwise roughly followed the trend in the as a whole (except in 1964). By the mid-1970s, however, inflationary trends began to diverge sharply. Africa experienced a relatively short-lived increase in inflation relative to the world aggregate in 1973-74. Latin America, in contrast, experienced steadily rising rates of inflation throughout the 1970s, with only a brief respite in 1977-78. An alarming acceleration in Latin American inflation occurred in the early 1980s.

The level of external borrowing in Latin America during the mid to late 1970s may have contributed to the diverging inflationary trends. Arguably these countries sustained high levels of economic growth by borrowing to support high, in fact excessive, levels of aggregate demand. This greatly moderated the economic downturn they experienced following the first oil shock, but with the cost of a sharp rise in inflation rates. This does not appear to be the case for the African continent as a whole (although it may characterize individual African countries well). Arguably, foreign borrowing facilitated at least a partial replacement of the larger drop in aggregate

demand that would otherwise have accompanied the drought-induced recession in 1978.

To the extent that Latin American countries had financed large fiscal deficits with large amounts of external borrowing, they were especially vulnerable when their access to foreign capital collapsed after 1982. They were forced to undertake fiscal adjustment or turn to money creation to finance the deficits. In many cases, the latter option prevailed. As a result, inflation skyrocketed.

********** insert Fig. II-4. **********

Primary Commodity Prices

The decline in developing countries' terms of trade during the world recession of 1980-82 is often mentioned as a factor that contributed to the debt build-up. Cline (1984, p.13), for example, calculates that "the total loss to nonoil developing countries from deteriorating terms of trade in 1981-82 was an estimate $79 billion." Much of this estimated loss presumably resulted from the downward movements in the prices of various primary commodities exported by LDCs. Table II-1 shows his calculations of the cumulative affect of a number of external developments impacting non-oil-importing LDCs: the oil price shocks, the deterioration in their terms of trade, and the surge in interest rates after 1979.

********** insert Table II-1 (from Cline, 1984, p.13) **********

It is a well-known fact that primary commodity prices exhibit considerably volatility over time. [3]/ This was true in the 1970s, but it was by no means peculiar to that period. The extent to which realized movements in commodity prices should be considered gains or losses in real income depends critically on one's impression about the "norm" as well as the persistence of deviations from the norm. In order to put various authors' estimates of LDCs' adverse terms of trade shocks into context, it is useful to review the historical behavior of fuel and non-fuel primary commodity prices. Grilli and Yang (1988) have recently produced an index of non-fuel primary commodity prices covering the 1900-86 period. Figure II-5 shows this index (GYCPI) deflated by two alternative indices of manufactured goods' prices, the manufactures unit value index (MUV) and the U.S. manufactures price index. The Figure certainly confirms the presence of a sharp deterioration in the relative price of primary commodities in terms of manufactures in the early 1980s, which is the basis for the real income loss calculated by Cline. When placed in historical context, however, the degree of volatility in primary commodity prices during the 1970s was not atypical.

********** insert Fig. II-5 here **********

For several reasons, it is somewhat misleading to argue that negative terms of trade shocks have played a major role in the creation of debt servicing problems. First, a number of debtor countries, namely those that

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[3]/ There is also an ongoing debate initiated by Prebisch and Singer about whether or not LDCs have experienced a secular deterioration in the relative price of commodity exports in terms of the price of imported manufactured goods.

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were oil exporters, greatly benefited from the surge in prices during the 1970s. In spite of this real income gain, many of them became mired in severe debt servicing problems as a result of massive "overborrowing." The experiences of countries like Nigeria and Mexico, which became major oil exporters during a decade when the real price of oil skyrocketed, serve as perhaps the most dramatic examples of this phenomenon.

Second, even if one considers only non-oil countries, should depressed commodity export prices in the early 1980s be considered as a factor contributing to the debt build-up? In fact, there was a sharp run-up in commodity prices (relative to the index's norm of roughly 100) during the mid-1970s, prior to the collapse in the early 1980s. [4/] Thus if one considers the negative income effect of the latter, one should also consider the income gain from the former.

The various commodity price booms during the 1970s ought to have reduced the external borrowing needs of LDCs exporting those commodities. A comparative analysis of LDC experiences with commodity booms by Cuddington (1988), however, shows that LDCs experiencing booms in the 1970s often responded by increasing not decreasing their use of foreign resources. In most instances, this borrowing strategy was hardly an optimal response to the opportunities provided by the export booms. Adept, well-planned management of temporary booms has been relatively rare. If the booms of the 1970s had been well-managed, less borrowing would have occurred and hence the resilience of these economies to subsequent downturns in commodity export prices would have been greatly enhanced.

[4/] Commodity prices continued to be soft well into the mid-1980s. More recently, they have again turned upward.

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I believe, therefore, that by looking at the downturn in commodity prices in the early 1980s, but ignoring the periodic years of strong price performance during the 1970s, one places too much blame for the debt crisis on external shocks and not enough blame on domestic policy responses by the LDCs themselves.

The Pattern of Current Account Imbalances during the 1970s

In the post World War II period, and especially in the 1970s as a result of two major oil price shocks, the pattern of current account imbalances and the requisite financing has shifted dramatically.

From the late 1800s through the early decades of the twentieth century, a major source of external finance for wealthier LDCs as well as a number of now-industrialized countries was private capital securitized in the form of bonds. This form of financial intermediation, however, dried up in the 1930s with the worldwide financial and economic collapse. Defaults on sovereign bonds were widespread. [See Eichengreen and Portes, 1989.]

In the first decade of the post World War II period, capital flows to developing countries were modest in size relative to the scale they had attained prior to the first World War. Official sources of development finance dominated, with private finance limited primarily to short-term trade credit. Private finance through the commercial banking system gradually grew in importance however. With the growth in trade and the importance of multinational firms, there was increasing pressure on banks in the major capital exporting countries (especially the US, but also in a number of European nations) to establish overseas operations to meet the global banking needs of their multinational clients. Thus by the late 1960s, and well

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before the first oil price shock in 1973/74, international banking activity -- much of it via the Euromarkets -- was growing rapidly.

External Adjustment to the Oil Price Shocks

The oil price hike in 1973/74 was undoubtedly the single most important disturbance to the global macroeconomy during the 1970s, although other primary prices and real interest rates also exhibited considerable volatility. Given that it was on the heels of the earlier price shock, the second oil shock, while also substantial in terms of magnitude, should not be considered to be nearly the "surprise" or "shock" that the first oil price shock was. Hence, adjustment to it might have been smoother had it not been for the large amounts of debt that many LDCs took on in their ill-advised attempts to borrow their way through the difficulties caused by dramatic shifts in the world economy.

Both the 1973/74 and 1979/80 oil price shocks entailed massive income transfers from oil-importing nations towards oil-exporters. These income shocks were, in turn, reflected clearly in the current account balances of both oil-exporting and oil-importing nations due to sharp differences in their propensities to save and invest in the years immediately following the price increases.

What happened to the global pattern of capital flows following the oil shocks of the 1970s? The current account surpluses expressed in US dollars for oil exporters, non-oil LDCs, and industrial nations are shown in Table II-2. Also shown is the total current account balance for these three broad groups taken together, which should be roughly equal to zero after allowance for trade with non-IMF-member countries of the Soviet bloc, timing

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asymmetries, etc. Clearly, our ability to carry out a detailed analysis of shifts in the pattern of international capital flows following the first and second oil shocks is severely hampered by the lack of overall consistency of data on current account balances: the residual balance of $107 billion in 1982 is embarrassingly large. [5] With errors and omissions of this magnitude any inferences about the direction and magnitude of international capital flows must be interpreted very cautiously.

********** insert Table II-2 here **********

on global current account patterns

Table II-2 estimates that the oil exporters current account surplus jumped from about $6 billion in 1973 to over $67 billion in 1974. By 1978 the surplus in the current account had disappeared. In 1979/80, however, oil prices surged again, causing the oil exporters surplus to leap to $60 billion in 1979 and over $100 billion in 1980. Interestingly, after the second oil shock, the current account surplus of the exporting countries evaporated much more quickly than it had after the first oil shock. This undoubtedly had important consequences for the speed with which countries with current account deficits had to adjust. However, the precise nature of these adjustments is difficult if not impossible to assess given the problems with the crudeness of the underlying data.

Current account movements in the industrial countries (ICs) were considerably less pronounced, particularly relative to the size of their

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[5] Recognizing this, the IMF has conducted a major research effort to account for and, where possible, to narrow the statistical discrepancy at the world level.

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aggregate GDP. (This level of aggregation, however, masks important income losses and concerted adjustment efforts undertaken by some ICs.) ICs as a group moved from a modest surplus position in 1970-73 -- perhaps 1-2 percent of total LDCs' GDP in terms of magnitude -- to a deficit of perhaps $22 billion in 1974. By 1975, the aggregate current account position of the industrial countries had apparently (i.e. taking the data at face value) moved back into surplus, so that they once again became net suppliers of saving to the world economy. This was temporary, however, as deficits reemerged in 1976 and 1977. Presumably these deficits reflected the generally expansionary aggregate demand policies pursued in ICs in order to limit and, in fact, reverse the output recession brought on by the first oil shock. In the 1980s, the ICs' current account deficits seem to have taken on a life of their own -- perhaps due, in part, to mounting data errors and omissions. According to the data in Table II-2, sketchy as they are, it appears that IC current account deficits reached a magnitude of 2-3 percent of total non-oil LDCs' GDP. At this level, crowding out of LDC demands for loanable funds from the world capital market would have been inevitable.

The aggregate behavior of non-oil LDCs' current account in the 1970s and early 1980s was quite different from the pattern exhibited by the industrial countries. First, these countries maintained deficits throughout the period. Their collective deficit moved from roughly 1 percent of their GNP prior to the first oil shock (although this may have been atypically low) to 4 percent of GNP in 1975. From there the deficit shrank to 2 percent of GNP, where it remained until the second oil shock.

Thus, one sees little attempt to adjust or at least little success in adjusting the current account back to its pre-oil shock levels. Instead, the

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current account deficit stabilized at a level that was roughly twice what it had been prior to 1973.

LDCs' tardiness in adjusting to the first oil shock -- or more precisely the decision to finance rather than adjust -- was aided by two developments. [6] First, the industrial countries returned rather quickly, albeit temporarily, to external balance so that the increased saving generated by oil exporters could be funneled to non-oil LDCs. Second, a number of LDCs benefited from surging commodity export prices. these booms offset to a considerable extent the negative income effect of higher oil import costs on their external accounts. The current account deficits of the non-oil LDCs peaked at roughly 4 percent of their aggregate GNP in 1981 and 1982 before being compressed over the next 5 years as voluntary lending ground to a halt in the wake of the debt crisis.

Unlike the first shock, LDCs were forced to adjust abruptly to the second oil shock as external funds became unavailable. In part this reflected the much faster erosion of current account surpluses in the oil exporting countries. In part, it was caused by growing industrial-country demand for external funding for ballooning government budget deficits. These factors affecting the supply of loanable funds in the international financial

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[6] The level of oil imports undoubtedly had a pronounced effect on the changes in current accounts experienced by various countries in the very short run. In the intermediate run following the oil shocks, on the other hand, Sachs (1981) has argued that changes in countries' patterns of fixed capital formation are much more important in determining what happened to individual countries' current accounts. These investment fluctuations may be exogenous shocks or responses of investment to shifts in the relative price of energy inputs. The latter may reflect the fact that oil is a key intermediate good. As firms reassess factor input mixes, major structural adjustments with high levels of investment may be needed. Second, decisions by domestic monetary and fiscal authorities on how to respond to the economic slowdown caused to higher oil prices may have a significant impact on investment.

markets, coupled with the dramatic change in market psychology regarding LDC creditworthiness led to a retrenchment of lending to most LDCs unequalled in their post-war histories.

Financing the Current Account Imbalances

Current account deficits, of course, need not imply a build-up in external indebtedness. Other financing methods include drawing down holdings of foreign exchange reserves, or selling equity rather than debt claims to foreigners. Nevertheless, there is a strong presumption that at least part of countries' current account deficits will indeed result in increased external borrowing. Table II-3 summarizes sources of financing for non-oil LDCs' current account deficits during the 1970s.

*** insert Table II-3 (source: World Economic Outlook, IMF, 1983, p. 194)

The 1970s witnessed a massive shifts in both the direction and the composition of international capital flows. The flow of capital from private sources in the industrial world via the international banking system gradually replaced official sources as the dominant provider of development capital to LDCs, as Table II-4 (from Fishlow, 1988) confirms. The possible role of such massive shifts in the pattern of international capital flows as a precondition for financial crisis is highlighted by Eichengreen and Portes. In "The Anatomy of Financial Crises," they (1987, p. 13) provide an interesting comparison of the systemic vulnerability of the international financial system during the 1920s and the 1970s:

> The 1920s were marked by three sets of developments which increased the international financial system's susceptibility to destabilizing shocks:

> flux in the foreign exchange markets, rapid institutional change in the banking system, and dramatic shifts in the volume and direction of international lending. Each set of developments had its immediate origins in the dislocations associated with World War I.

They go on to argue that the same factors were again at work in the 1970s but that institutional differences prevented the debt servicing crisis from becoming a full-blown financial crisis.

*** insert Table II-4 (from Fishlow, 1988, p. 193, Table 9-1).*******

Differing propensities to save and invest among the OPEC, OECD, and non oil developing countries had important impacts on both the supply and demand for funds in the international capital markets. Following the oil price shocks, a number of major oil exporting countries became large net savers, providing loanable funds to the banking system in unprecedented quantities. Although there was considerable concern about it at the time, the international banking system readily intermediated these funds to meet credit demands in both LDCs and many industrial countries. Lending to developing countries by the banking system continued to grow for the remainder of the decade, greatly outpacing the flow of official financing.

The abundant supply of loanable funds from OPEC following the first oil shock put considerable downward pressure on real interest rates. As Fig. I-4 (above) shows, the 6-month LIBOR deposit rate was forced considerably below its general upward trend in the mid-1970s. Spreads over LIBOR charged to LDCs also fell during this period. The softness in nominal interest rates coupled with rising world inflation rates drove real rates negative in 1975-77. (See the LIBOR rate deflated by the US GNP deflator in Fig. I-4 above.) Perhaps because of lack of experience with rising inflation, savers were slow

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to demand interest rates that adequately compensated for the rising inflation rate. Furthermore, as Fishlow (1988) has pointed out, banks viewed negative rates as a blessing: by pushing the repayment of principal into the future, they increased the debt load countries could sustain. Hence, aggressive lenders were able to easily rationalize their behavior.

From the point of view of LDC debtors, the negative real interest rates of the mid-1970s should hardly have been considered the historical "norm." [7] Rather these abnormally low rates should have been recognized as a temporary real income gain for debtor nations, just as high real rates at the end of the decade were represented real income losses.

Throughout the mid-1970s, new loans to LDCs from both official and private sources far exceeded their existing debt servicing commitments. Although loan disbursements peaked in 1982 (at $94 billion), net transfers to developing countries peaked much earlier -- in 1977 -- at roughly $30 billion. To some extent the shrinking net transfers was inevitable. As Diaz-Alejandro points out, a massive shift in the composition of industrial-country banks' portfolios took place as they expanded aggressively into the international arena in the late 1960s and 1970s. This portfolio adjustment to achieve international diversification was bound to trail off, as international investors went from a position of having too few LDC assets on their books towards a sustainable long-run equilibrium share of bank assets.

To some extent the diminished flow of financial resources from commercial banks to LDCs was also a natural consequence of the more rapid current account adjustment following the second oil shock. Recall that oil

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7/ One can examine the long history of real interest rates in the US compiled in Ibbotson and Sinquefield (1979) if there is any doubt about this.

exporters' surpluses of 1979/80 disappeared much more quickly than they had after the quadrupling of oil prices in 1973/74. At the same time, the major industrial countries were having increasing difficulty reigning in their aggregate demand policies, leading to considerable crowding out on a global scale -- as slow-adjusting LDCs ran head on into industrial countries with large fiscal deficits and restrained monetary policies.

Commercial Bank Recycling of Petro-Dollars

The oil exporting nations initially saved a large fraction of their greatly magnified export proceeds following the quadrupling of oil prices in 1973/74. In a number of the OPEC countries, domestic investment was limited by absorptive capacity among other things. Conservative investment attitude led to the deposit of funds in the Euromarket at short maturities. Because these funds were deposited in the Euromarket, commercial banks whose international operations had been expanding rapidly even before the price shock took a central role in the international financial intermediation process. In light of the fact that international loans were under-represented in bank portfolios in the early 1970s, there was considerable room for direct commercial lending to LDCs. This greatly reduced the burden for recycling petrodollar that fell on official lenders, including multilateral institutions such as the IMF and the World Bank. Unlike official lending, which had predominated during the 1960s, the recycling of petro dollars by commercial banks involved large amounts of maturity transformation. Even though interest rates were typically somewhat higher and the terms of maturity were typically shorter on commercial lending than

on official credits, many LDCs preferred the latter because of the absence of restrictive loan covenants and conditionality.

In addition to the improvement in loan terms as the market adjusted to absorb the massive supply of petrodollars, it is quite possible that many LDCs also experienced a relaxation in credit constraints imposed by lenders. Arguably, banks paid insufficient attention to LDCs' creditworthiness in their aggressive efforts to recycle petrodollars. As Hajivassiliou (1987, p 218) explains, "According to [the "petrodollar hypothesis"], the current debt problems in international capital markets have been caused to a large extent by "too easy" availability of credit following the influx of "petrodollar" in search of a borrower, that took place after the 1973 events, and by developing countries attempting to maintain their declining standards of living after the oil shock by obtaining higher external debts."

Hard empirical evidence on this point is skimpy, however. The one relevant article by Eaton and Gersovitz (1981) provides evidence on the prevalence of credit rationing in 1970 and 1974. They conclude that although the credit rationing was more prevalent than the unrationed regime in both years, relatively <u>more</u> countries were credit-constrained in 1974 than in 1970! Gersovitz's (1985, p.74) explanation for this finding seems to be that "bank lending was much less important [than official lending] before 1973-74." This explanation presupposes that commercial lenders are indeed more likely to impose credit limits than are official lenders -- a hypothesis that has not been tested.

Hajivassiliou (1987) examines the empirical support for the petrodollar hypothesis by including a post-1973 dummy variable in each of the three equations in his three-regime switching model (discussed above). The

variable was found to have a statistically insignificant impact on the supply of external credit, the allowable limit of arrears, and also on the demand for credit by the borrowing countries (after controlling for other explanatory variables, of course). Thus he is unable to find empirical support for the petrodollar hypothesis. Given the a priori plausibility of the hypothesis, I suspect that the test is not sophisticated enough. Hajivassiliou's data sample begins in 1970 (through 1982), so there are only four years that are not in the post-1973 period. His petrodollar dummy variable takes a value of zero in 1970-72, and a value of one for the rest of the sample period. It might help to extend the sample back in time. Also a more direct measure of the supply of petrodollars could be employed. For example, one might use OPEC's current account surplus or cumulative surplus after 1973 rather than the dummy variable just described to pick up the petrodollar impact.

Even though the empirical evidence on the petrodollar hypothesis is rather weak, most students of the debt crisis list the oil price shocks of the 1970s among the important causes, either because of their influence on LDC borrowing behavior and/or their influence on the level of world economic activity. Jeff Frieden (1983), however, takes issue with the common emphasis on the role of oil shocks in inducing developing countries to undertake massive external borrowing: "In this interpretation, the "oil shocks" of 1973-75 and 1979-80 drove the oil-importing LDCs to borrow heavily, while simultaneously flooding the Euromarkets with petrodollars available for lending." (p.3) He argues that:

> the big upsurge in commercial lending to LDCs began around 1969-70...
> Indeed, medium-term Eurocurrency credits to non-OPEC LDCs grew more rapidly between 1971 and 1973 than between 1973 and 1974. They reached an annual rate of increase of 87 percent between 1972 and 1973, compared

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> with a still considerable rate of 59 percent between 1973 and 1974. [8] By OECD figures, LDC debt to private lenders increased by 32 percent in 1971, 33 percent in 1972, 52 percent in 1973, and 32 percent in 1974. [9] By World Bank figures, total LDC debt to financial markets grew from $9.9 billion in 1971 to $22.7 billion in 1973, and then to $44.4 billion in 1975. [10] Thus major LDC borrowing from the international financial markets clearly began before the first "oil shock." (p. 4).

Do these facts presented by Frieden contradict Gersovitz's explanation (discussed above) of why credit rationing appears to have been more common in 1974 than in 1970. Perhaps not. Although the expansion of commercial bank lending to LDCs was well under way before 1974, the first oil shock induced a major change in the magnitude and direction of international capital flows. In particular, there was a massive wealth transfer to oil-exporting countries; these new suppliers of funds (OPEC) differed in important ways (e.g. they sought high liquidity and short terms) from the major source countries whose supplied funds to the Euromarkets in the pre-1974 period.

Retrenchment by Commercial Banks

Not only have commercial banks been accused creating the preconditions for a debt crisis by "overlending" in the mid 1970s, they have also been accused of bringing on the crisis in 1982 by abruptly cutting back on international lending. Carlos Diaz-Alejandro (1984, p.356) argues:

> what could have been a serious but manageable recession has turned into a major development crisis unprecedented since the early 1930s mainly because of the breakdown of international financial markets and an

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[8] R. C. Williams et al. International Capital Markets, IMF Occasional Paper No. 1. (Washington, D.C.: IMF, 1980), pp. 54-55.

[9] OECD, Development Assistance Committee, Development Cooperation: 1977 Review. (Paris: OECD, 1977), p. 211.

[10] World Debt Tables: External Public Debt of LDCs (Washington: World Bank, 1975).

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abrupt change in conditions and rules for international lending. (p.335)...In short, the 1982 collapse of a reasonably competitive, if flawed, international capital market (at least for Latin America) constitutes the major external shock to the region during the early 1980s.

This interpretation of events is somewhat controversial. Paul Krugman (1984, p.391), in the published comments on Diaz-Alejandro's paper, complain that "the sharp cutback of new lending to debtors in 1982-83 is treated [by Diaz-Alejandro] as an exogenous event -- rather as if Robert Shiller [a well respected rational-expectations macroeconomist] had descended from heaven and decreed lending to Latin America suddenly unfashionable. This is not a satisfactory procedure...I would prefer to regard domestic economic management, the terms of trade, and interest rates as the fundamentals here, and the supply of funds as an endogenous variable. This supports a view that assigns heavy weight to the external factors, but it does so to a somewhat less dramatic extent than this paper's approach."

Diaz-Alejandro's discussion of the role of international banks in reducing lending ignores the evolving structure of current account imbalance following the first and second oil price shocks. As mentioned above, the huge current account surplus of the oil exporting countries was dissipated only slowly --over a four year period-- following the first oil shock. The corresponding deficit of the industrial countries shrank very quickly. In fact, they restored their earlier surplus position by 1975 (although it subsequently deteriorated again). The non-oil LDCs, on the other hand, sustained large current account deficits. Relative to their pre-shock levels, they were major recipients of capital in the form of recycled petro dollars.

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The pattern of current account imbalances following the second oil shock was quite different. First, the surplus of the oil exporting countries was dissipated within two years; thus these countries provided loanable funds only temporarily. Second, a number of industrial countries became large capital importers -- at least, if the data are taken at face value in spite of the large statistical discrepancy at the global level. In addition to these factors, differencing perceptions about the permanence of the two oil price hikes and the growing caution about further lending to developing countries undoubtedly also played a role in reducing commercial lending to LDCs.

With the aforementioned factors contributing to a greatly reduced inflow of petrodollars to the commercial banks, a sharp cutback in lending was unavoidable. It is not clear from casual inspection of the data that there was, in fact, "an abrupt change in conditions and rules for international banking" as Diaz-Alejandro (p. 335) argues.

III. LDC Policies

A number of LDC policies potentially affect the country's vulnerability to debt servicing problems, particularly if the external economic environment becomes unfavorable. These include: (1) its external borrowing strategy, i.e. the extent to which foreign capital is used, as well as the management of the sources, maturity structure, and contractual aspects (notably fixed verses variable interest rates) of the debt, (2) exchange rate management, (3) trade orientation and other policies affecting market incentives in allocating resources, and (4) aggregate demand policies. In addition, countries may differ significantly in terms of structural characteristics. These, in turn, affect the distributional impact as well as the political and economic feasibility of various policy options.

Foreign Borrowing Strategy

When considering possible causes of the debt crisis, two difficult questions must be addressed: (1) did developing countries borrow "too much" from external creditors? and (2) were the borrowed funds used efficiently? The second question is really part of the broader question of whether the LDC's economic structure and policy environment is conducive to overall efficiency in resource allocation. Many policies play a role here, among them: credit allocation rules, exchange rate management, trade orientation (i.e. taxes, subsidies and quantity constraints facing exporters and importers), and government expenditure and revenue-raising policies. To the extent that these policies cause borrowed resources to be misallocated, they increase the difficulty in servicing the debt. In extreme cases, national

welfare can actulally be lowered by using foreign capital. [1]

Overborrowing? It is often claimed, without detailed empirical support, that many of the LDCs currently experiencing debt problems are suffering the consequences of earlier "overborrowing." In fact, evidence addressing this issue is hard to obtain. Analytical considerations, however, provide some insights. From a conceptual standpoint, there are a number of market failures that might give rise to overborrowing in a laissez-faire environment. [2] These points are taken up in this section.

First, the concept of overborrowing must be clearly defined. Suppose we interpret the term in its welfare-theoretic sense: it is a situation where private incentives or unenlightened government borrowing cause the country's level of foreign indebtedness to exceed the socially optimal level. Before there can be a need for foreign borrowing strategy (i.e. government policy action to prevent inappropriate levels of borrowing), one must believe that there is a discrepancy between the private and social costs and/or benefits of external borrowing.

At least two welfare distortions that might give rise to overborrowing come to mind. The first is based on the well-known optimum tariff argument: if the country's cost of borrowing rises as it takes on more debt, then the marginal cost of borrowing lies above the average cost. Policy action to limit borrowing to the point where the marginal cost equals the marginal (social) benefit is required. [I know of no countries that implement this policy by imposing an optimal tax on foreign borrowing. Many countries, on

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1/ See Brecher and Diaz-Alejandro (1977).

2/ For a more detailed discussion of this issue, see Cooper and Sachs (1985, pp. 42-45).

the other hand, have quantitative limits on borrowing. These limits may or may not be designed to achieve the above-mentioned objective.]

There is a second justification for policy limits or optimal taxation of foreign borrowing: to reduce the probability of financial distress, which rises sharply with the level of borrowing or "leverage." Using an analogy with individual firms, sovereign nation states can grow more rapidly (in terms of per capita consumption and dividend payments, respectively) to the extent that they undertake investment projects whose net present value is positive. In financing such investments, countries -- like companies -- must decide on the appropriate balance between self-financed internal growth and the use of external resources (in the form of debt or equity finance). Other things equal, a country becomes more vulnerable to economic shocks -- such as fluctuations in the prices of oil imports or primary commodity exports, or surging world interest rates, etc. -- when it takes on higher levels of external debt. Excessive reliance on debt, by increasing the "financial leverage" of the country as a whole, raises the likelihood and expected costs of "financial distress" in the event of adverse economic or political shocks. [3]/ These costs can be extremely high for borrowers as well as their creditors, as recent examples of third world debt and US real estate financing problems vividly illustrate. [4]/ Even if the borrowed funds are used efficiently, high financial leverage has potential costs. When loans are funneled into inefficient investment or excessive consumption, the

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[3]/ In addition, the probability of increased debt inducing financial distress depends on the maturity structure of the debt and whether it is contracted at fixed or variable interest rates.

[4]/ See Brealey and Myers (1988) for a good textbook treatment of the costs of financial distress.

potential for financial distress is exacerbated.

Given these negative externalities of borrowing, unmonitored borrowing by either a decentralized market system or semi-autonomous governmental bureaucracies will lead to overborrowing. [5] Hence, a well-articulated borrowing strategy makes good sense.

The Use of External Funds

Capital flows provide recipient countries with the potential to expand domestic consumption more smoothly and/or more quickly than would otherwise be possible. There are attendant costs, however, in terms of reduced national autonomy and financial flexibility, as was emphasized above.

Regarding the consumption-smoothing motivation for borrowing, it is countercyclical borrowing that enables consumption smoothing along the lines dictated by the permanent income theory of consumption. This type of borrowing may be limited by the prevalence of credit constraints, which tend to be adjusted procyclically rather than countercyclically by creditors. Furthermore, the credit ceiling is often not exogenous from the borrower's standpoint either. It may be a function of the use to which funds are put. Countries with high investment ratios allegedly face more liberal credit constraints than countries with potentially unsustainable consumption rates. [Unfortunately the estimated supply-of-funds schedules in the regime-switching models of Eaton and Gersovitz (1981) and Hajivassiliou (1987) do

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[5] The tendency for overborrowing can not, of course, result in excessive levels of actual borrowing unless there is complicity on the part of creditors. Widespread allegations of "loan pushing" by bankers who were rewarded on the basis of the volume of loan commitments rather than the ultimate profitability of that lending suggest that the precondition of careless lenders was met in the 1970s.

not include the investment/GDP. Thus their models provide no empirical evidence on this issue.]

The second motivation is to undertake profitable capital investments. These investments raise the economy's economic growth rate and hence permit higher steady-state levels of consumption. Whether foreign borrowing did, in fact, raise countries' economic growth rates during the 1970s is an open question (addressed below).

Two other uses of capital have also been of considerable importance during the debt build-up of the 1970s. As Table II-3 above shows, the level of external borrowing of non-oil developing countries more than covered their current account deficits over this period. Part of the difference reflected a substantial build-up in foreign exchange reserves (shown as negative numbers in the Table). In some countries (e.g. Venezuela) these reserves were so large as to make it essential to look at both gross debt and debt net of official reserves in order to get an complete picture of their debt burden and vulnerability to changes in world interest rates.

The Role of Capital Flight

A second form of foreign asset accumulation, private "capital flight", has received much greater attention as a contributing cause of the debt

problems. Capital flight is notoriously difficult to estimate. There is a lack of agreement on how it should be defined (Lessard and Williamson, 1987). Even once a definition is agreed upon, the very nature of capital flight makes it difficult to measure. In some countries, domestic capital can be moved abroad only by violating capital controls. In others, the export of capital may be perfewctly legal. The motivation for moving capital abroad may be to escape domestic taxation or to hide illegally earned income from the purview of domestic authorities. The incentives to "cover the tracks" of flight capital are obvious; hence the difficulty in measuring its extent.

Based on early estimates using various residual techniques calculated from balance of payments data (Cuddington (1986), Dooley et al (1986), Morgan Guaranty (1986), there seems to be general agreement that capital flight in the 1970s and early 1980s was large in several Latin American countries, most notably Mexico, Argentina, Uruguay, and Venezuela. Outside Latin America, the Philippines appears to be the country where capital flight has been most problematic.

A recent paper by Cumby and Levich (1987) provides an extremely useful comparison of earlier estimates using a common data base. Their work plus that of other researchers led to the "best guess" estimates summarized in Table III-1, which was taken from the summary chapter in Lessard and Williamson (1987).

********** insert Table III-1 here **********

The massive capital outflows estimated in Table III-1 occurred during the very period when these countries were borrowing so heavily abroad.

Hence, the question arises whether capital flight has been an important "cause" of the debt crisis. Of course, such two-way flows of capital might reflect portfolio diversification or maturity transformation occurring on a global scale. In the absneca of market failures, they need not be a policy concern. When capital-scarce developing countries that borrow heavily in the international capital markets are involved, however, there is a strong presumption that massive private capital outflows are socially counterproductive. In short, capital flight is usually a reflection of highly distorted private incentives rather thantha true opportunity cost of capital in the home market. Policy intervention to limit such capital flows may indeed be justified.

The limited empirical work on the determinants of capital flight points to the overvaluation of the exchange rate as perhaps the most important macroeconomic factor. (Dornbusch, 1985; Cuddington, 1986). Other empirically-significant determinants of capital flight include domestic (relative to foreign) inflation and interest rates, (Cuddington, 1986), the domestic economic growth rate (Conesa, 1987), and in some countries, the level of loan disbursements (Conesa, 1987; Cuddington, 1987). These variables are, for the most part, best interpreted as only the proximate causes of capital flight. They are, like capital flight itself, best viewed as symptoms of underlying macroeconomic disequilibrium. These same distortions often give rise to overborrowing. It is therefore rather simplistic to view capital flight as an independent cause of debt servicing problems.

The Impact on Domestic Saving and Investment

Even if overborrowing in the welfare-theoretic sense did not occur during the 1970s, there is the question of how efficiently borrowed funds were utilized. If there were no distortions affecting domestic saving and investment behavior (such as regulated sub-market interest rates and administrative credit rationing mechanisms), foreign capital inflows would generally cause both higher levels of investment and reduced domestic saving, i.e. higher private or public consumption. Indeed this is an efficient response. The relative magnitudes of the effects on investment and saving will depend on their respective interest elasticities. It is incorrect to conclude, as is often done, that funds have been allocated inefficiently if capital inflows are not reflected one-for-one in higher investment.

On the other hand, if financial repression keeps domestic saving far below its socially optimum level, further declines in saving resulting from increased foreign borrowing would be cause for policy concern. By exacerbating existing welfare distortions, borrowing may impose high costs on the economy. Current and future growth will be hampered, and financial distress in the event of a world recession will become more likely.

Views differ widely on the extent to which borrowed funds have been funneled into investment rather than consumption and the extent to which the funds devoted to investment have been used productively. According to Kharas and Levinsohn (1988), for example:

> Conventional wisdom holds that less developed country (LDC) debt rescheduling problems reflect, in part, the failure of borrowers to invest their loans in productive activities with returns, evaluated at border prices, higher than the interest rate on their debt. This worry became particularly acute because of the rapid switch of external financing in the 1970s away from official sources, mostly tied to closely supervised investment projects, towards commercial loans without such ties...The perceived danger was that such loans could be used to

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finance consumption and... would lead to long-term insolvency. Indeed most non-oil developing countries had lower average savings rates after 1973. [Middle-income oil-importing developing countries on average had savings rates of 21.5% in 1973 and 18.0% in 1981.]

Dornbusch and Fischer (1986) claim that:

> A large part of Latin American borrowing was wasteful or unjustified in that it primarily financed consumption and government deficits rather than investment. A very significant part of the increase in external debt has as its counterpart capital flight by residents of those countries.

Cline (1984, p.16) apparently disagrees, stressing that:

> Aside from the notable amount of capital flight in [Argentina, Mexico, and Venezuela], the use of most borrowing appears to have been productive. Thus, domestic savings did not decline in the 1970s when external financing was heavy. For middle-income oil-importing countries, gross domestic savings were 21 percent of GDP in 1980 compared with 19 percent in 1960, and gross domestic investment was 27 percent compared with 21 percent, [7]/ suggesting that not only did foreign financing help increase domestic investment, but also that it was not used for the purpose of raising domestic consumption and reducing domestic savings. Similarly, for 10 major borrowing developing countries, the average savings rate rose from 20.6 percent of GNP in 1965-73 to 21.9 percent in 1974-79, and the investment rate rose from 20.4 percent to 22.6 percent. [8]/

The World Bank also echoes this view in the 1982-83 <u>World Debt Tables</u> (p. vii):

> The resulting special difficulties encountered by the developing countries in the turbulent opening years of the 1980s do not support the widespread contention that banks lent imprudently to developing countries as a whole during the 1970s and that the countries wasted the proceeds. On the contrary, the record shows that most of them used external capital for productive investment, which sustained their growth and helped them increase their capacity to earn foreign exchange.

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[7]/ <u>World Development Report</u> 1982 (Washington, D.C.: The World Bank, 1982), p. 118.

[8]/ Jeffrey D. Sachs (1981, 201-68).

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The evidence they provide to substantiate this conclusion is suggestive, although hardly definitive. [9]

Kharas and Levinsohn (1988) attempt to examine the empirical validity of the conventional wisdom (in their quotation above) by addressing two questions: (1) has increased foreign borrowing been associated with a fall in average savings rates (or, equivalently, a rise in the consumption share of GDP)? and (2) has there been a discernable difference between the marginal propensities to consume out of project and non-project foreign financing? Due to lack of disaggregated data for addressing the latter question, they resort to a simpler test, namely checking for structural breaks in individual countries' consumption functions between the 1960s and early 1970s -- when project financing presumably dominated -- and more recent years -- when non-project financing became increasingly important.[10] Their empirical work covering 26 LDCs finds 12 countries that experienced significant rises in consumption when foreign borrowing increased. (As the authors recognize, however, this is not necessarily indicative of a welfare loss from borrowing for the reason outlined above). Nevertheless, some countries exhibited very high propensities to spend out of borrowed funds, leaving little for increased investment (unless the capital inflow causes a large multiplier effect on national income). [11] In Bolivia, for example, the marginal propensity to spend out of foreign loans was .88; in Colombia, it was .99;

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[9] See World Debt Tables, 1982-83 edition, p. ix.

[10] The exact year of the structural break differed from country to country based on their detailed knowledge of each countries circumstances.

[11] It would have been informative to estimate the impact of foreign borrowing on the domestic investment function directly.

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in Guyana, 1.2. Certainly, on the basis of this evidence, the hypothesis that foreign borrowing facilitated a consumption binge in these countries can not be ruled out, but more comprehensive and conclusive evidence would certainly be desirable here.

Regarding the possibility of different propensities to consume out of official loans and private loans, Kharas and Levinsohn conclude: "for most developing countries there is no strong evidence that the expansion of non-project lending in the 1970s led to a structural change in the propensity to consume out of foreign inflows." (1988, p. 782). "It appears that from a macroeconomic view, foreign funds have been sufficiently fungible with domestic resources such that their impact on domestic investment and consumption has remained unchanged, regardless of whether the loans were tied to specific projects or not." (1988, p.785).

Investment Efficiency

Were the borrowed funds that found their way into investment rather than financing higher current consumption or capital flight used efficiently? Even if one concludes that LDCs used a large portion of their external funding for investment, the question is the efficiency of this investment remains, in part due to inherent difficulties in measuring the productivity of investment. Diaz-Alejandro (p.338) argues that some, but not all, Latin American debtor suffered from a deterioration in investment productivity after 1973:

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Using gross fixed investment and GDP data, one can compute marginal capital-output ratios to obtain a rough index of the productivity of the investment. With three-year averages and investment lagged one year the ratios are as follows:

	1961-63 to 1971-73	1971-73 to 1979-81
Argentina	4.4	11.1
Brazil	2.9	3.3
Chile	3.8	5.0
Colombia	3.1	3.3
Mexico	2.5	3.1
Venezuela	4.2	7.2

Brazil, Colombia, and Mexico - the fastest growers - had the lowest marginal capital-output ratios, and the ratios increased only slightly from one period to the next. Argentina, Chile, and Venezuela not only had lower investment productivity (which could be due either to supply inefficiencies or to poor management of aggregate demand) throughout the years under study but also experienced a sharp decline in that productivity after 1971-73. For Venezuela, disaggregation into oil and non-oil sectors might yield a better picture for the non-oil sector: non-oil output has grown more than OPEC-restricted petroleum production since the early 1970s.

Although the changes in these incremental capital/output ratios (ICORs) over time are suggestive, it should be noted that similar calculations for the early 1980s would yield meaningless values, because income growth turned negative in many countries and resulted in considerable excess capacity. This highlights the limitations of such crude aggregate measures of investment productivity. It would be highly desirable to investigate the ex post profitability of foreign-financed capital investments on a project by project basis to shed more light on the rates of return realized in proactice.

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The Impact of Foreign Borrowing on Economic Growth

The information on the productivity of capital investment in various LDCs does not yield unambiguous conclusions regarding the efficiency with which external funds were utilized. Hence, in the absence of detailed econometric work, further circumstantial evidence makes a contribution. The 1982-83 edition of the World Debt Tables makes a simple comparison of economic growth rates across countries with low and high levels of foreign borrowing. It concludes that regions where borrowing was heavy did seem to grow more rapidly during the 1970s. Unfortunately, the extent to which differential growth performance might be explained by factors other than use of foreign funds is unclear. [12]

Policies that Alter Incentives

Many government policies in LDCs have a rather direct impact on the allocation of both domestic and foreign resources. Here we focus on two of them: exchange rate management and trade orientation. These policies are important because they affect the likelihood that funds borrowed abroad will be employed efficiently, thereby insuring that the debt can later be serviced. In economic environments that are highly distorted, the potential for gross misallocation is much greater. In addition to their impact on long-run economic growth, the two policies affect the economy's ability or flexibility to respond to external shocks. That is, adjustment is much less costly in efficient economies than in economies with major rigidities and

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[12] It would be interesting to extent the literature on comparative growth performance, most notably Kormendi and Meguire (1985) and Fry and Lilien (1986), by including foreign borrowing among their list of explanatory variables.

distorted incentive structures.

The Relative Importance of External Shocks: Their Size and the Policy Response

Several authors have examined the relative importance of external shock and internal policies in contributing to debt problems. (See, e.g. Balassa (1982, 1984), Donovan (1984), and Sachs(1985)). At this point, there seems to be general agreement that the incidence of debt servicing problems does not depend in any systematic way on the magnitude of the external shocks faced by developing countries during the 1970s and early 1980s. Rather, countries' policy response to external shocks and their economic structure, rather than the magnitude of the shocks *per se*, determined which countries adjusted efficiently and which became ensnared in debt servicing problems Almansi (1988, p.1) summarizes the received wisdom as follows:

> Recent studies by Balassa (1984, 1986) and Sachs (1985) have provided renewed support for the belief, very popular in the development literature, that the economic performance of a developing country facing an external shock is explained mainly by the country's policy response to it, and not by the shock's direct effects on the country's economy. In particular, different commercial policies are credited with success of failure in preserving economic growth after the onset of the "debt crisis" in 1982. Both Balassa and Sachs point to the contrasting experiences of countries in East Asia and Latin America in the aftermath of such events.

While some LDCs experienced shocks that reduced their real income, others -- most notably the oil exporting countries, but also the exporters of other primary commodities (discussed above) -- benefitted from net positive shocks. The latter group includes countries such as Mexico, Venezuela, and Nigeria (among others) which nonetheless encountered debt servicing problems.

Studies by Donal Donovan (1984) and Nuriel Roubini (1985) also emphasize the importance of countries' policy responses to external shocks. These

authors find the magnitude of terms-of-trade movements was not markedly different for groups of reschedulers and nonreschedulers. Commenting on these papers, Sachs (1985, pp.529-30) notes that "while the cumulative terms-of-trade movements during 1978-83 were comparable for the two groups, Roubini shows that for the rescheduling group, the terms of trade improved more during 1977-81 and then fell more during 1981-83 than it did for the nonreschedulers. This finding seems to hinge on the heavy representation of oil exporters in the rescheduling group."

Regardless of whether oil exporters are involved as Sachs conjectures, this observation suggests that positive terms of trade shocks are more likely to induce excessive debt build-up and subsequent debt servicing problems than are negative shocks. Perhaps this is because credit constraints are relaxed by lenders during periods when borrowers' export markets are booming. In such situations, the booming LDC often rushes to take advantage of the greater credit availability. Unless the funds can be invested wisely, however, the country's debt servicing burden will grow. This scenario has been all too common. [See Cuddington, 1988, for a discussion of developing economies that experienced booming commodity export markets at some point during the 1970s and yet later encountered debt serving difficulties.]

Trade Orientation

Balassa (1982, 1984, 1986) among others has stressed the importance of a country's trade orientation in determining the efficiency with which it adjusted to the external shocks of the 1970s. He claims that although "outward oriented economies" are more vulnerable to external shocks because of their greater openness to trade and international capital movements, they

also exhibited greater resilience in adjusting to these shocks, thereby avoiding excessive reliance on external borrowing.

Balassa notes that trade orientation is highly correlated with "free market orientation" or a relatively non-interventionist stance by the public sector:

> Outward-oriented economies by-and-large adopted realistic exchange rates and interest rates; gave similar incentives to industry and agriculture; eschewed price controls; limited the scope of public investments while giving attention to efficiency considerations in the choice of these investments; and had a relatively small deficit in the government budget. By contrast, inward-oriented economies tended to have overvalued exchange rates and negative real interest rates; biased the system of incentives against agriculture; made use of price controls; had a larger share of often inefficient public investment projects; and incurred relatively high budget deficits. (1984, p.9). [13]

Balassa (1984, Table 2) provides estimates of the external shocks faced by non-oil developing countries in two five-year periods: 1973-78 and 1978-1983. Countries are grouped according to whether the author considered their trade orientation to be outward-oriented or inward-oriented. Perhaps not surprisingly, the group of outward-oriented economies suffered adverse shocks of greater magnitude due to their openness to trade and/or international capital movements. In 1974-76, the outward-oriented countries' external shock amounted to 6.4 percent of GDP, while inward-oriented economies experienced a negative shock of roughly 3.5 percent. Similarly in 1979-81, outward-oriented economies faced external shocks equal to roughly 11.1 percent of GDP, while inward-oriented economies' external shocks were only 4.2 percent of GDP. This characterization included the net effect of adverse

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[13] Balassa refers the reader to his 1982 paper for the corroborating evidence on this point.

terms of trade movements, declining export volumes, and (in the 1979-81 subperiod) rising world interest rates. The same pattern emerged between outward-oriented and inward-oriented countries when the various external shocks were considered separately.

Almansi (1988) is skeptical about the received wisdom (summarized in the above quotation from his paper). He notes that this view is based, in part, on the empirical observation that Latin American debtors adjusted to the cut-off in external credit by reducing imports by more than the collapse in their exports. In contrast, Asian debtors adjusted by expanding exports more rapidly than imports. Through the use of a simple analytical model, he shows that these differing outcomes may be the consequence of structural differences in the economies of the two regions, rather than their trade orientations. His model assumes that the Latin American economies export primary products and import manufactures. For Asia, the opposite trade pattern prevails. Manufactures require intermediate imported goods, whereas primary products, by assumption, do not. In this context, if governments in both regions protect their respective import-competing sectors by placing quantitative restrictions on final-goods imports, an exogenous reduction in the availability of foreign capital (as happened in the early 1980s) will cause very different outcomes: Asia will expand exports by more than the growth in imports. Latin America will contract imports by even more than the fall in exports. Almansi's point is that these differing responses of exports and imports in the two regions need not tell us anything about differences in their trade orientations. He concludes that: "Beyond the particular details of the example studied here, the main implication...is that we should pay more attention to structural differences, and less to

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political idiosyncrasies, in order to understand policy behavior in developing countries." (1988, p.11) Perhaps more importantly, one must be careful not conclude that all changes in import/GDP and export/GDP ratios reflect policy changes rather than endogenous economic adjustments (efficient or otherwise).

While Almansi's argument is quite compelling if one considers trade changes in the post-1982 adjustment period, Latin America and Asia have exhibited very different long-term trends in export performance -- presumably in large part because of their trade orientations. As Sachs (1985, p. 536) argues, "It is not easy to get good measures of the size of the tradeables sectors over time... The typical recourse...is simply to measure the extent of actual exports relative to total income to get an estimate for the growth of the tradeables sector. Though admittedly imperfect, the data strongly indicate the rapid growth of exports relative to GDP in East Asia since 1965 compared with a fairly flat pattern in Latin America." [my emphasis]. Sachs also attempts to assess differences in economic structure (in part, policy-induced) by comparing the sizes of the service sectors in Asia and Latin America: "The data [in his Table 5, not reproduced here] suggest that the Latin American countries have a much larger service sector, and hence presumably a much larger nontraded goods sector, than do the Asian economies." (1985, p.537). Countries with large nontradeables sectors will, Sachs believes, feel less pressure to carry out rapid external adjustment than countries with small nontradeables sectors.

Exchange Rate Management

By and large, LDCs that encountered debt servicing problems experience much more dramatic movements in their real exchange rates in the early 1980 than countries that avoided difficulties. This reflects their exchange rate management policies as well as other policies (e.g. expansionary fiscal policy) that affect real exchange rates. Table III-2 (from Sachs (1985)) compares the real exchange rate movements and black market exchange premia Latin America and Asia over the 1976-1983 period. There is a clear tendency towards large real appreciations in the former region compared to the latter. It seems highly unlikely that underlying determinants of equilibrium real exchange rates justify these changes in actual rates. Presumably, exchange rates were, in fact, becoming severely overvalued in a number of the Latin American debtor nations as inflation skyrocketed relative to world rates. (Recall Fig. I-4 above.)

Overvalued exchange rates contribute to debt problems through a number of channels. First, they undermine the competitiveness of the country's exports while making imports seem artificially cheap. The result is unsustainable current account deficits, which are financed by external borrowing. As we discussed, exchange rate overvaluation also fuels capital flight by creating expectations that a devaluation is imminent. Capital flight, in turn, contributes to the erosion of the domestic tax base. Unless public expenditures can be reduced correspondingly, foreign borrowing and/or domestic money creation must be used more aggressively.

********** insert Table III-2 (from Sachs, 1985, Table 6, p.541). **********

Structural and Income-Distribution Considerations that Limit Policy Choice

A recent study by Berg and Sachs (1988) has gone beyond the use of simple financial indicators in simple econometric models of debt servicing problems. Their objective is to get at some of the political economy considerations that make it difficult for LDC policy makers to undertake the policies needed to avert servicing difficulties. Hence they investigate the potential role of several structural characteristics of individual debtor countries. [14]

Like earlier work by Balassa (1982, 1984) and Sachs (1985), they show that a country's foreign trade regime is an extremely important determinant of debt crises (defined as the occurrence of rescheduling of debt to private creditors). Unlike earlier work, which proxied the orientation of trade policy with output-based measures such as growth in the export/GDP ratio or the excess of this ratio relative to a predicted value, Berg and Sachs use a World Bank measure of the orientation of trade policy itself. Their findings corroborate existing research concluding that outward-oriented trade policy not only enhances growth prospects, it also improves their capacity to adjust to external shocks.

Berg and Sachs maintain that: "For many countries, the debt crisis reflects a political crisis as well as an economic crisis." (p. 12). This leads them to consider a number of political determinants of rescheduling in their cross-section of 35 developing countries. These structural variables

[14] In addition to fitting a simple probit model attempting to explain the cross-country pattern of reschedulings and no reschedulings, they use a tobit model to explain the level of the discount on an LDC's bank debt in the secondary market, arguing that this discount is a good cardinal measure of creditworthiness. The conclusions regarding the statistical significance of the foreign trade regime, as well as their measure of income inequality and the agricultural share of GDP remain are similar across the two models.

are: (i) the fraction of total income obtained from the agricultural sector and (ii) the extent of income inequality. The latter is measured as the ratio of the percentage of total income received by the 20 percent of the households divided by the percentage of income received by the poorest 20 percent. They conjecture that: "a high degree of income inequality should be associated with a high probability of rescheduling, since the income inequality undermines the political stability and political effectiveness needed for successful macroeconomic management." (p.14) Regarding the first variable, they argue: "The share of agriculture in production is included to offer a rough indication of the extent to which governments can derive their political backing from rural interests rather than urban interests." The theory is that a rural power base tends to be more stable and more supportive of export-promoting policies. (The authors provide a detailed discussion of the political science literature elaborating on these hypotheses in order to provide adequate justification for the explanatory variables chosen.)

One potential shortcoming of the Berg-Sachs work is that it ignores supply-side considerations: why do creditors who observe undesirable structural or political characteristics lend amounts sufficient to create servicing problems in such countries? It would be interesting to include the Berg-Sachs measures for political and structural characteristics in the supply and demand schedules for foreign loans in a three-regime model of the sort estimated in McFadden et al (1985) and further improved upon by Hajivassiliou (1987).

Conclusion

The hope in 1982 when the debt crisis emerged was that it would be short-lived. The resumption of economic growth in the major industrial countries would remove the potential threat to the stability of the international financial system, and previous levels of capital inflow to LDCs would be restored.

More than seven years after the onset of the crisis, the threat to the banking system has been alleviated. From the point of view of developing countries, however, the debt problem is perhaps the number one economic development issue; its is likely to remain so throughout the 1990s. Early hopes that a couple of years of strong economic growth would allow major debtors to emerge from their debt traps proved to be wildly optimistic. Without substantial debt forgiveness, the debt "work out" period to bring creditworthiness indicators back into the "acceptable" range will be a very long one. [14]/ So far, none of the countries that rescheduled debt in the 1980s has subsequently succeeded in obtaining voluntary loans from the private credit markets (except in conjunction with World Bank cofinancing). Highly indebted LDCs in Latin America and Africa remain in a state of seige, threatened by impatient creditors, on one hand, and restless domestic constituents, on the other.

The need to consider alternative policy actions by official institutions, both national and multinational, is as real today as it was at the time of the Bank's earliar conference on developing country debt in early 1984. Yet the nature of the proposed solutions will undoubtedly have a

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[14]/ See Selowsky and Van der Tak (1986) for a simulation exercise that substantiates this claim.

somewhat different emphasis. Today, concerns for stability of the international financial system are less acute. The primary issue is how to regain the development momentum of the 1960s and early 1970s. Is this best done through more lending, or less lending? What are the merits of case-by-case verses more generalized debt forgiveness schemes?

The purpose of the present paper is not to evaluate alternative courses of action. That is the task of other authors at this conference. This paper's objective was to set the historical stage, by reconsidering the role of debtors and creditors, as well as other parties, in bringing on the crisis. As we anticipated earlier, there is lots of blame to go around. Our analysis of causal factors also considered the contribution of policy actions by the OPEC and the OECD countries. The price shocks of 1973/74 and 1979/80 and the industrial countries' macroeconomic policy response, which adversely affected national economies in both the industrial and developing worlds to some extent, were highlighted. These shocks were by their nature global or systemic rather than country-specific. They shaped the international environment in which the massive expansion in sovereign lending occurred. Their impact, however, varied greatly from country to country depending on their past macroeconomic, financial, and development strategies. LDCs with bad policies accumulated large amounts of debt without a corresponding increase in their productive capacity. Hence their economic and financial flexibility has been weakened considerably.

Part III of the paper reviews the role of internal policies in the LDCs themselves in contributing to debt problems or helping to avoid them. It concludes that debt ridden countries typically share the following characteristics: they have highly distorted price systems as a result of

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overvalued exchange rates, and inward-oriented trade policies. Furthermore, they often responded inappropriately to transitory booms and busts, leading to fiscal disequilibrium and unsustainable deficit financing strategies.

Although these policies caused some countries to become especially vulnerable to worldwide economic downturns, domestic reforms to correct policy distortions will probably not be sufficient at this point to un-do the damage inflicted by the current debt overhang. Although bad policies by individual LDCs may well have caused their difficulties, good policies by creditors and the international community are now required to extricate them.

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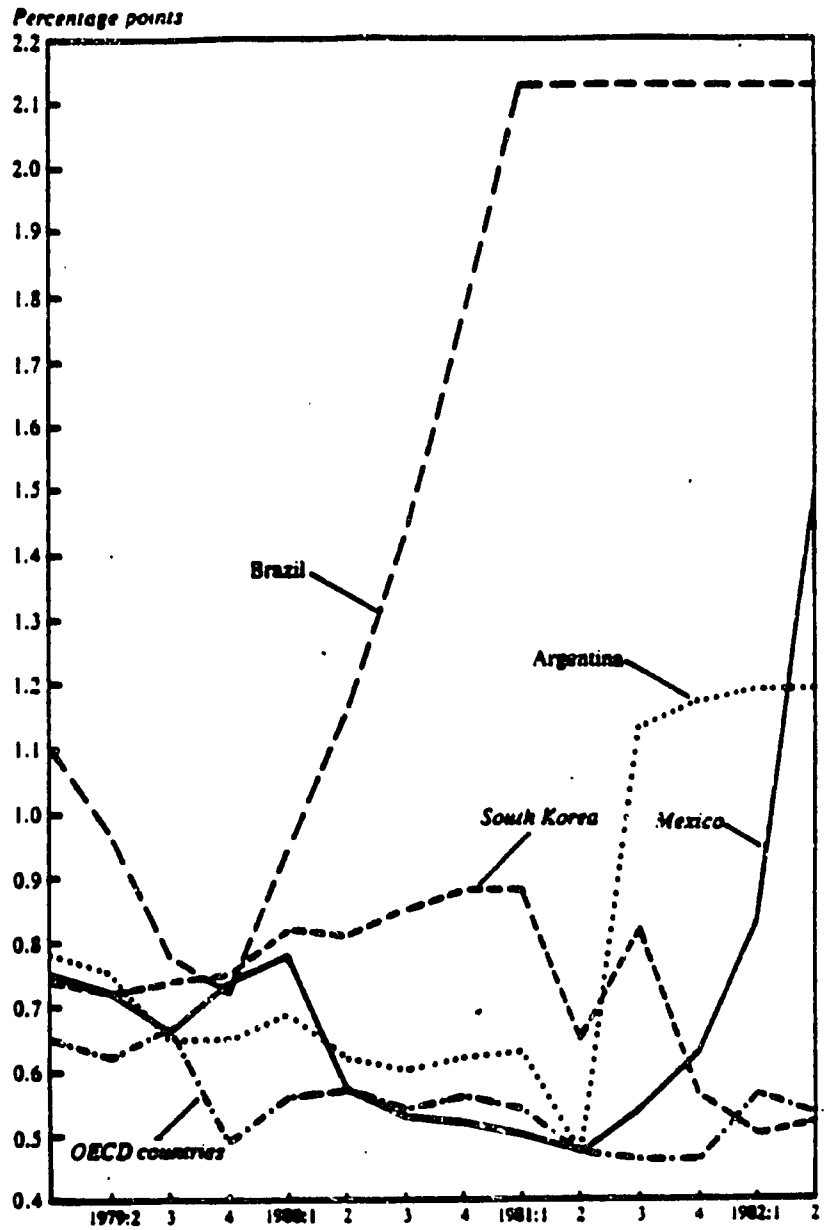
Figure I-1: Average Loan Rate Spreads over LIBOR:

Selected Countries, 1979:1 - 1982:2

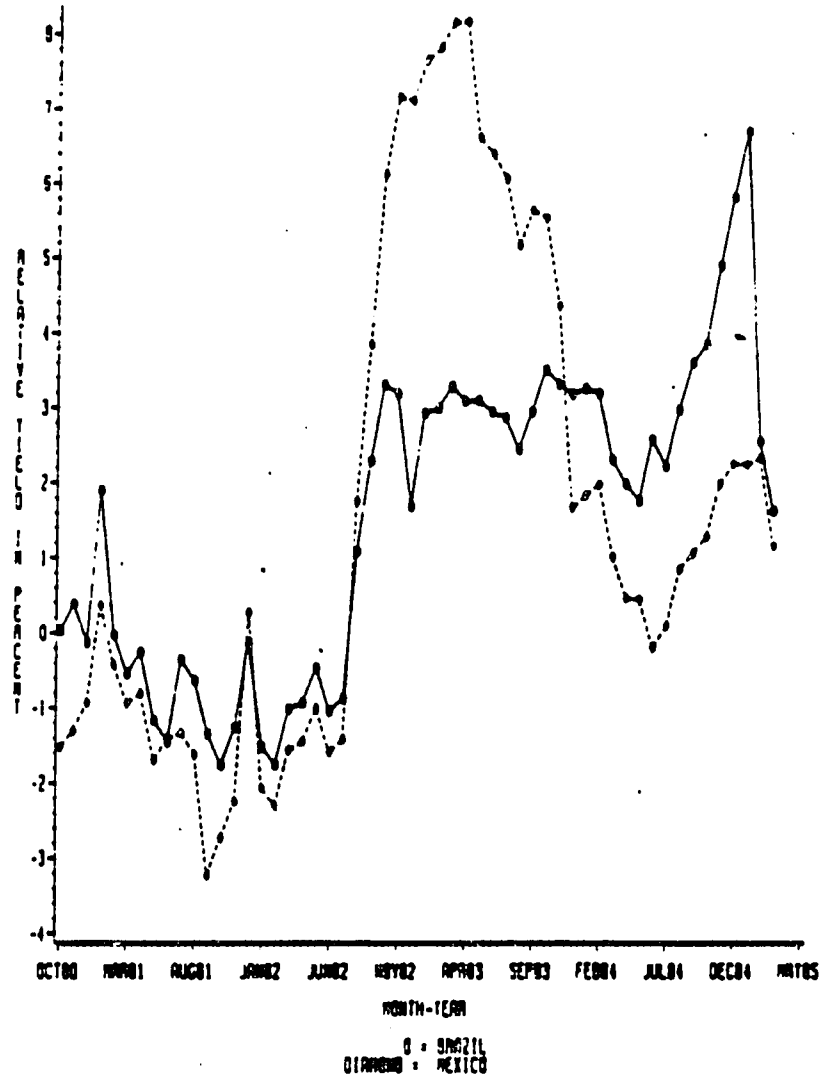


Sources: Data for the OECD spreads are from Organization for Economic Cooperation and Development, *Financial Market Trends* (Paris: OECD, June 1982), and previous issues. Data for individual LDCs were provided by Morgan Guaranty Trust Company of New York.

Source: Carron (1982, Figure 1, p.413)

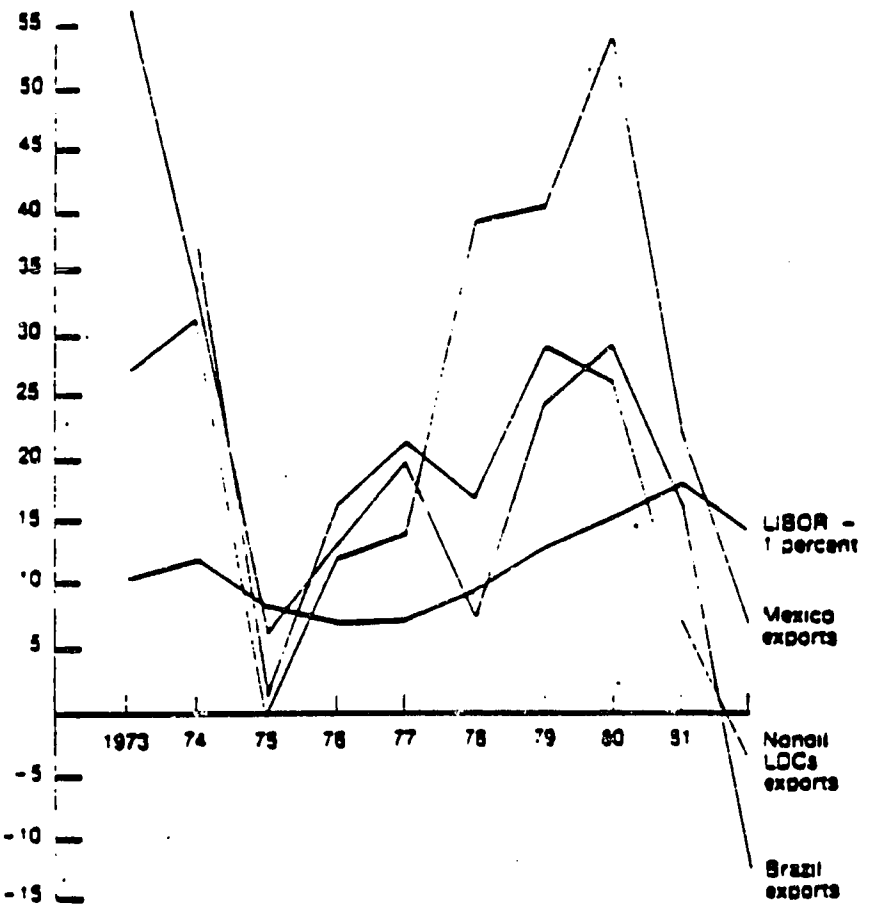
Figure I-2:

Spreads on Mexican and Brazilian Bonds, 1980.10 - 1985.3.



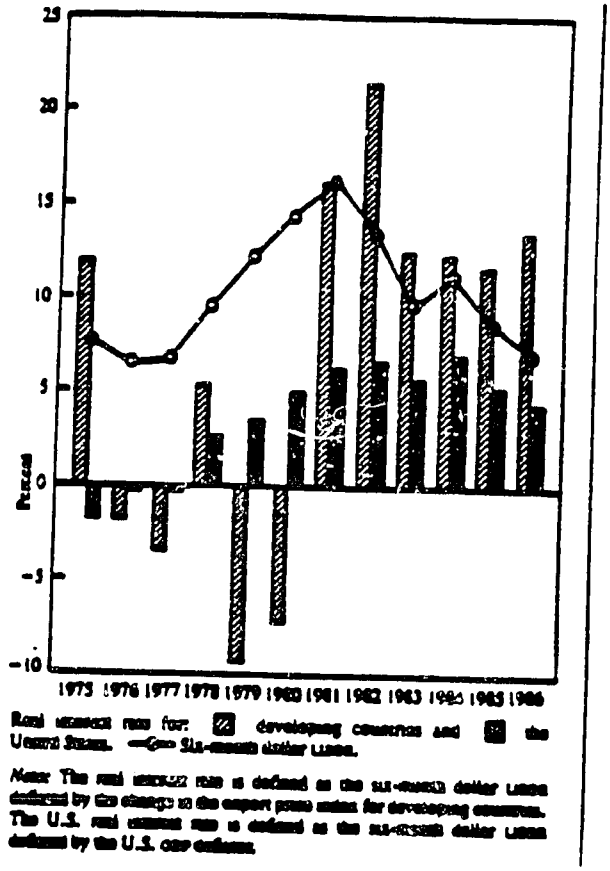
Source: Edwards (1986, Figure 1, p. 583).

Fig. I-3: The Relationship between
Nominal Export Growth and International Interest Rates



source: Cline (1984, Fig. 1.3, p.9).

Fig. I-4:
Real Interest Rates and LIBOR
1975-86



source: World Debt Tables, 1986-87 edition, p. xii).

Table 1-5

External Debt, GNP, and Exports of All DRS Countries

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Total External Debt (EDT)	66990	78509	92229	110537	138808	166696	203035	307829	383005	454672	579372
Long-term Public/Guaranteed Debt (DOD)	49743	58791	68843	84270	104338	126161	155536	194877	247961	294146	359103
Gross National Product (GNP)	414671	455285	506592	627679	780254	1037573	1128780	1280284	1487703	1772127	2046732
Exports of Goods and Services (XGS)	47192	66772	80070	114944	171196	171757	199663	235064	265535	345675	447596
DOD/GNP	12.0	12.9	13.6	13.4	13.4	12.2	13.8	15.2	16.7	16.6	17.5
DOD/XGS	105.4	88.0	86.0	73.3	60.9	73.5	77.9	82.9	93.4	85.1	80.3
% change in DOD/GNP		7.6	5.2	-1.2	-0.4	-9.1	13.3	10.5	9.5	-0.4	5.7
% change in DOD/XGS		-16.5	-2.3	-14.7	-16.9	20.5	6.1	6.4	12.6	-8.9	-5.6
EDT/GNP	16.2	17.2	18.2	17.6	17.8	16.1	18.0	24.0	25.7	25.7	28.3
EDT/XGS	142.0	117.6	115.2	96.2	81.1	97.1	101.7	131.0	144.2	131.5	129.6
% change in EDT/GNP		6.7	5.6	-3.3	1.0	-9.7	12.0	33.7	7.1	-0.3	10.3
% change in EDT/XGS		-17.2	-2.0	-16.5	-15.7	19.7	4.8	28.8	10.1	-8.8	-1.5
EDT growth rate		17.2	17.5	19.9	25.6	20.1	21.8	51.6	24.4	18.7	27.4
DOD growth rate		18.2	17.1	22.4	23.8	20.9	23.3	25.3	27.2	18.6	22.1
GNP growth rate		9.8	11.3	23.9	24.3	33.0	8.8	13.4	16.2	19.1	15.5
XGS growth rate		41.5	19.9	43.6	48.9	0.3	16.2	17.7	13.0	30.2	29.4

Source: World Bank Debt Reporting System, August 1988.

Table 1-5 (cont.)

External Debt, GNP, and Exports of All DRS Countries

	1981	1982	1983	1984	1985	1986	*** 1971-80: avg.	std.	std/avg ***
Total External Debt (EDT)	671988	745192	807831	876833	949074	1021166			
Long-term Public/Guaranteed Debt (DOD	402555	454665	528041	603199	682393	780435			
Gross National Product (GNP)	2157983	2087526	2008796	2035568	2036172	2135878			
Exports of Goods and Services (XGS)	469395	440775	434332	471074	462843	450516			
DOD/GNP	18.7	21.8	26.3	29.6	33.5	36.5	14.5	1.8	0.121
DOD/XGS	85.8	103.2	121.6	128.0	147.4	173.2	80.1	8.8	0.109
% change in DOD/GNP	6.3	16.8	20.7	12.7	13.1	9.0	4.1	6.4	1.576
% change in DOD/XGS	6.8	20.3	17.9	5.3	15.1	17.5	-1.9	12.3	-6.372
EDT/GNP	31.1	35.7	40.2	43.1	46.6	47.8	20.9	4.3	0.205
EDT/XGS	143.2	169.1	186.0	186.1	205.1	226.7	114.5	19.0	0.166
% change in EDT/GNP	10.0	14.6	12.7	7.1	8.2	2.6	6.3	11.0	1.750
% change in EDT/XGS	10.5	18.1	10.0	0.1	10.2	10.5	0.2	15.0	88.858
EDT growth rate	16.0	10.9	8.4	8.5	8.2	7.6	24.4	9.6	0.395
DOD growth rate	12.1	12.9	16.1	14.2	13.1	14.4	21.9	3.1	0.140
GNP growth rate	5.4	-3.3	-3.8	1.3	0.0	4.9	17.5	7.3	0.414
XGS growth rate	5.0	-6.1	-1.5	8.5	-1.7	-2.7	26.1	14.6	0.560

Table 1-7

A More Detailed View of the Debt/Export Ratio

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
DOD/Exports (%) =	105.4	88.0	86.0	73.3	60.9	73.5	77.9	82.9	93.4	85.1	80.3
DOD/GNP (%)	12.0	12.9	13.6	13.4	13.4	12.2	13.8	15.2	16.7	16.6	17.5
divided by XGS/GNP	8.8	6.8	6.3	5.5	4.6	6.0	5.7	5.4	5.6	5.1	4.6
%change in DOD/Exports (%) =		-16.5	-2.3	-14.7	-16.9	20.5	6.1	6.4	12.6	-8.9	-5.6
%change in DOD/GNP (%)		7.6	5.2	-1.2	-0.4	-9.1	13.3	10.5	9.5	-0.4	5.7
minus the %change in XGS/GNP		-22.4	-7.2	-13.7	-16.5	32.5	-6.4	-3.7	2.9	-8.5	-10.7

Table 1-8

A More Detailed View of the Debt Service Ratio

	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
Debt Service/Exports (%) =	11.7	9.2	9.3	9.1	7.2	8.5	8.5	9.8	13.0	13.4	12.5
Debt Service/DOD (%) x	11.1	10.4	10.9	12.4	11.8	11.6	10.9	11.8	13.9	15.8	15.5
DOD/XGS	1.05	0.88	0.86	0.73	0.61	0.73	0.78	0.83	0.93	0.85	0.80
%change in IDS/Exports (%) =		-21.5	1.7	-2.8	-20.6	18.0	0.3	14.5	33.2	3.5	-7.4
%change in IDS/DOD (%) +		-6.1	4.1	14.0	-4.5	-2.1	-5.5	7.6	18.2	13.5	-1.9
%change in DOD/XGS		-16.5	-2.3	-14.7	-16.9	20.5	6.1	6.4	12.6	-8.9	-5.6

Table I-7 (cont.)

A More Detailed View of the Debt/Export Ratio

	1981	1982	1983	1984	1985	1986	*** 1971-80: avg.	std.	*** std/avg
DOD/Exports (%) =	85.8	103.2	121.6	128.0	147.4	173.2	80.1	8.8	0.109
DOD/GNP (%)	18.7	21.8	26.3	29.6	33.5	36.5	14.5	1.8	0.121
divided by XGS/GNP	4.6	4.7	4.6	4.3	6.4	4.7	5.6	0.7	0.122
%change in DOD/Exports (%) =	6.8	20.3	17.9	5.3	15.1	17.5	-1.9	12.3	-6.372
%change in DOD/GNP (%)	6.3	16.8	20.7	12.7	13.1	9.0	4.1	6.4	1.576
minus the %change in XGS/GNP	0.4	3.0	-2.3	-6.6	1.8	7.8	-5.4	14.3	-2.655

Table I-8 (cont.)

A More Detailed View of the Debt Service Ratio

	1981	1982	1983	1984	1985	1986	*** 1971-80: avg.	std.	*** std/avg
Debt Service/Exports (%) =	14.0	16.4	16.5	16.3	19.2	21.3	10.0	2.0	0.202
Debt Service/DOD (%) x	16.3	15.9	13.6	12.7	13.0	12.3	12.5	1.8	0.146
DOD/XGS	0.86	1.03	1.22	1.28	1.47	1.73	0.8	0.1	0.109
%change in TDS/Exports (%) =	12.6	37.1	0.6	-1.3	17.7	10.9	1.9	16.0	8.566
%change in TDS/DOD (%) +	5.4	-2.7	-14.7	-6.3	2.2	-5.6	3.7	8.6	2.298
%change in DOD/XGS	6.8	20.3	17.9	5.3	15.1	17.5	-1.9	12.3	-6.372

Table I-9

Growth in Long-term Public/Guaranteed Debt

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980
change in DOD	9048	10052	15427	20068	21823	29375	39341	53084	46185	64957
Net Flows	6914	9680	12834	17353	24463	28474	34034	43280	45803	52088
Difference	2134	372	2593	2715	-2640	901	5307	9804	382	12869
Net Flows/DOD(t-1)	13.9	16.5	18.6	20.6	23.4	22.6	21.9	22.2	18.5	17.7
DOD growth rate	18.2	17.1	22.4	23.8	20.9	23.3	25.3	27.2	18.6	23.1

Table I-9 (cont.)

Growth in Long-term Public/Guaranteed Debt

	1981	1982	1983	1984	1985	1986
change in DOD	43452	52110	73376	75158	79194	98042
Net Flows	56468	58744	51145	42555	33295	26966
Difference	-13016	-6634	22231	32603	45899	71076
Net Flows/DOD(t-1)	15.7	14.6	11.2	8.1	5.5	4.0
DOD growth rate	12.1	12.9	16.1	14.2	13.1	14.4

*** 1971-80: ***		
avg.	std.	std/avg
19.6	2.9	0.149
21.9	3.1	0.140

Figure II-2

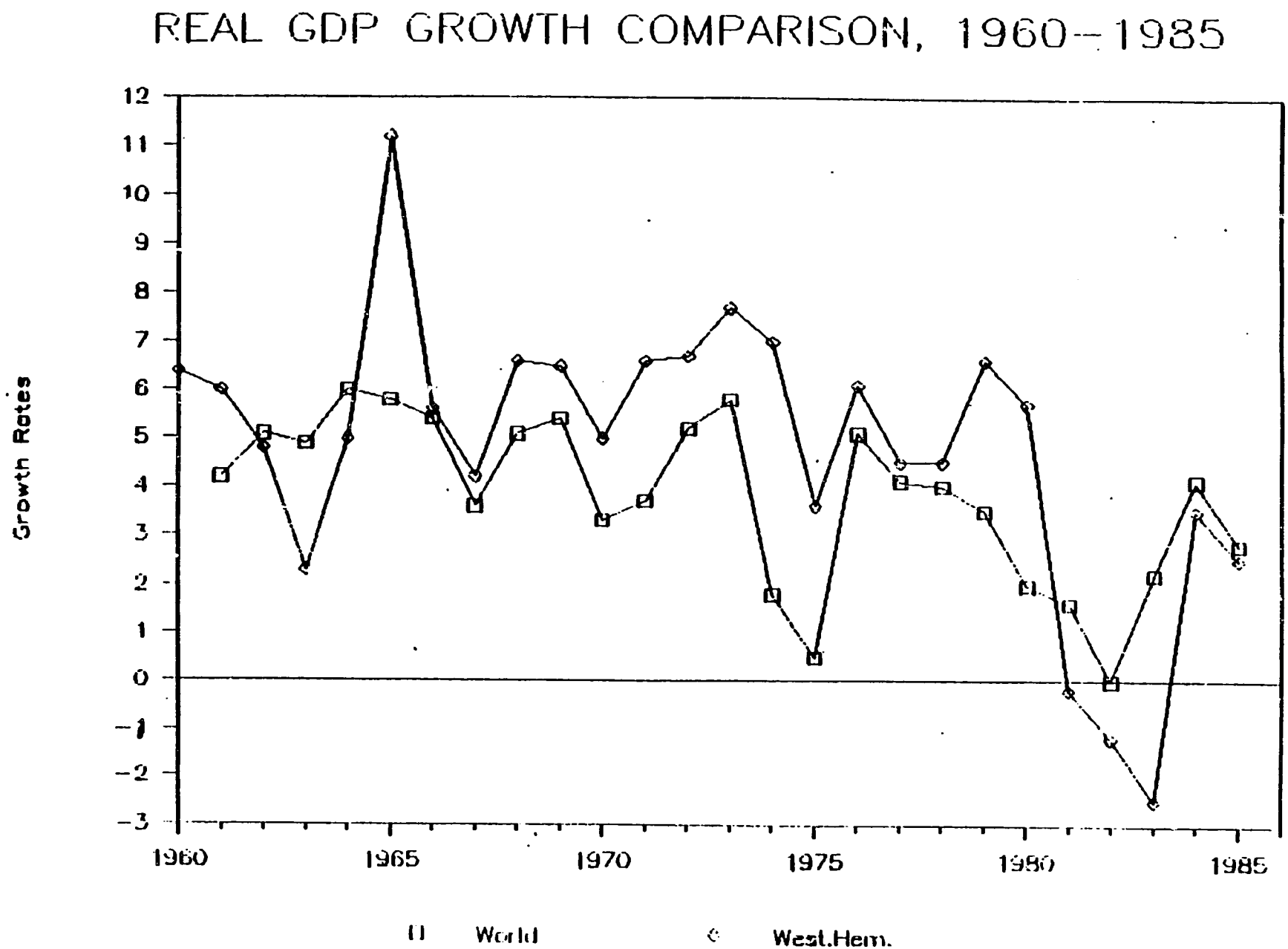

REAL GDP GROWTH COMPARISON, 1960-1985
Growth Rates
12
11
10
9
8
7
6
5
4
3
2
1
0
-1
-2
-3
1960
1965
1970
1975
1980
1985
World
West.Hem.

Figure II-3

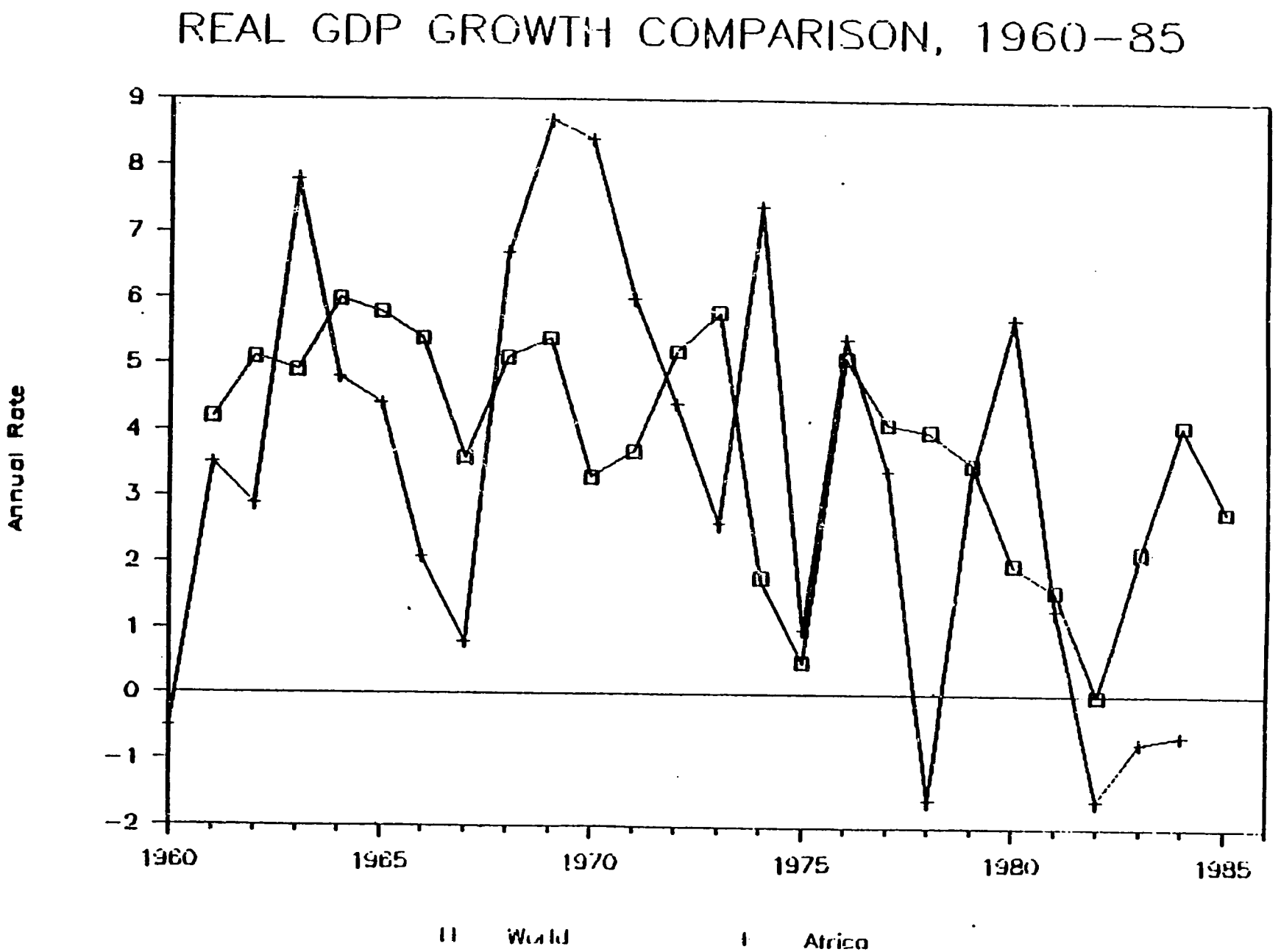

REAL GDP GROWTH COMPARISON, 1960–85
Annual Rate
9
8
7
6
5
4
3
2
1
0
−1
−2
1960
1965
1970
1975
1980
1985
World
Africa

Figure II-4

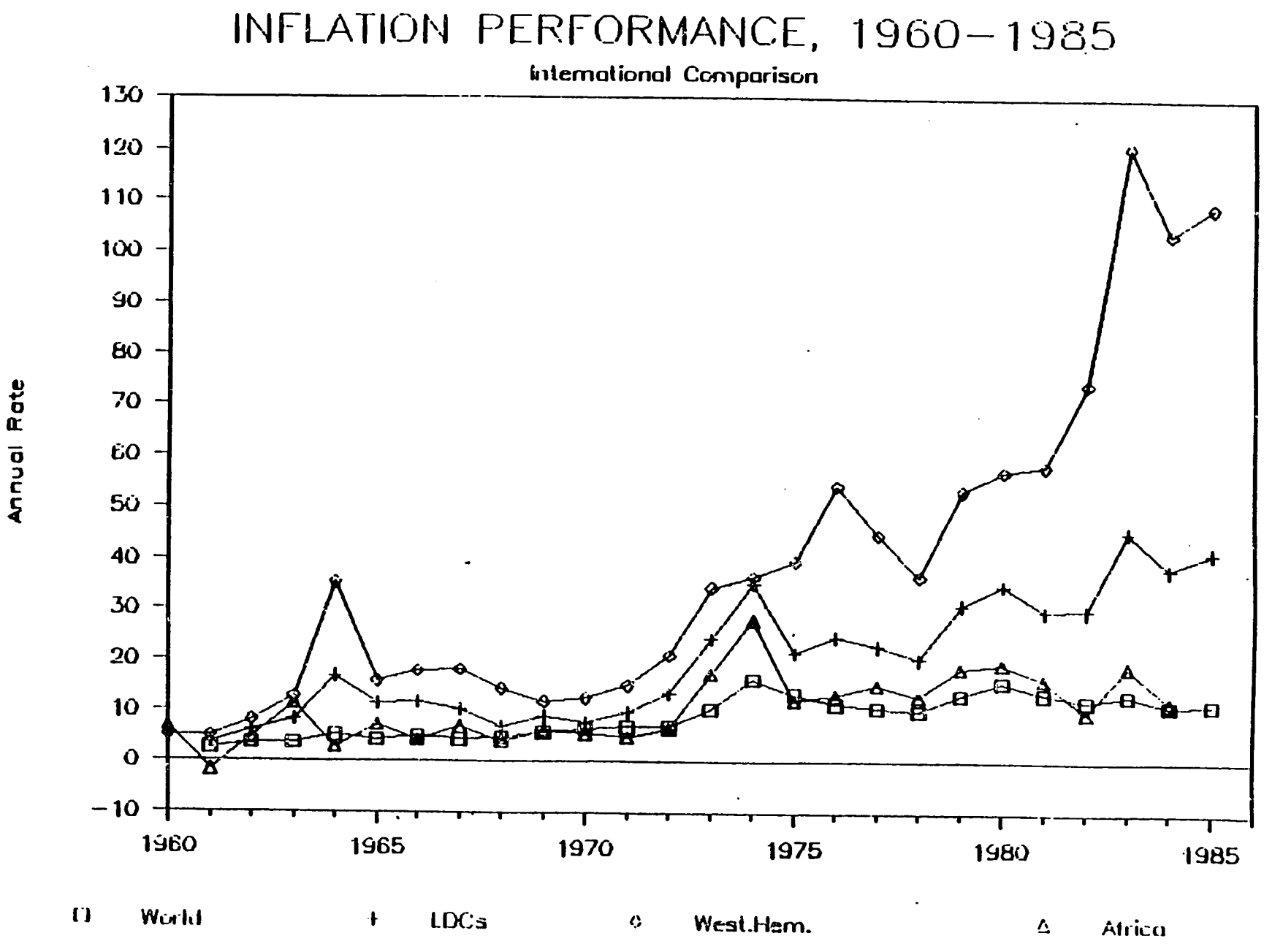


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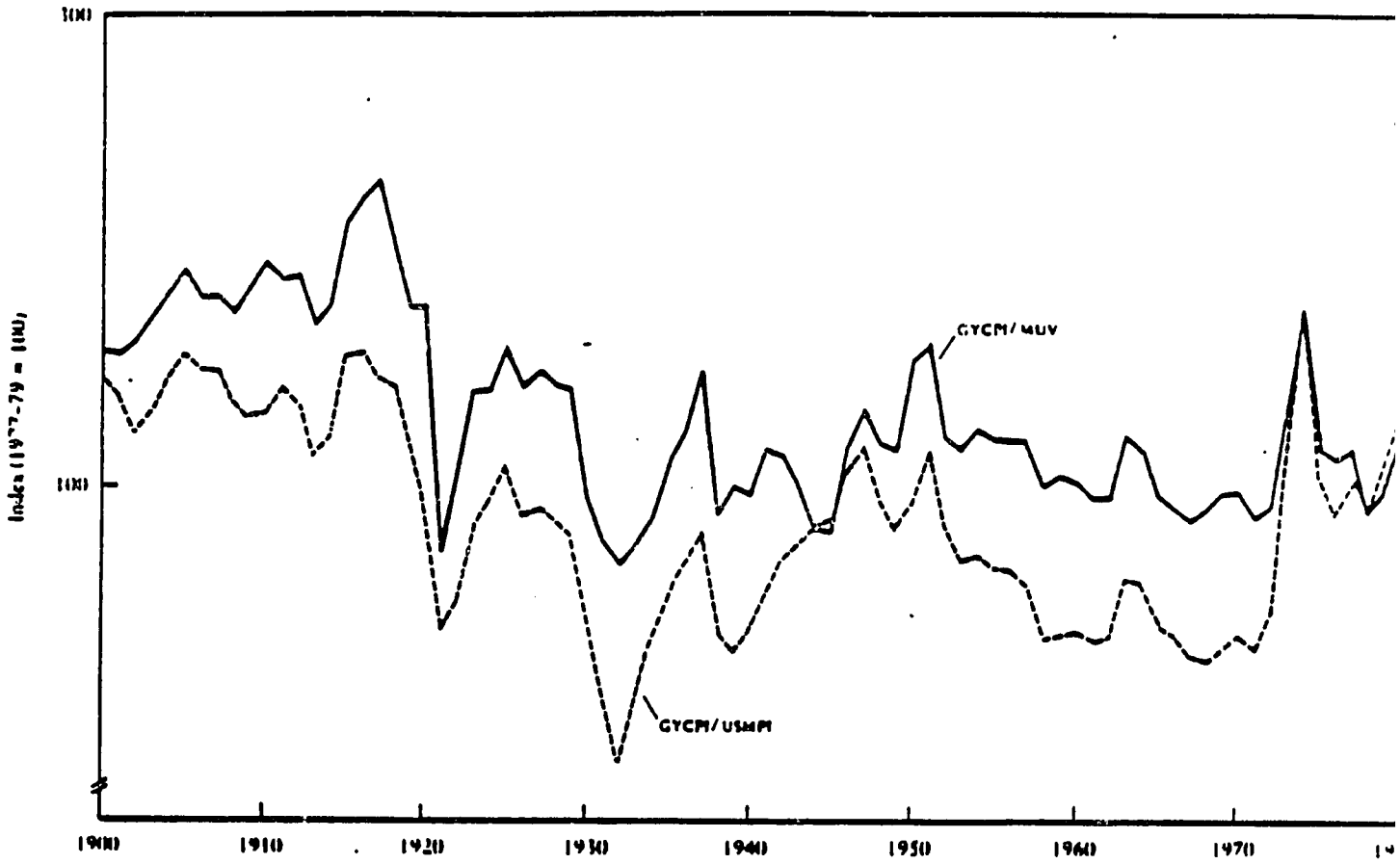
Figure II-5: Indexes of Relative Prices of Nonfuel Primary Commodities



Source: Grilli and Yang (1988), Appendix 1.

Table I-1: Transition Matrix for Repayment Problems, 1970-82

Year t-1		Year t: R	A	I	RA	RI	AI	RAI	ϕ	Row total
	R	0	0	1	0	0	0	0	2	3
	A	0	171	0	4	1	8	5	44	233
	I	0	1	38	0	7	4	0	31	81
	RA	1	4	0	1	0	0	3	0	9
	RI	0	0	2	0	1	1	0	3	7
	AI	0	7	2	1	0	7	3	2	22
	RAI	0	4	1	1	2	2	2	0	12
	ϕ	3	52	33	0	3	4	0	564	659
Column total		5	239	80	8	14	26	14	646	1,032
Total all years		5	253	90	9	15	26	15	712	1,125

Legend: R = Rescheduling, A = Arrears on long-term debt (arrears on principal exceeding 1 percent, or arrears on interest exceeding 0.1 percent of debt outstanding and disbursed), I = IMF higher-tranche support, ϕ = None. Combinations of letters indicate combinations of forms.

Note: Data for ninety-three countries, 1970–82, excluding eighty-four missing observations.

Source: McFadden et al. (1985, Table 7.6, p. 189).

Table I-2:

Incidence of Restructuring*
(millions of US dollars)

Year	Official Multilateral Debt Reschedulings		Bank Debt Restructuring		Total	
	number	amount	number	amount	number	amoun
1975	1	230			1	23
1976	1	270			1	27
1977	3	249			3	24
1978	3	1783	3	449	6	223
1979	4	2987	3	2847	7	583
1980	3	3072	5	1243	8	431
1981	8	3079	6	1656	14	473
1982	6	539	6	6644	12	718
1983	16	9600	24	43800	40	5340
1984	13	3573	23	87000	36	9057
1985	20	16406 #	13	22900	33	3930
1986	19	13597	10	72400	29	8399
1987 (through September)	13	18488	12	84100	25	1025

* amounts include Poland throughout.
# includes $10,300 million for Poland.

Sources: IMF, Recent Developments in External Debt Restructuring, (Washington, 19
Occasional Paper 40, Table 4, pp.7-8 for 1975-84 (official).

IMF, Recent Multilateral Debt Restructuring with Offical and Private Cre
(Washington, 1983), pp.16-22 for 1978-82 (bank, except Poland).

World Bank, World Debt Tables, 1987-88 edition,
Table IV-2 for 1983-87 (bank) and Table IV-3
for 1985-87 (official) and information on Poland.

Table I-3

Secondary Market Prices for Bank Loans to LDCs
(U.S. cents per Dollar of Loan Face Value)

Country	*June 1986*	*June 1987*	*September 1987*
Argentina	64.00	47.00	37.00
Bolivia	6.00	9.00	9.00
Brazil	75.00	61.00	39.00
Chile	66.00	69.00	58.00
Côte d'Ivoire	74.00	62.00	60.00
Ecuador	63.50	49.00	33.00
Mexico	60.00	56.00	47.25
Nigeria	55.00	29.00	25.00
Philippines	59.00	69.00	59.00
Turkey	97.50	97.00	96.50
Venezuela	76.00	70.00	53.00
Yugoslavia	79.00	75.00	60.00

a. Bid prices.
Source: Salomon Brothers, Inc., New York, N.Y.

Source: World Debt Tables 1987-88 edition, Table II-1, p. xxvi.

Table I-4a

Net Transfers to DRS Countries
(Long-term public/Guaranteed Debt Only)

	1971	1972	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985
net transfers	4952	7337	9581	13105	18941	21758	25632	31438	39457	28704	25215	22439	14538	2117	-11895
official creditors	3173	3490	4371	6531	9861	8970	10127	11154	10210	14949	17378	14513	12921	11616	4870
private creditors	1779	3847	5210	6574	9080	12788	15505	20274	18247	11555	7837	7926	1617	-9499	-16765
GNP (in dollars)	537020	600608	750918	942457	1037431	1124232	1285807	1485649	1774717	2061447	2211784	2144788	2044760	2085017	2095596
								Ratios to GNP							
net transfers	1.0	1.5	2.0	2.7	3.9	4.4	5.2	5.4	5.8	5.5	5.2	4.6	3.0	0.4	-2.4
official creditors	0.6	0.7	0.9	1.3	2.0	1.8	2.1	2.3	2.1	3.0	3.6	3.0	2.6	2.4	1.0
private creditors	0.4	0.8	1.1	1.3	1.9	2.6	3.2	4.1	3.7	2.4	1.6	1.6	0.4	-1.9	-3.4

Source: World Bank Debt Reporting System, August 1988.

Table I-4b
Net Resource Transfers to Debtor Countries, 1981-84
(Billions of Dollars)

Category	1981	1982	1983	1984
Major debtor countries				
Official creditors	5.7	5.4	1.5	4.6
Private creditors	4.8	1.0	-1.8	-10.0
Latin America				
Official creditors	2.6	3.0	1.8	3.2
Private creditors	4.0	0.4	-3.5	-10.9
Sub-Saharan Africa				
Official creditors	3.3	3.2	3.3	2.0
Private creditors	1.7	2.6	1.8	-2.1

Source: World Bank, *World Debt Tables: External Debt of Developing Countries*, 1985–86 ed. (World Bank, 1986). For World Bank country classifications, see pp. xiii–xiv.

Source: Sachs (1986, Table 5, p. 407).

Table I - 6

Jeffrey D. Sachs

External Debt Indicators, 1981 and 1980–83[a]

Percent

Country	*Cumulative current account deficit, 1970–80 (percentage of 1981 GDP)*	*Debt-GDP ratio, 1981*	*Debt-export ratio, 1981*	*Debt service ratio, 1980–83*
Latin America				
Argentina	2.3	31.6	334.7	214.9
Brazil	22.8	26.1	298.7	132.6
Chile	19.8	47.6	290.0	153.3
Mexico	13.9	30.9	258.8	161.8
Peru	19.3	44.7	223.5	122.2
Venezuela	−7.5	42.1	134.0	117.8
Weighted average	13.6	31.3	271.5	153.8
Colombia	0.4	21.9	182.9	103.8
East Asia				
Indonesia	0.6	24.1	87.1	n.a.
Korea	24.6	27.6	76.6	90.1
Malaysia	−2.0	27.8	51.8	16.9
Thailand	22.4	25.7	103.1	58.1
Weighted average	11.9	25.9	82.1	61.7
Philippines	18.3	40.6	214.6	152.7

Sources: Debt stocks are from the DRI International Data Base. The cumulative current account deficit is estimated from *International Financial Statistics* data and is divided by the GDP of the country measured at the official exchange rate. Exports are from the national income account series for exports of goods and services of *International Financial Statistics*.

n.a. Not available.

a. The debt service ratio equals total debt servicing expenditures relative to exports. Debt servicing equals interest payments on all debt, plus amortization of principal on medium- and long-term debt, plus the stock of short-term debt (the principal of which, by definition, comes due within the year). Debt stocks are end-of-year total gross debt.

Source:
Sachs 1985, p. 533

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Table I-10

Significant Macroeconomic Correlates of Repayment Crises in Developing Countries

Variable	Study[a]					
	Frank-Cline (1971)	Grinols (1976)	Feder-Just-Ross (1981)	Sargen (1977)	Saini-Bates (1978)	Cl (19
Debt service/exports	-		-	-		
Principal service/debt	-					
Imports/reserves	-		-			
Debt/GDP		-				
Debt/exports		-		-		
Debt service/reserves		-				
GNP per capita			-[b]			
Foreign exchange inflows/debt service			-			
(Current account)[c]/exports						
Exports/GNP			-			
Rate of domestic inflation				-		
Growth rate of money supply					-	
Growth rate of reserves					-	
Growth rate of GNP per capita						
Total borrowing/total imports						

a. Variables with significant effects are indicated by sign of effect. Note that these studies differ in countr time periods considered and in details in definitions of both dependent and independent variables.

b. Defined relative to U.S. GNP per capita.

c. This variable is multiplied by the sign of the current account surplus.

d. Cline reports significant positive and negative signs on this variable.

source: McFadden et al (1985, Table 7-5, p. 188)

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Table 3

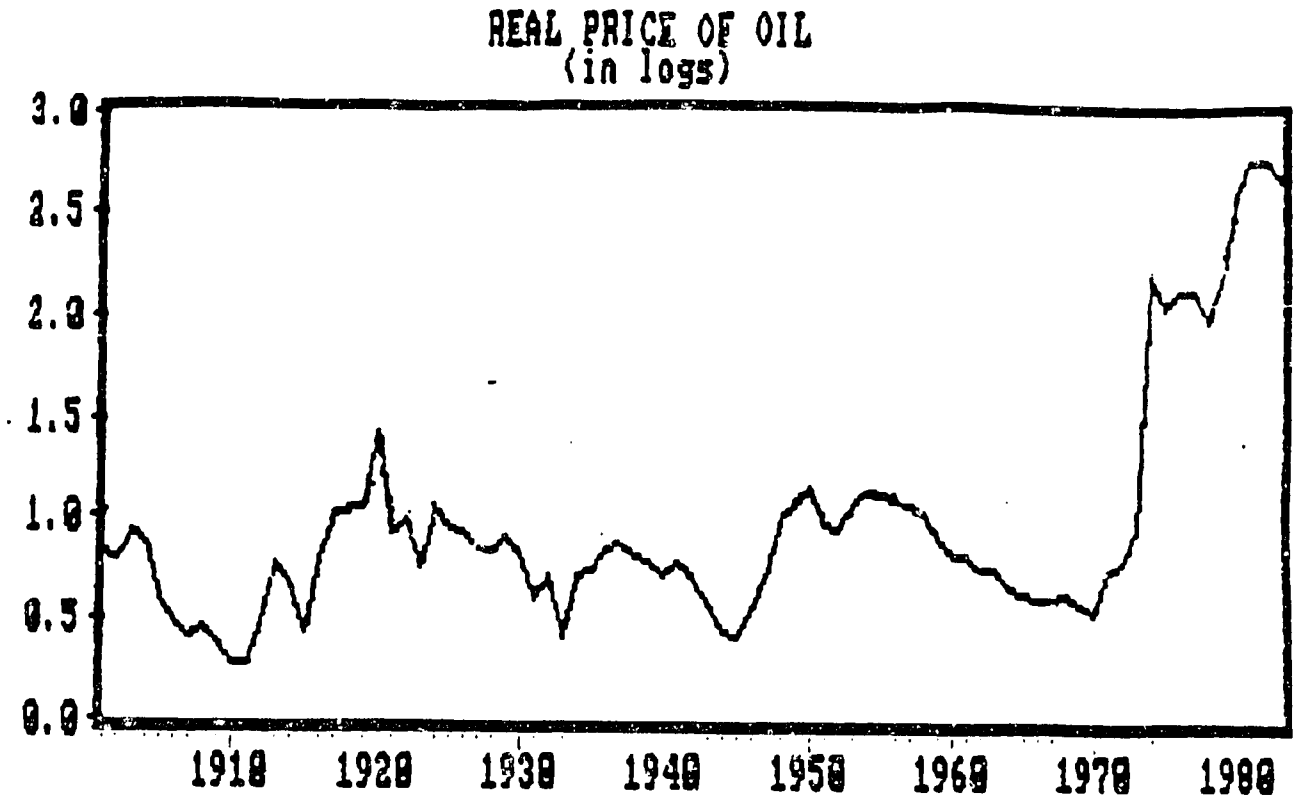
Panel estimates of three-regime model; dependent variables are *DVDEL*, *DNEW*, and *ARR* (asymptotic *t*-statistics in parentheses).[a]

Variable (lagged one year)	New loan demand	New loan supply	Limit on arrears
Constant	−0.342 (2.051)	0.460 (8.841)	0.0356 (0.067)
Debt service due/Exports	5.650 (20.072)	—	1.983 (2.680)
Real GNP/Capita	−0.439 (5.405)	—	—
Imports/GDP	1.149 (6.205)	—	—
Reserves/Imports	—	0.116 (1.274)	—
Debt/Exports	—	0.0523 (1.915)	0.146 (1.225)
Indicator for IMF support or rescheduling	—	−0.175 (2.358)	−1.375 (6.435)
Indicator for arrears	—	−0.261 (4.963)	—
Interest due/Exports	—	0.436 (0.485)	—
Principal due/Exports	—	0.0624 (0.310)	—
Standard deviation	0.944 (2.375)	0.453 (20.975)	
Correlation	0.182 (3.828)		
Random effects	η	θ	
Standard deviation	0.369 (7.529)	0.109 (6.425)	
Likelihood value	−1607.892		

[a] *DVDEL* = 1 if either a rescheduling is requested and/or an IMF agreement is in effect; *DNEW* = total new debt obtained within the period (scaled by the flow of exports); *ARR* = total significant principal and interest outstanding arrears on debt obligations.

Source: Hajivassiliou (1987, Table 3, p. 219)

Figure II-1



Real oil prices are defined by deflating nominal oil prices by the manufactures unit value index.

Source: Cuddington and Urzúa (1987)

Table II-1

Impact of Exogenous Shocks on External Debt of Nonoil Developing Countries

(billions of US dollars)

Effect	Amount
Oil price increase in excess of US inflation, 1974–82 cumulative[a]	260
Real interest rate in excess of 1961–80 average: 1981 and 1982	41
Terms-of-trade loss, 1981–82	79
Export volume loss caused by world recession, 1981–82	21
Total	401
Memorandum items	
Total debt: 1973	130
1982	612
Increase: 1973–82	482

a. Net oil importers only.

Source: Cline, 1984, Table 1-4, p.13.

Table II-2
Global Current Account Patterns

Current Account Balances
(excluding exceptional financing)

	in millions of US dollars				percentages* of non-oil LDCs' GDP			
	oil exporters	ICs	non-oil LDCs	total	oil exporters	ICs	non-oil LDCs	total
1970	-985	6937	-10028	-4076	-0	1	-2	-1
1971	1038	9725	-16068	-5034	0	2	-3	-1
1972	3298	7761	-8637	2422	1	1	-1	0
1973	6355	13076	-7044	12387	1	2	-1	2
1974	67268	-21961	-28828	16479	7	-2	-3	2
1975	32611	9180	-38279	3512	3	1	-4	0
1976	37924	-10261	-27293	370	3	-1	-2	0
1977	22188	-15428	-23065	-16306	2	-1	-2	-1
1978	-2364	14737	-32612	-20238	-0	1	-2	-1
1979	60154	-24588	-48830	-13264	3	-1	-3	-1
1980	103457	-61754	-73346	-31643	5	-3	-4	-2
1981	46748	-21394	-96850	-71496	2	-1	-4	-3
1982	-9235	-23283	-74320	-106838	-0	-1	-3	-5
1983	-20483	-23976	-38041	-82499	-1	-1	-2	-4
1984	-4988	-59083	-22588	-86658	-0	-3	-1	-4
1985	2328	-48747	-25342	-71760	0	-2	-1	-3
1986	-25172	-17452	-13167	-55791	-1	-1	-1	-3

ources: Current Account -- IFS Yearbook 1985 for 1970, 1987 Yearbook for others
GNP -- World Bank data files (standard data file-IECSE)

* given the size of errors and omissions in the data, all figures have been rounded to the nearest percentage point.

Table II-3

Current Account Financing, 1973-83
Non-Oil Developing Countries

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Net oil exporters											
Current account deficit [2]	2.6	5.1	9.9	7.7	6.4	7.9	8.5	12.5	23.5	15.6	14.2
Use of reserves	−1.3	−1.5	−0.3	−0.7	−1.9	−1.2	−3.8	−3.7	−0.7	2.8	−0.6
Non-debt-creating flows, net	2.2	3.3	3.7	2.7	3.3	3.9	5.5	5.6	7.2	5.3	4.9
Net external borrowing	1.6	3.3	6.5	5.7	5.0	5.2	6.8	10.6	17.0	7.5	9.9
Long-term borrowing [3]	2.2	3.2	7.6	7.5	7.7	7.6	7.2	8.6	15.4	11.5	21.6
From official sources	0.8	1.2	3.4	2.2	4.2	3.4	2.4	3.0	3.5	3.3	3.9
From private sources	1.4	2.0	4.2	5.3	3.4	4.2	4.8	5.5	11.9	8.1	[illegible]
Reserve-related liabilities [4]	—	—	—	1.2	−0.1	—	—	−0.4	0.1	3.0	0.3
Other short-term borrowing [5]	−0.6	0.1	−1.1	−2.9	−2.6	−2.4	−0.4	2.4	1.5	−6.9	−12.0
Major exporters of manufactures											
Current account deficit [2]	3.6	18.8	19.1	12.2	7.9	9.8	21.7	32.5	37.6	34.3	18.6
Use of reserves	−5.8	2.0	2.0	−7.1	−4.4	−10.2	−3.1	2.1	−2.3	4.0	−5.0
Non-debt-creating flows, net	3.8	4.4	2.9	4.6	4.5	6.4	7.5	7.4	7.9	8.2	8.1
Net external borrowing	5.6	12.4	14.1	14.7	7.7	13.7	17.3	23.1	32.0	22.0	15.5
Long-term borrowing [3]	5.6	8.6	9.8	9.7	8.0	15.9	11.7	13.2	23.1	8.4	22.7
From official sources	1.8	2.1	2.5	2.7	2.6	3.7	3.3	3.1	3.1	3.5	3.7
From private sources	3.8	6.5	7.3	7.0	5.4	12.2	8.4	10.1	19.9	4.9	19.0
Reserve-related liabilities [4]	—	0.2	1.1	1.9	0.3	−0.5	−0.6	0.5	1.0	3.3	3.3
Other short-term borrowing [5]	0.1	3.5	3.2	3.0	−0.6	−1.7	6.2	9.4	7.9	10.3	−10.5
Low-income countries (excluding People's Rep. of China and India)											
Current account deficit [2]	3.4	6.6	7.3	5.5	5.4	8.4	9.9	11.8	12.1	12.0	11.4
Use of reserves	−0.5	−0.3	0.4	−0.7	−1.0	0.1	−0.2	−0.2	0.1	0.3	−0.1
Non-debt-creating flows, net	2.3	3.2	2.4	2.3	2.7	3.0	4.0	4.3	4.5	4.2	3.6
Net external borrowing	1.6	3.7	4.4	3.9	3.7	5.3	6.1	7.7	7.5	7.6	7.9
Long-term borrowing [3]	1.6	3.0	3.1	2.9	2.8	3.9	5.1	5.5	4.9	4.7	4.7
From official sources	1.0	2.1	2.8	3.0	1.9	3.0	5.6	4.6	5.8	4.5	7.3
From private sources	0.6	0.9	0.3	−0.1	0.9	0.8	−0.5	0.8	−1.0	0.2	−2.6
Reserve-related liabilities [4]	0.1	0.5	0.4	0.4	0.1	0.1	0.4	0.6	1.2	1.1	1.4
Other short-term borrowing [5]	−0.1	0.3	0.9	0.5	0.8	1.4	0.6	1.6	1.4	1.7	1.8
Other non-oil developing countries [6]											
Current account deficit [2]	1.1	5.6	9.7	8.3	12.0	14.7	18.9	27.6	33.0	26.4	23.1
Use of reserves	−2.9	−2.4	—	−2.7	−2.7	−5.0	−3.7	−2.8	1.3	4.9	1.7
Non-debt-creating flows, net	1.8	1.7	2.7	2.6	3.6	4.2	6.1	6.1	7.3	6.8	[illegible]
Net external borrowing	2.2	6.3	7.1	8.4	11.1	15.5	16.5	24.2	24.4	14.8	14.3
Long-term borrowing [3]	1.9	4.2	5.6	6.9	6.3	10.0	11.3	16.6	18.0	14.5	12.3
From official sources	1.4	1.4	2.0	2.3	3.7	3.9	3.9	7.9	9.8	7.3	8.[illegible]
From private sources	0.4	2.8	3.6	4.6	2.6	6.1	7.4	8.7	8.2	7.1	3.7
Reserve-related liabilities [4]	0.1	0.3	0.8	1.4	0.3	0.8	0.6	0.7	2.7	1.6	4.4
Other short-term borrowing [5]	0.2	1.8	0.6	0.1	4.4	4.8	4.5	6.9	3.7	−1.3	−2.5

source: World Economic Outlook, IMF, 1983, p. 195.

Table II-4

Financial Flows to Developing Countries
(billions of 1980 dollars)

Year	Total	Official development assistance	Private: Total	Private: Direct private investment	Private: Portfolio	Private: Export credits
1956–60	21.9	13.2	8.7	—	—	—
1961–70	29.0	16.2	11.5	6.0	2.6	2.9
1971–80	76.6	28.1[a]	38.1	10.7	19.9	7.4

Note: Data between periods are not strictly comparable because of redefinition. Dollars have been deflated by GDP deflator for industrial countries.

a. $19.8 billion excluding assistance from the Council for Mutual Economic Assistance and the Organization of Petroleum Exporting Countries.

Sources: 1956–60: OECD, Development Assistance and Efforts in 1961 of the Members of the Development Assistance Committee (September 1962); 1961–70: OECD, Development Assistance, 1971 Review (1971); 1971–80: OECD, Development Cooperation, 1981 Review (1983).

Source: Fishlow, 1988, p. 193, Table 9-1.

Table III-1

Estimates of resident capital outflow and capital flight, 1976–84 (billion dollars)

	Argentina	Brazil	Korea	Mexico	Philippines	Venezuela	Total
1. Cuddington measure	16.0	−0.1	2.8	36.2	3.7	13.1	71.7
2. Morgan Guaranty measure	25.0	17.3	3.9	53.4	3.7	29.6	132.5
3. Bank deposits (end-1984)	8.2	8.8	0.4	15.1	1.0	12.2	45.7
4. Interest-compounding adjustment	4.9	0.0	n.a.	17.2[a]	n.a.	1.9	n.a.
5. Misinvoicing adjustment	−5.4	−2.1	−10.8	−18.4	n.a.	0.0	−36.7
6. Stock of "legitimate" resident external capital, end-1984	2.4	12.0	6.5	18.9	4.8	2.5	37.1
7. Zedillo's residual	n.a.	n.a.	n.a.	26.0	n.a.	n.a.	n.a.
8. Preferred measure	16	9	0	27	4	30	86

n.a. not available.

Source: Row 1. Cumby-Levich (ch. 3) estimate of Cuddington measure using consistent data set. Row 2. Cumby-Levich (ch. 3) estimate of Morgan-Guaranty measure using consistent data set. Row 3. *International Financial Statistics*. Row 4. Cuddington (ch. 3, table 3.2). Row 5. Gulati (ch. 3). Row 6. Cumby-Levich (ch. 3) estimate of Dooley measure. Row 7. Zedillo (ch. 7). Row 8. see text.

a. This estimate is an exaggeration inasmuch as the Mexican balance of payments figures already contain some allowance.

Source: Lessard and Williamson (1987), Table 9.2, p.206.

Table III-2

Exchange Rate Management, Selected Periods
(percent)

Country	Real appreciation, 1979–81 over 1976–78	Black market premium on currency	
		1977–81	1982–83
Latin America			
Argentina	36.9	10.7	36.0
Brazil	−20.5	16.9	51.8
Chile	7.5	6.1	29.6
Mexico	13.3	2.4	32.7
Peru	−7.2	5.0	1.0
Venezuela	7.0	0.2	. . .[b]
Weighted average	2.9	9.4	40.4
Colombia	10.4	0.9	6.9
East Asia			
Indonesia	−29.7	2.3	9.1
Korea	3.8	9.0	10.0
Malaysia	−4.6	0.1	0.5
Thailand	1.0	−0.7	0.5
Weighted average	−10.5	3.7	6.9
Philippines	6.7	6.8	16.2

Sources: Official exchange rates and price data are from *International Financial Statistics*, series ae and 64; black market rates (or parallel market rates) are from *1984 World Currency Yearbook* (International Currency Analysis, Inc., 1984).

a. The real exchange rate is calculated for each year as EP^{*}/P, where E is the official exchange rate in units of domestic currency per dollar, P^{*} is the U.S. consumer price index, and P is the domestic price index. All variables are annual averages. The black market premium is computed for the months of March, June, September, and December, using official rates and the black market rates. Annual average premiums are then computed.

b. Not comparable for Venezuela, since in the split exchange rate system operating since 1983, nontraditional exports are sold at the parallel market rate, and hence are subsidized. However, private sector nontraditional exports represent less than 3 percent of total exports.

Source: Sachs, 1985, Table 6, p.541.

LATIN AMERICA

THE REVIVAL OF GROWTH AND THE WORLD BANK

Presentation by

S. Shahid Husain

Vice President, Latin America and the Caribbean

to the

Executive Directors

of the World Bank

December 12, 1988

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1. Six years after the onset of Mexico's payments difficulties, which marked the beginning of the so-called debt crisis, with some exceptions, the countries of Latin America have not succeeded in resolving the crisis. Sustained growth has eluded them. During these years, in the Region as a whole, per capita GNP has stagnated. In many countries, particularly the petroleum exporters, it has declined. Almost throughout the continent, real wages are lower than they were at the beginning of the crisis. In Mexico, for example, real wages in the industrial sector today are only 60% of what they were in 1982.

2. With the exception of Peru, Nicaragua, El Salvador and Guyana, until recently all countries have made some attempts to adjust to the international economic environment and the domestic economic situations they face. There is a growing awareness of the need for radical change, for economies with increased mobility of resources and trade regimes that are more open than in the past. In Chile, Costa Rica, Jamaica, Uruguay and Mexico, and lately in Argentina, adjustment has been sustained and coordinated. Yet, excluding Chile and Uruguay, even in these countries adjustment and reform have not quite led to a normalization of relationship between borrowers and lenders, investment, growth and improvement in standards of living. There is a growing concern in the Region about the social and political consequences of this prolonged malaise. In a number of countries populism is on the rise and, if the trend continues, the progress that Latin American countries have made in establishing institutional governments and market economies may be reversed.

3. If this assessment is valid, the question that the Latin American governments and their external partners have to ask, is how to reinforce or change the recent policies and approaches in order to arrest the impoverishment of these societies. In focusing on this issue, I shall analyze the problems leading to the crisis, the challenge facing the governments and their external partners, questions for the future and the World Bank's program.

4. What has happened since 1982 is not a mere financial phenomenon. In Latin America, as in a number of countries in other regions, the crisis represents the end of the line, an indication that the institutional makeup, the policies and the relationships that led to some impressive growth and development during the three decades after the second World War were no longer tenable. They had progressed to a point where the benefits were no longer commensurate with costs. Many of the costs and inefficiencies of that development process were postponed and had accumulated. With the huge external debt -- which largely was a part of the postponed and accumulated cost of policies of both the borrowers and the lenders -- and a fundamental change in the international financial markets, there was no way any more to postpone costs or to externalize them. Rather, the Latin American societies had to bear, and cope with, the inherited costs of the past -- the debt and the inflexible economic structures.

5. The theory and practice of economic development in the Latin American countries, as in many other developing countries, had certain common basic precepts. There was too much preoccupation with the accumulation of capital as the engine of growth. Less thought was given to the issue of efficiency. Through time, and particularly during the '70s,

there was an impressive decline in the productivity of capital, aided by inefficient projects and distorted prices. Abundant international credit, often pressed upon the borrowers by banks and exporters, lowered the quality of screening of investment both in the private and public sector. The result was that many countries which managed to increase sharply their investments between the decades of the '60s and the '70s, did not see a commensurate change in their growth. Actually in many, growth declined.

6. There was also unlimited faith in the efficacy of governmental action and management. Governments expanded their role and ownership in all aspects of economic life, including public employment, direct provision of credit and subsidies and management of a variety of enterprises. The statistics are astounding. In Peru, public expenditure rose from 24% of GDP in 1970, to 60% in 1982. In Mexico, the increase was from 22% to 46%. In Argentina and Venezuela, by the beginning of this decade, public expenditures were in excess of 50% of GDP. In Brazil, municipal employment grew by 40% between 1982 and 1985. During that period 60% of the increase in formal sector employment ended up in the public sector.

7. This increase in the size of governments has represented a massive centralization of decisions on mobilization and disposal of resources, pricing, investments and relationship between management and labor. The demands it places on the administrative and political machinery are so great that public agencies and enterprises have become hosts to inefficiency, waste and vested interest. Decisions such as public utility tariffs, discontinuance of service and subsidies have become totally politicized. In Argentina, for example, the railways lose close to $1 billion per year. Yet, the railways carry a mere 6% of the domestic cargo. The politicized labor union and the entrenched position of suppliers make change a difficult political process. In Brazil, the Government's National Development Bank accounts for more than 50% of the long-term credit and its large access to government funds has prevented the development of private institutions. It routinely rolls over the arrears to it. Its claims on public resources are of the order of 3-4% of GDP.

8. The expansion of the economic apparatus of governments has also led to tremendous rigidity. Each policy and each institution creates a vested interest in its perpetuation. Organizations once created are seldom liquidated. And, inevitably, as the governments have expanded their direct management of production and finance, there has arisen a deep conflict between the role of government as maker of policy and governmental organizations as beneficiaries or opponents of those policies. It is common that external tariffs and quantitative restrictions insulate public enterprise from competition. Public enterprises may survive but welfare suffers.

9. Paradoxically, while governments have become overextended in production and finance -- where the private sectors could easily function efficiently -- they lacked aggressiveness in other areas, particularly in the social sectors. Few resources and administrative capabilities were diverted to target these services to the most vulnerable groups in society. In Brazil, 78% of all public spending in health is devoted to large curative, high-cost hospitals concentrated in the urban areas. Only 22% is devoted to all forms of basic health care, including maternal and child care, communicable disease control and immunization programs. The infant mortality rate in Northeast Brazil is double that for the rest of Brazil.

10. An adjunct to the expansion of the public sector, too many activities in the private sector came to depend on the actions and inactions of government. Almost universallly in Latin American countries, long-term credit came from government banks, mostly at subsidized rates. For favored investments in particular industries or regions, various taxes were forgiven. In many cases, in the name of preventing excess capacity, specific enterprises obtained monopoly or quasi-monopoly of the market. The phenomenon of "negative value added" became common, i.e., the value of inputs at international prices was greater than the value of output at international prices. Government regulations and subsidies became a fountain of rent, essentially a transfer to favored groups from the rest of the society.

11. Import substitution and limits to external competition, proliferation of public enterprise, excessive dependence of private enterprise on rent channelled through subsidized credit (often not repaid), import licenses, and control on competition ultimately created closed, rigid and high cost industrial structures which could not grow any more -- the domestic market was limited and so was the capacity of the societies to transfer rents to them in terms of subsidies and high costs. Furthermore, an industrialization process which catered essentially to the domestic market was inherently contradictory with large external borrowing -- it did not, through exports, generate the foreign exchange necessary to service the debt. Simultaneously, an increasing proportion of domestic public resources was channelled to the maintenance of these structures -- a fundamental reason for the drying up of funds for development, large and untenable budget deficit, and growing internal and external debt. The final result is the transfer problem, both internal and external.

12. External capital, increasingly from commercial banks and with variable interest rates, partly contributed to the increases in production capacity, but also increasingly aided the postponement of adaptation to economic circumstances, internal and external. In the liquid days of the seventies, there was too much of a pressure from lenders and it was much too easy to succumb to easy money. As it turned out, the costs and risks in the process were almost entirely those of the borrowers. Interest rates were variable and the burden of risk and uncertainty was the borrowers'. Syndications, cross-default clauses, and later the cartelization of commercial banks through the advisory committees, ensured that while the banks as a group dealt with individual borrowers, individual borrowers could not deal with individual lenders. The system did initially lend to debt reschedulings and some new money but essentially lacked the flexibility to respond to a change as fundamental as we have seen.

13. The sum total of my remarks, hitherto, is that the problems that have culminated in the economic decline, stagnation and financial crisis in the Latin American economies have been a long time in the making. They have become institutionalized. There are diverse, vocal and influential vested interests in the continuance of the practices and structures that have developed. Adjustment, which means modification of internal policies and institutions to reinitiate growth and development and reestablish the financial viability of the process, has many facets and requires external capital flows. Let me summarize these and review as to how much of adjustment has taken place in Latin American countries and what issues arise.

14. The crisis of development and finance has been a crisis of management of governments, a crisis of the relationship of governments with the domestic private sectors and a crisis of the economic relationship of countries with the world outside. Therefore, a resolution of these is essential to restore growth.

15. First, the domestic environment for efficiency, enterprise, savings and investments has to be more hospitable than in the past. Key prices, such as interest rates, exchange rates and public utility tariffs have to be based on economic criteria and based on the market, wherever possible. Taxation systems have to stimulate efficiency and should lead to a certain stability of expectations. Much too often the relationship between governments and the private sector has been based on discretionary controls, licenses and subsidies. This discretion, by substituting for the allocative role of prices, has been a major source of "rents," as distinct from income derived from efficient production and services. An essential element of adjustment has to be the elimination of discretion and special favors.

16. Second, the sheer size of the government has to be reduced and its efficiency increased. The major roles and objectives of the government have to be restated. The cost of achieving non economic objectives like defense and self sufficiency in the so-called "strategic" sectors must be reassessed. Objectives that could be justified in the '70s cannot be justified today. Sharp reallocations have to be made towards public infrastructure, complementing private investment, and social services targetted toward the most vulnerable groups. There can be no adjustment without sustained improvement in the efficiency of government administration and public enterprises. These adjustments have to be in objectives, projects, programs, investments, pricing, procurement, internal management and control as well as in the continuance of uneconomic services and enterprises. Where possible, market tests should be applied and privatization of enterprises, where necessary and feasible, has to be an essential element.

17. Third, the issue of budget deficits. This is a crucial area and I will be spending some time on it. Budget deficits have become the major source of inflation and high real interest rates which have stunted private investment. To reduce inflation and interest rates a policy of deficit reduction must be seen as credible and sustainable. Improved expectations are crucial for their success. The mode and speed of that reduction also must be consistent with efficiency and long-run growth. Expedient instruments to cut the deficit quickly -- such as increases in export or import taxes or excessive cuts in public investment -- are usually inefficient. It takes time for an efficient tax reform to be implemented, to eliminate projects and programs, to cut public employment and to privatize public enterprises. This puts limits on the speed at which the deficit can be reduced: there is a trade-off between the speed of the deficit reduction and the "quality" and sustainability of the program. This has some important implications worth elaborating.

18. In the short run the uncertainty created by high inflation -- particularly when capital is mobile -- is the main constraint on the recovery of private investment and growth. Consequently, in the short run, the main objective of deficit reduction should be to lower the need for inflationary financing and the crowding out of domestic capital markets.

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Because it takes time for the deficit to be reduced efficiently -- but we do want to reduce the domestic financing of government quickly -- the role of external financing becomes crucial during this transition. It allows the temporary financing of the difference between the ultimately desirable deficit consistent with stability and the immediately achievable deficit consistent with efficiency and social acceptance. Clearly, this gap has to be bridged and over not too long a period. The required external flows may increase the relative debt burden temporarily. However, this process of deficit reduction is likely to be more sustainable than otherwise and permit a faster recovery of growth.

19. Fourth, the external trade regime has to contribute to a viable and sustained increase and diversification of exports. Furthermore, trade has to be open, not subject to discretionary controls and frequent changes. These regimes should reverse the past trend of penalizing exports and insulating domestic industry from competition to lower costs and to improve efficiency.

20. An essential aspect of external economic relations is indebtedness and capital flows. In the near term, the revival of investments cannot be pursued if the countries are net exporters of resources in the magnitudes that have been seen. True, one cannot expect that the debts of the debtor countries would keep on increasing indefinitely at the rate of world interest rates. But it is not conceivable either that a reasonable momentum of growth can be established if countries transfer significant resources abroad. If economic policies in developed countries lead to even higher interest rates internationally and restrictions on trade, the need for capital inflows increases and the problem of indebtedness becomes even more serious.

21. External financing is not only important for long-run growth; it is crucial in assisting countries to undertake an efficient stabilization program, one that minimizes short term output losses and is compatible with long-run efficiency. We have learned in Latin America that there is a close relationship between the debt problem, the mode of stabilization, the reinitiation of growth and the sustainability of the process. Short and long term are complementary and cannot be separated into neat compartments. This has important implications for the work of the World Bank.

22. I should now like to examine how countries of Latin America have fared against these criteria. I shall group them according to the issues faced, their responses, external finance and prospects for the future. Argentina and Brazil are sufficiently unique and therefore I shall treat each of them separately.

(i) Chile, Mexico and Uruguay.

During the last six years, these countries have made more far-reaching changes than any middle-income country in the developing world.

Chile has gone the farthest. There has been almost a total deregulation of the economy. The size of the Government, relative to GNP, was significantly reduced, even prior to the 1982 crisis. That clearly

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helped. In subsidies and social expenditures there has been a sharp targetting towards the less privileged. Government budget deficit has been eliminated and public savings are about 5% of GNP. Both private savings and investments have increased. In external trade, there has been a sharp real devaluation of the currency. With the elimination of quantitative import restrictions and a uniform import tariff of 15%, the bias against exports has been practically eliminated. External debt to commercial banks has been reduced by 25%, largely through conversions to equity. The economy has been growing at about 6% per annum during the last three years. New money from commercial banks was available until this year, but even Chile is having difficulty in resuming a normal and voluntary relationship with banks. For now the need for external finance is, however, limited because of the substantial improvement in the price of copper.

Mexico's transformation is no less impressive. The most far-reaching changes have been in the size and efficiency of the public sector and external trade. Mexico, which had a massive budget deficit in 1982, now has a non interest fiscal surplus of close to 8% of GDP. Non interest public expenditure has been reduced by 8 percentage points of GDP. There has been a sharp reduction in public investments, transfers and subsidies. Interest subsidies have been practically eliminated. Public utility tariffs have been sharply increased. Simultaneously, there have been reductions of tax rates and improvements in the administration and efficiency of taxes. Seven hundred public enterprises have been sold, privatized or closed. The operating losses of the remaining have been eliminated.

But, perhaps, the most far-reaching changes have been in external trade. Quantitative import restrictions, which until recently covered almost the entire import bill, have been reduced to less than 20% of the tradeable goods. Tariffs have been reduced to an average of 11% and a maximum of 30%. Foreign investment regulations and procedures have been simplified.

The adjustment has not been easy, particularly because of the drying up of commercial credit during the last four years, when private creditors refinanced less than 20% of Mexico's interest payments to them. To generate the necessary domestic resources to service the remaining portion, the public sector had to resort to inflationary finance and sharp cutbacks in investments. Inflation reached record levels and only now has sharply been

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reduced. Investment remains low and growth has not yet resumed and, as I mentioned earlier, real wages are a fraction of what they were in 1982. International organizations and bilateral sources have become the main sources of new funds.

Uruguay has followed in the footsteps of Chile and Mexico in the reform of the domestic economy and the external trade regime.

(ii) Argentina.

One of the most difficult cases of economic atrophy and indebtedness. Essentially, Argentina has been in a secular decline for the last 40 years. It never quite made the transition from an economy where the question was how to share the bounty of nature between the urban and rural classes to a modern economy based on diverse and efficient production and trade. The industrial sector was old and heavily dependent on protection, monopoly and government favors. Labor was highly organized and militant and yet, there had been a steady erosion of real wages. The Government gradually became very large; at the peak, public expenditures were more than 50% of GDP. A vast array of public enterprises in finance, industry, petroleum and infrastructure were established. Steadily their management deteriorated and became politicized. Their investments and deficits became a massive burden on the exchequer. Internal regulations proliferated and the external trade regime was highly protectionist. Growth and development were brought to a halt, by large claims on government for internal transfers and external debt service.

Much of the adjustment effort until recently was centered around the reduction of the budget deficit without addressing the underlying structural issues. For example, receipts of existing taxes were declining while inefficient and self-defeating new taxes were introduced. Little attention was paid to the administration of the tax system. Ceilings were placed on new credit; no attention was paid to the governmental and provincial financial institutions which were an engine for credit creation through the central bank. Little attention was paid to the reform of public enterprises which were such a large part of the fiscal and allocative problem.

During the last year an integrated program of adjustment has been put in place, emphasizing liberalization of trade, reform of the banking system, privatization, and improvement in the efficiency of public enterprise and tax reform. But there is a long way to go. The issues have developed over a long

period. Also, stabilization and structural adjustment will remain intertwined. Stabilization measures can be sustained only if they are consistent with efficiency and growth. In the meantime, external finance is an issue. The weight of Argentina's debt is high and economic reform will be slow to produce results.

(iii) Brazil.

Brazil's GNP is more than $250 billion, approaching the proportions of some of the European economies. It is one of the most diverse and dynamic economies anywhere and one of the few with a potential to "grow out of debt." Its debt and debt service, relative to GNP and exports, are the smallest in Latin America. Yet, because of the very size and complexity of the public sector, the many vested interests in the existing system, the rigidities brought about by universal indexing and ultimately by a difficult political situation, Brazil has been unable to sustain meaningful adjustment. There is only one exception, a flexible and realistic exchange rate. And even here, the real exchange rate has not bee maintained lately. Brazil now is generating a monthly trade surplus of $1.5 billion. But the internal transfer problem, aggravated by large domestic debt service, remains intractable. The underlying reform of programs, projects and institutions, public enterprise and regulation is not in view.

(iv) Colombia, Costa Rica and Ecuador.

Colombia has been a conservatively managed economy. Consequently, issues of indebtedness and adjustment never attained the same proportion as in other Latin American countries. For the longer term though, the issue is whether Colombia can continue sufficient progress in growth and expansion of human opportunity without the reform of internal regulations and the relatively closed trade regime. Colombia has had a relatively large access to finance from international organizations. Despite the domestic economic performance and an exemplary behavior as a debtor, Colombia is not succeeding today even in obtaining a refinancing of amortization payments from commercial banks.

Costa Rica has had a sustained progress in domestic reform to reduce the public sector deficit domestic regulation, the financial sector and the external trade regime. It has not, however, succeeded in obtaining any new money from commercial banks despite its own efforts and those of the World Bank.

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In Ecuador, the reform effort has been halting and discontinuous. Until about a year policies were pursued to improve domestic mobility of resources, to improve the working of the financial sector and to diversify exports. There was a substantial setback in the last year of the previous government and because of the inability of the commercial banks to fulfill their commitment on the size of a new money package. The new administration has started a promising adjustment effort.

In all these countries, reform has been an issue but no less an issue has been the availability of private finance to aid adjustment. Practically all of net resources were from international and bilateral official sources.

(v) Bolivia, Dominican Republic, Jamaica, Haiti, Guatemala, Honduras, El Salvador and Eastern Caribbean Islands.

The common characteristic of these countries is their poverty and lack of actual and potential creditworthiness for commercial borrowing. Among these, Bolivia and Jamaica have pursued sustained policies of internal deregulation, reform and reduction of trade restrictions. Lately, Honduras has initiated similar policies. Yet, in all these countries, some of them saddled with heavy debt service, bilateral concessional finance has been inadequate to aid adjustment and stimulate growth.

(vi) Guyana, Nicaragua and Peru.

These are countries which slipped into economic breakdown because of a total mismanagement of the economies and breakdown of relationship with sources of external finance. Guyana is now adopting policies of reform and a support group of donors has been constituted to mobilize finances for the clearance of arrears to international financial institutions and to assist development. Peru has moved into hyperinflation and extensive economic disruption. The economic situation in Nicaragua is similar.

23. With the advantage of hindsight, we can say now that as the crisis began to unfold, there was understanding of the issues of adjustment but definitely not enough about the process and difficulties of adjustment. So, let me summarize what we have learned about the process of adjustment and what conclusions we derive from it.

24. Adjustment is adjustment of government, of the relationship of government with a variety of private interests and of the country's economic relations with the outside world. It cannot be purely an

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economic affair. It is a political affair and a social affair. It is a change in vested interests, acquired rights, incomes, benefits, rents and costs. Where economic structures and practices that need change have been established for some time and an entire generation has come to regard them as the norm, the frictions and pains of adjustment are enormous. In most of the countries the political structures are fragile. There are memories of military governments and populist governments. So, changes, if they are to be enduring, will take time. A few disembodied variables over relatively short periods cannot symbolize the success or failure of adjustment. How changes ultimately translate into deficits, balance of payments, capital flows and inflation is no doubt important. But more important is the quality of management and change of policy, institutions and relationships behind these. These will determine whether the improvements will be sustained or ephemeral. We should also expect that the political and social nature of reform will make progress discontinuous and a process where the second or the third best rather than the theoretical optimum may well be the preferred solution.

25. The issues of adjustment cannot be neatly categorized as stabilization, balance of payments management and development. Stabilization is essential for growth and development. But stability cannot be sustained if the result is stagnation and a prolonged decline in the standard of living. The focus increasingly has to be on stabilization which is consistent with increased mobility and efficiency of resources and a reasonable investment rate. Similarly, balance of payments management and exchange rates have to be regarded as key elements in domestic efficiency and growth. Improvements in balance of payments which come largely from the compression of imports and improvements in the domestic resource balance which come largely from sharp reductions in investments cut at the root of future growth and efficiency and are not likely to be sustained.

26. All this links closely with the role of external finance, to which I now turn. The abruptness of the external adjustment experienced by Latin America during the 1982-87 period -- largely obtained through cuts in imports, investment, and thus, output growth -- simply mirrors the abruptness in the decline of external credit. Creditors cannot expect countries to generate quickly 4% to 6% of GDP in resource transfers to be a sustainable process. Transfers of this magnitude from stagnant economies are not tenable. Not only do they cut on needed import and investment -- it takes time to expand exports and savings -- they also prevent the institutional changes required to allow a sustainable and efficient fiscal adjustment. Here, we find again a tradeoff between the speed of the adjustment and its quality and sustainability.

27. No doubt, external finance can only complement domestic effort, but where there is domestic effort, inadequacy of external finance can abort the program. Therefore, the recent experience of Colombia, Costa Rica and Ecuador and the difficulty in putting together a financing package for Argentina are cause for concern. Much has been said about the case-by-case approach to the problem of debt. But a true case-by-case approach should lead to the tailoring of finance and the form of finance to the specific conditions of a country and its program and performance. In commercial finance, this approach is not yet visible. If the current trend cannot be reversed, there will be a case for

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greater financing by international institutions. The risk to these international institutions of the failure of adjustment and growth in the debtor countries is far greater than increased exposure in support of viable programs.

28. Even if adequate capital flows can be ensured, there would be countries where the weight of debt relative to the economy, the gravity of the institutional and economic distortions and the external terms of trade is such that substantial new borrowing on commercial terms would lead to an explosive increase in debt service. For such countries, negotiated debt reductions may be the only recourse. This is an area where the international financial arrangements need flexibility, a flexibility which has been lost because of the nationalization of substantial private debt in many Latin American countries. Some of the most intractable debt problems in the 19th and 20th centuries, including Indonesia's as late as the mid-sixties, were resolved this way.

29. And now a word about the Bank's response and its approach for the future.

30. The issues of economic analysis, assistance in the design and implementation of programs, lending and coordination with financing that we face are without parallel. Early in the eighties we, as many others, failed to see the approaching crisis. When it came, we tried to dismiss it as a problem of liquidity and our approaches were slow to develop. But over the last three years the Bank has made a major contribution to adjustment and finance in the Latin American countries. In Chile, Mexico and Uruguay, the adjustment owes much to the analysis and framework developed jointly between the Governments and the Bank and supported by the Bank through adjustment loans. In Argentina, lately, we have worked intensively with the Government on a comprehensive program, supported by substantial lending. In Bolivia, Jamaica and Costa Rica, we have been the main interlocutors on policy reform and the largest sources of finance. And lately, we have increased our work on other Central American countries and in countries such as Venezuela, Trinidad and Tobago, and Guyana. We have tried our best in Peru but without success. Everywhere we have made painstaking effort to mobilize commercial bank and bilateral finance. In Argentina, Mexico, Chile, Ecuador, Honduras and Costa Rica, bilateral finance from Japan has been particularly important. In commercial bank finance, there are increasing difficulties, as I have already mentioned.

31. Let me now look ahead. Vis-a-vis the countries, I regard the Bank's work as a package, a continuum. Our economic and sector work is the foundation, and an increasingly important foundation, of our relationships. Subjects like growth, macroeconomic adjustment, institutional changes, reforms in the sectors, and issues of transition, require constant investigation as to their causes, effects, remedies and implementation. Solutions of today will not be solutions of tomorrow. We are not dealing with an exact science. There has to be constant learning from experience. There have to be mid -course corrections and a continuing stimulus to debate and discussion. Ultimately, the value of economic and sector work is its contribution to policies and institutions in the countries and to the design of the

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Bank's lending. With the scarcity of resources, the economic and sector environments in the countries have assumed a central role in the productivity of investments and operations, particularly when projects or programs have to be couched in suitable policies and institutions. In our general relationship with the countries, we shall emphasize continuity of effort in economic and sector work and lending. Experience has shown that intermittent relationship is crisis ridden and ultimately breaks down.

32. Just as operations cannot be undertaken in isolation from economic, sectoral and institutional policies, they have to take account of what other lenders do or do not do. Without subordinating itself to the judgments and actions of others, the Bank will have to satisfy itself about the adequacy of overall financing, for this may make the difference between the success and failure of projects and programs it supports.

33. In economic and sector work in the Region, there will be four fundamental themes: macroeconomic issues of stabilization and growth, sectoral and institutional reform, external finance and issues of transition. In stabilization and growth we shall pay special attention to public finances, external trade, financial markets and reforms in the overall regulatory environment for an increased role of the private sector. In sectoral and institutional issues we shall underline the link with macroeconomic issues, public enterprises, the relationships between central and provincial governments, agricultural development and environment, efficiency and targetting of social services and the role of women in development. In external finance the theme will be the link between adjustment and growth and external finance and the viability of specific approaches to external finance. The issue of transition will cut across all of our work. We are not concerned with the absolute optimum for no one ever reaches it. We are concerned with progress towards constantly shifting optimum.

34. Our lending, as of late, would be a graduated response to the countries' own economic and sectoral programs and projects and their implementation. The core lending would be for investments that have impact over the long run and whose benefits can accrue even if the macroeconomic environment is somewhat inadequate. Typically, such lending would be for education, health, environment and agricultural infrastructure and research. In the absence of suitable macroeconomic and sectoral policies, these cores may remain rather limited. Beyond these, as Bank's lending increases, there would be increased emphasis on policy and institutional environments that ensure a reasonable domestic resource mobilization and efficiency of resources. We would undertake adjustment lending only if there is a satisfactory macroeconomic and sectoral program.

35. I should like to summarize our approaches in different types of countries. In Central America and the Caribbean, we would emphasize human and physical infrastructure, institutions, agriculture and environment. In Colombia and Venezuela, our main concerns would be the incentive regime, trade, and the financial sector. In Brazil and Argentina, we would emphasize stabilization, trade reform, public finances, the financial sector, and energy. In Chile, Mexico and

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Uruguay, we would make major efforts to sustain the adjustment and lay the foundation of growth across the economies.

36. In Argentina and Mexico, we have shown our capacity to mobilize our economic and sector work and lending to address comprehensively and quickly the questions of reform and finance, provided the government itself is willing and able to undertake adjustment. We shall continue to do so, even though it will require considerable mobility in our manpower and strains in management.

37. A last word about coordination with financial institutions. We attach great importance to our relationship with the IMF and we draw upon their experience and analysis. We consider it important that the IMF should assist well-conceived programs of adjustment. We also value very highly our close coordination with the Inter-American Development Bank and draw upon their experience in the Region. We shall also work hard to help countries in mobilizing commercial and bilateral finance. All this said, we shall need a certain amount of eclecticism in our approaches and those of others. Situations will vary and the responses of various institutions to situations will vary. The Bank will always have to ask how its own effort and timing help the overall goal of development.

SELECTED STATISTICAL TABLES

Table A: WESTERN HEMISPHERE

		Average 1970-79	1980	1981	1982	1983	1984	1985	1986	1987
A05	Real GDP 1/	5.7	6.0	0.2	-1.1	-2.4	3.5	3.5	3.9	2.5
A06	Per Capita Real GDP 1/	3.1	2.6	-1.9	-3.4	-4.7	1.1	1.8	1.6	0.2
A07	Gross Capital Formation 2/		23.4	22.9	20.6	17.0	17.2	17.9	18.3	17.8
A11	Consumer Prices- Weighted Averages 1/	34.8	85.7	80.7	66.6	108.6	131.8	143.5	88.3	131.2
A12	Consumer Prices - Median Estimates 1/	11.6	19.2	14.7	9.0	18.1	12.0	15.0	11.5	14.6
A15	Broad Money Aggregates 1/		62.4	70.5	74.4	106.7	141.4	137.0	84.5	149.6
	Median Estimates		18.4	18.0	14.8	16.1	16.6	18.7	24.0	20.0
A19	Central Government Fiscal Balances 2/		-0.7	-4.1	-6.2	-5.0	-4.0	-3.9	-5.1	-6.3
	Median Estimates		-3.0	-5.8	-6.4	-5.1	-4.7	-5.0	-2.9	-4.2
A24	Export Volumes 1/	1.9	2.0	6.7	-5.0	7.6	8.1	0.6	-0.8	6.5
A25	Import Volumes 1/	6.8	9.4	4.0	-17.7	-22.6	3.1	1.5	3.2	3.6
A26	Export Unit Values 3/	16.0	28.6	-0.1	-6.7	-6.2	2.3	-6.1	-15.6	6.8
A27	Import Unit Values 3/	11.8	19.8	4.8	-2.1	-3.3	-1.4	-8.5	-1.5	7.8
A28	Terms of Trade 1/	3.6	7.4	-4.8	-4.7	-3.0	3.8	-2.7	-14.5	-0.9
A29	Non-Oil Commodity Prices 1/	10.5	5.1	-14.4	-3.1	6.0	-0.4	-8.5	4.9	-6.4
A29	Oil export unit value 1/	29.1	63.5	9.9	-4.8	-11.9	-2.1	-5.0	-50.2	28.4
A29	Export unit value of manufactures 1/	10.6	10.4	-3.9	-2.1	-2.5	-3.0	1.0	17.7	12.0
A36	Current Account Transactions 4/									
	Exports (f.o.b.)		94.4	100.6	91.0	91.6	101.6	96.0	80.4	91.4
	Imports (f.o.b.)		96.4	105.0	84.6	83.3	94.3	83.0	84.1	71.5
	Trade balance		-2.0	-4.3	6.4	28.5	37.2	23.0	15.3	19.8
	Services, net		-29.0	-40.1	-50.0	-41.2	-42.2	-40.6	-36.9	-35.3
	Goods and services balance		-31.0	-44.4	-43.6	-12.7	-5.0	-7.6	-20.6	-15.5
	Unrequited transfers		1.2	1.5	1.2	1.8	2.4	2.9	8.7	4.0
	Current account balance		-29.8	-42.9	-42.4	-10.9	-2.5	-4.7	-16.9	-11.3
	Exports of goods and services		126.2	137.1	121.7	117.9	130.6	124.3	103.8	120.7
	Investment income, net		-16.1	-25.6	-33.8	-32.1	-34.8	-32.6	-29.0	-27.9
	Of which: Interest payments		-25.4	-38.6	-45.4	-40.3	-44.1	-41.5	-36.5	-33.8
	Oil trade balance		17.9	23.1	22.9	28.5	27.2	25.3	11.9	15.1
A41	Summary of External Financing 4/									
	Deficit on goods, services and private transfers		20.3	43.5	43.2	11.5	5.6	6.1	18.1	12.7
	Use of reserves		-3.2	1.4	20.7	-2.4	-11.4	-5.4	9.5	-3.9
	Asset transactions, net		-9.3	-7.2	-6.1	-2.3	-2.4	-2.3	-1.9	-2.2
	Errors and omissions		-3.3	-26.9	-17.4	-3.4	-2.2	-0.7	3.3	-1.1
	Non-debt-creating flows, net		5.5	6.1	7.2	4.3	4.7	6.0	3.3	6.4
	Net external borrowing		23.6	37.2	41.7	13.6	15.8	7.2	8.8	12.5
	Long-term borrowing from official creditors		3.8	4.8	4.9	7.4	8.9	8.2	10.6	12.9
	Reserve-related liabilities		1.0	1.2	11.1	7.5	3.5	0.8	4.5	2.3
	Other borrowing		18.7	31.2	25.8	5.7	2.5	-1.8	-6.5	-2.2

1/ Annual changes in percent.

2/ In percent of GDP.

3/ Annual changes in percent of US dollars.

4/ In billions of US dollars.

Table A: Western Hemisphere (cont'd.)

	Average 1970-79	1980	1981	1982	1983	1984	1985	1986	1987
A47 External Debt, by Class of Creditor End of Year 1/									
Total debt	231.2	287.8	330.2	342.2	356.4	360.1	382.9	411.2	
Short-term	44.0	49.5	62.1	44.8	44.6	35.4	35.7	33.5	
Long-term	187.2	238.3	268.1	297.9	313.8	342.7	366.2	377.7	
To official creditors	81.6	86.0	40.7	47.7	56.0	65.5	77.9	94.6	
To financial institutions	88.7	101.1	117.8	149.2	153.2	188.7	198.5	209.1	
To other private creditors	71.8	101.2	110.1	101.0	94.6	83.4	79.8	74.0	
A50 Long- and Short-Term External Debt Relative to Exports 2/	183.2	210.0	271.4	290.2	274.4	266.1	351.8	340.6	
A50 Long- and Short-Term External Debt Relative to GDP 2/	34.5	39.3	43.6	46.4	46.3	45.5	45.5	46.5	
A51 Debt Service Ratio 2/	33.3	41.8	51.6	40.8	40.9	40.3	45.0	35.5	
Of which: Interest Service Ratio 2/	18.4	24.8	32.6	30.7	30.6	30.2	29.8	22.1	

Source: IMF World Economic Outlook, October 1988

1/ In percent.

2/ In percent of exports of goods and services.

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	Annual Averages				
	1980-81	1982-83	1984-85	1986-87	1984-87
Rate of Growth of GDP per capita (percentage)					
ARGENTINA	-2.8	-2.4	-2.5	1.5	-0.6
BOLIVIA	-3.1	-8.2	-4.0	-3.1	-3.5
BRAZIL	0.5	-3.3	4.5	2.9	3.7
CHILE	5.0	-9.1	2.8	4.1	3.4
COLOMBIA	1.2	-0.7	1.4	3.2	2.3
ECUADOR	1.3	-3.7	0.9	-7.2	-3.3
JAMAICA	-3.9	0.1	-4.1	1.6	-1.3
MEXICO	5.3	-5.4	0.4	-3.9	-1.8
URUGUAY	3.4	-8.3	-1.5	5.0	1.7
VENEZUELA	-3.9	-5.2	-3.3	0.3	-1.5
Rate of Growth of Private Consumption per capita (percentage)					
ARGENTINA	-1.8	-6.3	-0.5	5.8	2.3
BOLIVIA	6.0	-9.4	2.7	-8.2	-3.3
BRAZIL	-1.3	-1.3	1.0	2.1	1.5
CHILE	6.0	-9.1	-2.1	3.8	0.8
COLOMBIA	1.9	-0.5	0.6	1.6	1.1
ECUADOR	3.4	-3.2	-0.6	-5.2	-2.9
JAMAICA	-6.1	-1.0	-1.3	-0.9	-1.1
MEXICO	4.9	-5.9	0.0	-5.4	-2.7
URUGUAY	5.1	-10.3	-3.0	6.6	1.7
VENEZUELA	-2.6	-6.7	-2.8	-7.8	-5.3

	Annual Averages				
	1980-81	1982-83	1984-85	1986-87	1984-87
Debt to GDP Ratio (percentage) 1/					
ARGENTINA	23.3	73.7	69.0	66.8	67.9
BOLIVIA	51.2	55.4	51.2	107.5	79.3
BRAZIL	27.4	38.8	47.5	39.4	43.4
CHILE	44.2	79.3	112.8	117.0	114.9
COLOMBIA	22.4	28.0	36.1	45.8	40.9
ECUADOR	53.6	66.4	76.9	82.0	79.5
JAMAICA	73.6	82.2	158.1	142.0	150.0
MEXICO	31.8	57.0	53.3	77.0	65.1
URUGUAY	17.8	45.1	69.4	59.7	64.5
VENEZUELA	49.1	51.3	59.3	63.0	61.1
Interest Payments to GDP Ratio (percentage) 1/					
ARGENTINA	2.3	8.5	7.5	5.3	6.4
BOLIVIA	5.4	5.6	5.6	1.9	3.7
BRAZIL	3.5	4.9	5.3	3.4	4.3
CHILE	5.4	9.5	11.7	10.2	10.9
COLOMBIA	2.3	2.8	3.3	3.9	3.6
ECUADOR	4.0	6.9	7.3	7.3	7.3
JAMAICA	6.0	6.1	11.0	10.3	10.7
MEXICO	3.5	7.0	6.2	6.1	6.1
URUGUAY	2.8	4.3	5.6	3.8	4.7
VENEZUELA	3.4	5.3	6.1	5.3	5.7
Interest Payment to Exports Ratio (percentage) 1/ 2/					
ARGENTINA	28.8	56.0	54.4	51.0	52.7
BOLIVIA	25.0	28.0	23.9	12.7	18.3
BRAZIL	35.2	47.8	38.2	37.5	37.8
CHILE	31.0	45.9	45.7	32.5	39.1
COLOMBIA	16.7	26.0	25.8	20.5	23.1
ECUADOR	19.1	30.3	29.6	31.0	30.3
JAMAICA	12.3	17.0	19.8	19.1	19.4
MEXICO	29.8	41.9	37.9	33.6	35.7
URUGUAY	10.4	19.2	23.0	17.3	20.1
VENEZUELA	10.4	21.3	22.3	28.1	25.2

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	Annual Averages				
	1980-81	1982-83	1984-85	1986-87	1984-87
Net External Borrowing (millions of US$) 3/					
ARGENTINA	4626	3614	1390	1491	1440
BOLIVIA	295	109	5	187	96
BRAZIL	6591	6119	2326	-1170	578
CHILE	2744	1240	1088	608	848
COLOMBIA	1105	1152	1347	764	1055
ECUADOR	1102	123	456	634	545
JAMAICA	271	365	250	46	148
MEXICO	9674	5169	761	2558	1660
URUGUAY	290	312	33	156	94
VENEZUELA	1575	584	-689	-1537	-1113
Net External Borrowing Financial Markets (millions of US$) 3/ 4/					
ARGENTINA	1094	2316	1471	934	1203
BOLIVIA	141	-15	-1	-6	-3
BRAZIL	4550	4447	2804	-937	933
CHILE	143	1114	842	80	461
COLOMBIA	613	445	290	352	321
ECUADOR	412	-65	287	180	233
JAMAICA	-11	-15	18	-7	6
MEXICO	6545	4784	270	1499	884
URUGUAY	205	353	61	58	59
VENEZUELA	1198	695	-642	-906	-774
Ratio of Net External Borrowing to Total External Interest 3/					
ARGENTINA	148.7	72.0	27.1	35.8	31.4
BOLIVIA	167.7	56.0	-1.6	227.6	113.0
BRAZIL	90.2	70.6	32.3	-19.7	6.3
CHILE	233.5	74.9	60.1	43.1	51.6
COLOMBIA	139.2	106.6	111.8	58.5	85.1
ECUADOR	237.7	21.6	58.9	139.0	98.9
JAMAICA	236.1	249.8	124.6	19.9	72.3
MEXICO	176.5	65.7	7.4	35.6	21.5
URUGUAY	212.6	151.9	11.3	58.4	34.9
VENEZUELA	104.4	27.8	-36.9	-65.5	-51.2
Ratio of Net Financial Markets to Interest Financial Markets Loans (%) 3/ 4/					
ARGENTINA	175.2	218.2	47.0	92.8	69.9
BOLIVIA	127.0	-13.2	-4.8	-183.3	-94.1
BRAZIL	110.3	91.8	65.5	-24.4	20.5
CHILE	40.6	250.6	102.7	7.6	55.2
COLOMBIA	330.0	133.2	91.1	105.2	98.2
ECUADOR	178.8	-8.4	46.9	54.0	50.5
JAMAICA	-18.6	-17.2	24.3	-13.6	5.4
MEXICO	159.5	82.4	3.9	32.5	18.2
URUGUAY	228.1	229.2	24.6	26.9	25.8
VENEZUELA	101.8	41.6	-46.2	-55.7	-50.9

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	Annual Averages				
	1980-81	1982-83	1984-85	1986-87	1984-87
Resource balance to GDP Ratio (percentage) 5/					
ARGENTINA	-1.5	4.1	5.5	1.3	3.4
BOLIVIA	1.2	3.7	2.6	-6.5	-1.9
BRAZIL	-1.3	0.9	5.4	2.8	4.1
CHILE	-7.3	0.4	0.8	3.9	2.4
COLOMBIA	-1.5	-3.6	0.4	6.7	3.5
ECUADOR	-1.2	2.4	6.7	0.8	3.7
JAMAICA	-5.3	-9.3	-8.4	-0.5	-4.4
MEXICO	-2.4	7.3	6.4	6.1	6.2
URUGUAY	-4.8	1.8	4.4	3.6	4.0
VENEZUELA	7.0	3.5	10.6	0.5	5.5
Gross Domestic Investment as a Percentage of GDP 5/					
ARGENTINA	21.7	14.9	11.8	12.5	12.1
BOLIVIA	13.0	9.2	4.5	6.6	5.5
BRAZIL	22.0	17.4	16.1	19.1	17.6
CHILE	21.9	10.6	13.7	15.8	14.7
COLOMBIA	19.9	20.2	19.0	18.5	18.8
ECUADOR	23.0	19.7	15.6	20.6	18.1
JAMAICA	16.9	20.3	24.4	20.6	22.5
MEXICO	27.3	21.9	20.9	18.1	19.5
URUGUAY	16.2	13.1	8.4	7.9	8.1
VENEZUELA	24.9	21.6	14.6	18.9	16.7
Gross Domestic Savings as a Percentage of GDP 5/					
ARGENTINA	20.2	19.0	17.3	13.7	15.5
BOLIVIA	14.1	12.9	7.1	0.1	3.6
BRAZIL	20.7	18.2	21.5	21.9	21.7
CHILE	14.6	11.0	14.5	19.7	17.1
COLOMBIA	18.4	16.7	19.4	25.2	22.3
ECUADOR	21.8	22.1	22.3	21.4	21.8
JAMAICA	11.7	11.1	16.0	20.2	18.1
MEXICO	24.9	29.2	27.3	24.1	25.7
URUGUAY	11.4	14.8	12.7	11.5	12.1
VENEZUELA	31.9	23.1	25.2	19.3	22.3

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	Annual Averages				
	1980-81	1982-83	1984-85	1986-87	1984-87
Imports of Goods and Non-Factor Services as a Percentage of GDP 5/					
ARGENTINA	9.4	10.0	8.8	9.5	9.1
BOLIVIA	17.0	17.3	20.5	22.3	21.4
BRAZIL	10.4	8.8	7.5	5.9	6.7
CHILE	26.9	21.3	25.8	28.1	27.0
COLOMBIA	15.5	14.2	12.5	12.3	12.4
ECUADOR	23.8	17.7	14.5	22.2	18.3
JAMAICA	54.4	45.1	63.7	54.5	59.1
MEXICO	13.0	9.9	10.1	12.3	11.2
URUGUAY	19.9	19.7	20.1	18.7	19.4
VENEZUELA	25.6	21.2	16.7	19.3	18.0
Exports of Goods and Non-Factor Services as a Percentage of GDP 5/					
ARGENTINA	8.1	15.7	14.2	10.7	12.5
BOLIVIA	18.1	21.1	23.1	16.0	19.5
BRAZIL	9.1	9.7	12.8	8.7	10.7
CHILE	19.6	21.7	26.7	32.1	29.4
COLOMBIA	14.1	10.7	12.9	19.0	15.9
ECUADOR	22.7	20.1	21.3	23.0	22.1
JAMAICA	49.2	35.9	55.8	54.0	54.9
MEXICO	10.6	14.7	16.4	18.3	17.3
URUGUAY	15.1	21.5	24.5	22.4	23.5
VENEZUELA	32.6	27.5	21.3	22.9	22.1
Real Exchange Rate (index 1980=100) 6/					
ARGENTINA	114.9	215.7	214.2	235.6	224.9
BOLIVIA	89.7	76.5	48.7	123.5	86.1
BRAZIL	91.2	86.9	97.8	105.4	101.6
CHILE	108.2	94.6	76.7	56.6	66.6
COLOMBIA	98.8	89.4	102.6	131.5	117.0
ECUADOR	94.7	93.7	114.2	160.1	137.2
JAMAICA	96.9	93.2	147.1	147.7	147.4
MEXICO	95.9	135.9	112.9	148.7	130.8
URUGUAY	85.5	111.8	147.0	153.8	150.4
VENEZUELA	94.7	86.6	109.0	157.5	133.3
Terms of Trade (index 1980=100)					
ARGENTINA	102.7	87.1	67.9	72.0	79.9
BOLIVIA	101.0	104.0	104.6	60.3	82.5
BRAZIL	97.7	104.0	120.1	134.2	127.2
CHILE	91.0	81.2	78.3	78.4	78.4
COLOMBIA	93.0	88.2	91.1	101.9	96.5
ECUADOR	100.4	90.4	85.7	69.3	77.5
JAMAICA	97.1	94.2	95.4	109.9	102.7
MEXICO	101.5	86.6	75.2	60.5	67.8
URUGUAY	100.6	95.1	97.7	99.0	98.3
VENEZUELA	98.1	69.7	77.0	61.3	69.1

	Annual Averages				
	1980-81	1982-83	1984-85	1986-87	1984-87
Ratio of Public Sector Primary Deficit (+) or Surplus (-) to GDP (%) 7/					
ARGENTINA	5.0	7.4	4.2	2.0	3.1
BRAZIL	0.0	-1.0	-4.3	-0.1	-2.2
CHILE	-5.0	0.1	-1.8	-0.6	-1.2
COLOMBIA	2.2	6.0	5.5	0.9	3.2
ECUADOR	2.6	0.7	-5.4	3.8	-0.8
JAMAICA	8.3	5.7	-3.9	-9.0	-6.5
MEXICO	5.1	0.8	-5.0	-4.1	-4.5
VENEZUELA	-0.2	2.3	-10.6	0.9	-4.9
Ratio of Public Sector Overall Deficit (+) or Surplus (-) to GDP (%) 8/					
ARGENTINA	10.4	15.6	9.4	5.9	7.6
BOLIVIA	8.4	16.8	17.0	6.8	11.9
BRAZIL	4.6	6.6	3.5	4.6	4.0
CHILE	-3.2	3.2	3.5	1.5	2.5
COLOMBIA	2.9	5.7	3.6	-2.6	0.5
ECUADOR	5.2	4.9	-1.7	7.6	3.0
JAMAICA	16.1	15.0	5.9	-0.1	2.9
MEXICO	9.2	5.0	4.5	2.3	3.4
URUGUAY	0.9	7.5	3.8	1.3	2.5
VENEZUELA	-0.2	7.1	-6.7	4.7	-1.0
Inflation Rate (percentage)					
ARGENTINA	109.4	321.7	536.7	130.1	333.4
BOLIVIA	24.6	312.5	5173.9	38.4	2606.1
BRAZIL	93.3	135.4	215.7	227.3	221.5
CHILE	20.4	21.9	24.7	19.5	22.1
COLOMBIA	26.1	20.3	20.4	22.5	21.5
ECUADOR	16.2	38.4	24.8	29.9	27.3
JAMAICA	16.7	11.9	27.6	9.4	18.5
MEXICO	29.3	89.8	61.5	132.5	97.0
URUGUAY	36.1	36.0	74.6	63.9	69.3
VENEZUELA	15.3	7.2	12.0	26.3	19.2

	Annual Averages				
	1980-81	1982-83	1984-85	1986-87	1984-87
World Bank Gross Disbursements (millions of US$)					
ARGENTINA	96	77	120	602	361
BOLIVIA	61	22	15	26	20
BRAZIL	365	914	1033	1267	1150
CHILE	22	28	136	338	237
COLOMBIA	235	284	526	447	486
ECUADOR	44	44	54	149	101
JAMAICA	49	91	62	44	53
MEXICO	441	384	762	1001	881
URUGUAY	5	21	41	55	48
VENEZUELA	0	0	0	0	0
World Bank Net Disbursements (millions of US$)					
ARGENTINA	56	28	47	468	257
BOLIVIA	57	12	1	6	3
BRAZIL	246	668	660	522	591
CHILE	12	15	115	305	210
COLOMBIA	163	176	367	171	269
ECUADOR	33	25	32	110	71
JAMAICA	43	78	44	8	26
MEXICO	344	227	468	505	486
URUGUAY	-2	11	23	30	26
VENEZUELA	-25	-19	-21	-22	-21
World Bank Outstanding and Disbursed Debt (millions of US$)					
ARGENTINA	441	519	602	1643	1122
BOLIVIA	260	304	285	372	328
BRAZIL	2194	3190	4651	8494	6572
CHILE	192	226	369	1237	803
COLOMBIA	1099	1448	2007	3703	2855
ECUADOR	167	224	273	612	442
JAMAICA	194	345	397	654	525
MEXICO	2240	2781	9443	6456	4950
URUGUAY	71	89	134	256	195
VENEZUELA	120	78	48	17	32
Share in World Bank Portfolio (%)					
ARGENTINA	1.9	1.6	1.4	2.1	1.7
BOLIVIA	0.7	0.6	0.4	0.3	0.4
BRAZIL	8.8	9.1	10.6	10.9	10.7
CHILE	0.8	0.7	0.8	1.6	1.2
COLOMBIA	4.3	4.1	4.5	4.7	4.6
ECUADOR	0.4	0.5	0.6	0.8	0.7
JAMAICA	0.7	1.0	0.9	0.8	0.9
MEXICO	9.0	8.0	7.6	8.2	8.0
URUGUAY	0.3	0.2	0.3	0.3	0.3
VENEZUELA	0.6	0.3	0.1	0.0	0.1

	Annual Averages				
	1980-81	1982-83	1984-85	1986-87	1984-87
Ratio of World Bank Net Disbursements To Net External Borrowing (%) 3/					
ARGENTINA	1.2	0.8	3.4	31.4	17.9
BOLIVIA	19.2	11.1	11.1	3.2	3.4
BRAZIL	3.7	10.9	28.4	-44.6 a/	102.2
CHILE	0.4	1.2	10.5	50.2	24.7
COLOMBIA	14.8	15.3	27.2	22.3	25.4
ECUADOR	3.0	20.0	6.9	17.3	12.9
JAMAICA	15.9	21.4	17.6	17.4	17.6
MEXICO	3.6	4.4	61.4	19.7	29.3
URUGUAY	-0.7	3.5	68.2	19.3	27.9
VENEZUELA	-1.6	-3.2 a/	3.1 a/	1.4 a/	1.9 a/
Ratio of World Bank Debt Service To Total Debt Service (%) 3/					
ARGENTINA	1.4	1.2	1.2	3.1	2.1
BOLIVIA	8.8	8.3	6.4	6.7	6.5
BRAZIL	2.9	3.4	4.4	7.2	5.8
CHILE	1.4	1.3	1.9	5.9	3.9
COLOMBIA	14.1	13.4	15.2	22.8	19.0
ECUADOR	2.4	2.9	3.2	6.2	4.7
JAMAICA	9.2	11.2	10.8	15.4	13.1
MEXICO	3.4	3.1	3.6	6.2	4.9
URUGUAY	3.8	3.0	3.7	6.3	5.0
VENEZUELA	0.4	0.3	0.1	0.1	0.1
Ratio of World Bank Debt to Total External Debt (%) 3/					
ARGENTINA	2.1	2.3	2.7	4.3	3.5
BOLIVIA	5.3	7.9	8.7	24.7	16.7
BRAZIL	2.1	3.5	6.8	13.7	10.2
CHILE	0.9	1.1	1.7	5.1	3.4
COLOMBIA	22.3	18.0	20.3	23.6	22.0
ECUADOR	1.9	3.4	4.2	12.0	8.1
JAMAICA	7.6	12.7	15.2	19.5	17.3
MEXICO	2.7	2.9	3.6	8.1	5.8
URUGUAY	5.8	4.6	6.0	11.0	8.5
VENEZUELA	0.8	0.6	0.8	0.6	0.7

a/ Average net external borrowing was negative during this period.

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NOTES

1/ Includes Short Term debt.
2/ Exports of Goods and Non Factor Services
3/ Medium and Long Term Debt only. Source: World Debt Tables.
4/ Medium and long term external debt, public or publicly guaranteed, from private banks and other financial institutions. Source World Debt Tables.
5/ Ratios from variables at current prices. Exports and imports of goods and nonfactor services.
6/ The Real Exchange Rate index is the nominal exchange rate (in local currency per US$) adjusted by chages in domestic and foreign prices. An increase means that more domestic goods can be bought with one unit of foreign goods, i.e. a devaluation of the local currency.
7/ The Public Sector Primary Deficit equals Non-Interest Public Sector Expenditures minus Total Public Sector Revenues. Excludes both domestic and external interest.
8/ The Overall Public Sector Deficit equals inflation-adjusted public sector expenditures minus public sector revenues.

SOURCE: LAC Regional Staff, World Debt Tables

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A PROPOSAL LINKING INTEREST RELIEF ON EXTERNAL DEBT TO STRUCTURAL ADJUSTMENTS IN DEBTOR COUNTRIES TO ENHANCE THE PROGRAM FOR SUSTAINED GROWTH

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A PROPOSAL LINKING INTEREST RELIEF ON EXTERNAL DEBT TO STRUCTURAL ADJUSTMENTS IN DEBTOR COUNTRIES TO ENHANCE THE PROGRAM FOR SUSTAINED GROWTH

Section I: Executive Summary

We propose that creditor country governments support creation of a new World Bank debt facility to offer temporary debt servicing relief on a case-by-case basis to middle-income countries which agree to carry out serious structural reform. In contrast to other proposals for debt facilities, this one is more market-oriented and offers strong "carrots and sticks" for policy reforms that must be made if sustained growth is to be achieved and debts paid. Without such a plan, too many middle-income countries will remain mired in a "Catch 22" quagmire in which debt servicing absorbs too much of national savings to permit adequate growth, and, without growth, debts cannot be paid.

Key focus of the debt proposal. The main emphasis is policy reform. The Latin American problem debtors serve as an excellent example. Their policies, such as overvalued exchange rates, destabilizing inflation rates, import substitution, price distortions, and a general pernicious interventionism and lack of discipline are largely responsible for the debt burden carried by these countries.

While the debt situation itself is probably responsible for the first tentative steps toward economic reform that have occurred, the political will for many remaining necessary changes is not present and, in fact, appears to be diminishing as the years pass without more progress on debt and as new governments take power. In order to obtain the changes that are sine qua nons for these countries to achieve growth, to become able to pay our private and public creditors, and to purchase more goods and services from us, it is clear that something else is needed.

We believe that limited and temporary interest relief in return for policy reform can work as long as the countries are offered relief commensurate with their willingness to undertake reforms and not with the value of their debt in the secondary market. The Baker Plan has been excellent in establishing a context and an emphasis on the need for economic reform. However, we believe that providing interest relief, instead of only the offer of new loans, could make it possible for some governments to gain public support for the reforms.

Successful "debt workouts" have not occurred and are unlikely to occur due to the differing interest of the parties involved. Those who argue that voluntary workouts are feasible fail to take into consideration the continued risk associated with any new debt instruments issued in place of existing bank debt. This proposal would have creditor countries and IFIs play a more active role in the "debt workout" than they have previously. An international debt facility (IDF) would temporarily assume the risk associated with the adjustment process, and at the same time work with the debtor country to ensure that structural adjustments are made to support sustained economic growth over the long term.

How the plan would work. The IDF would buy at a discount part of the medium/long term commercial debt of countries willing to undertake a vigorous structural reform program. The IDF would then reduce the country's interest payments on this debt for a period of five to ten years. This reduction would provide the breathing space necessary to permit critical and politically difficult economic reforms to be carried out. With reforms in place, the economies of these countries can more readily grow their way out of the debt morass. As policy reform is enacted, the country's creditworthiness will increase, resulting in an appreciation in (or "capital gains" from) the value of this debt. These capital gains are what fund the reduction of interest payments.

In brief, the plan would work as follows:

o The IDF would invite banks to tender at a discount some or all of their existing medium/long term claims on a participating debtor country.

o For those offers accepted by the IDF, the facility would issue in exchange negotiable zero-coupon bonds (ZCBs) with a maturity of 8-12 years, depending on the situation of the debtor country. The market value of these bonds when issued would equal the value of the debt as tendered by the banks to the IDF.

o The IDF would work with the debtor country government in its reform and adjustment efforts, and the debtor country would make interest payments to the IDF.

-- The amount of these payments would be based on a target interest/GDP ratio for the country, and the target would gradually increase over the program period. This target would delink interest payment levels from export levels, to avoid either encouraging overvalued exchange rates or discouraging export-led growth.

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o At the end of the program period, with the debtor country's creditworthiness having improved, the debtor country would obtain commercial financing at rates comparable to rates on their current debt and turn the proceeds over to the IDF. It is not necessary for any country to be fully creditworthy for these sales to raise enough money to provide the IDF with sufficient funds to retire zero coupon bonds issued for the participating countries' programs.

o To set individual debt relief targets (in terms of the present value of interest relief) for each country participating in the plan, a formula is proposed which takes into account the objective factors of per capita income, and changes in per capita income and terms of trade. For example, countries with lower per capita income and a greater decline in terms of trade would be eligible for more debt relief. Thus, secondary market discounts, which often reflect countries' prior actions in servicing debt have no influence on the debt relief offered and an important moral hazard is avoided.

o The analysis in this paper shows that, under reasonable assumptions, the program can be carried out with a high probability of no net outlays by creditor country taxpayers. Willingness of creditor countries to provide $5-10 billion would enhance the benefits of this program, but is not necessary for its implementation.

o Bank participation is voluntary and the plan is fully consistent with our case-by-case approach because the specifics of the plan would reflect the particulars of each country's situation.

-- The plan also complements and supplements the Program for Sustained Growth because economic reforms leading to renewed creditworthiness could lead to renewed voluntary commercial bank lending, especially in the later years of the program when the country needed greater financing as it resumed growth.

We believe that these features meet the criticisms leveled against earlier debt facility proposals.

As an example of how the facility would operate, we examine the case of Argentina. Argentina currently owes 4.6 percent of its GDP for interest on medium/long term bank debt. We believe that if this interest burden could be significantly reduced for several years, it would provide Argentina both the economic and political space needed to readjust its economy toward future economic growth.

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Under the suggested level of interest relief presented in this paper, which can be provided with no cost to and no cash outlay by creditor governments, Argentina would qualify for about $14 billion worth of interest relief. The IDF would negotiate with Argentina specific and significant reforms (e.g. unification and deregulation of exchange rates, and elimination of fiscal deficit through such measures as privatization of the state oil and telephone companies) that, if actually carried out, could, for example, lower Argentina's interest payments on medium and long term commercial bank debt to 1 percent of GDP for 5 years, followed by a gradual annual increase of .3 percent of GDP. In the tenth and last year of the program, Argentina would be able to resume full payments of contractual interest. At the end of the program, assuming steady economic growth of 7 percent (3 percent real growth after adjusting for dollar inflation) as a result of reforms, these payments would represent only 2.5 percent of GDP, down significantly from the current level of 4.6 percent.

In order to provide the initial debt relief with no cash outlays, the IDF would purchase and hold $32 billion of Argentina's total $41 billion medium and long term commercial bank debt. The remainder of the bank debt would be directly serviced in full. In order to pay for the debt it purchases, the IDF would issue zero coupon bonds (ZCBs) with a maturity of 10 years, the length of the program. These bonds would be backed by creditor governments. While the secondary market value of the Argentine debt is currently 27 cents on the dollar based on the very thin market, we are assuming in this study that banks, on average, require 43 cents on the dollar to induce them to exchange their debt voluntarily. The IDF would reinvest interest payments it receives from Argentina over the course of the program, and use these proceeds as partial funding for retiring the ZCBs at maturity.

By the end of the program, Argentina would have received, in present value terms, a total of $13.9 billion in interest relief. Argentina's creditworthiness would have increased over the program period, and because of its improved ability to service debt, Argentina would have regained access to international financial markets for future financing needs. To satisfy its remaining obligation to the IDF, Argentina would reissue the debt initially purchased by the IDF ($32 billion). Although different forms would be appropriate, we assume for illustrative purposes that the reissue would be in the form of 20 year fixed interest bonds paying 1% over an assumed USG long term bond rate of 9%.

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Although its debt servicing ability would have improved, investors may still see some risk associated with Argentine debt. We are assuming that the residual risk faced by investors would require a 13% rate of return as compensation for this risk. Since Argentina would be paying only 10% on these bonds, it would receive approximately 80 cents on each dollar of debt refinanced, a significant increase over the average acquisition cost initially paid by the IDF of 43 cents on the dollar. Argentina would turn the proceeds of this sale over to the IDF, which, together with the accumulated interest fund, gives the IDF a total of $35.0 billion with which to retire $32.1 billion in ZCBs. The IDF thus turns a "profit" of $2.9 billion which can be used to fund possible losses from programs with other countries.

Sections II, III and IV of this paper discuss, respectively, operational aspects of the facility, a case study of an IDF program for Argentina, and critical considerations in proposing an IDF. Appendices include (A) discussion of criteria for country participation; (B) method of debt purchase used by the IDF; (C) terminating the IDF role; and (D) technical documentation for nine other countries analyzed.

Section II: Operation of the Facility

The plan we propose involves the establishment of a multilateral agency hereinafter called the international debt facility (IDF). Backed by creditor country governments, the IDF would purchase a portion of the debtor country's medium/long term bank debt at a discount, paying for it with IDF-issued zero-coupon bonds (ZCBs). These bonds are used here only as one mechanism to raise capital; other means clearly exist. The advantage of using ZCBs is that the impact on financial markets is minimized. Also, use of ZCBs means that the IDF, which offers deep up-front interest relief to participating countries, does not need to capitalize the relief through up front cash outlays. The deep temporary interest relief offered by the IDF in exchange for significant policy reform will provide a needed "breathing space" for the debtor country. The IDF will redeem maturing ZCBs from an accumulated interest fund and from proceeds of bonds issued by the debtor country at the end of the program.

How Much Debt Relief to Offer

The IDF, working with the creditor countries, would determine a set of objective criteria for debt relief, which would provide a target for the present value of the interest relief to be offered. We have included an example of an objective level of debt relief, consistent with the

case-by-case approach, based on per capita income, change in per capita income, and change in terms of trade. The details are included in Appendix A. This formula avoids the possibility that a country could benefit by forcing the discount on its debt down to low levels simply by halting regular debt servicing.

The "Program for Growth"

Once the IDF receives a formal statement of interest from a country, it would solicit offers from commercial banks to sell specific loans to the IDF at a discount. The details of how debt is acquired and paid for is discussed below. Before the debt is actually acquired, the IDF would negotiate with the debtor country a medium term adjustment program of from 8 to 12 years, what we will call a "program for growth". Over the program period, the IDF would work with the debtor country government in its structural reform and adjustment efforts, and the debtor country would make interest payments to the IDF. The amount of these payments would be based on a target interest/GDP ratio negotiated with the country. These targets would be low for several years and would gradually rise to full interest payments on the obligations held by the IDF.

There are two reasons the interest/GDP target was chosen over the interest/export target. First, the interest/export target would require a country to increase interest payments as exports expand, thus acting as a disincentive to export-led growth. Second, because neither interest payments nor export values in debtor countries are measured in local currency, use of the interest/export target does not discourage a country from maintaining an overvalued exchange rate. Use of the interest/GDP ratio would require larger interest payments for a given target level if the exchange rate was overvalued.

We expect that the IDF would be able to negotiate more significant reforms than are currently negotiated by the IMF and World Bank. The deep interest relief offered (with deferral of principal on the debt held by the IDF) should offer the debtor country the political flexibility for dealing with special interests who would be affected by the reforms. It offers the country a chance to grow out of the debt morass, and with the higher growth rates, the opportunity for improving the economic welfare of the middle and lower classes.

While some interest relief (perhaps in the range of 30%) should be offered simply for participating in this program, most should be tied to the debtor country actually taking specific reform steps. Indeed, much of the interest relief could be offered as a rebate on interest paid for carrying out

specific, politically sensitive actions (such as privatization of key parastatals, meeting fiscal targets, etc.). This will minimize risk to the IDF since a country which does not take action to become more creditworthy will not get significant relief. If a reform program is suspended by the participating country, full interest on debt held by the IDF will be required. Countries which default with the IDF will be ineligible for additional IFI loans and would therefore be removing themselves from the international financial system.

Acquisition of Debt at a Discount

The commercial banks would make their offers to sell specific medium/long term debts of the debtor government at a discount using sealed bids, much like T-bill transactions. This would minimize the cost of this debt to the facility by having the IDF purchase along the "supply" or "offer" curve for this debt. This is discussed more fully in Appendix B.

We propose that the IDF only buy debt contracted or guaranteed by the debtor country government prior to creation of the facility. This would avoid the possibility of governments borrowing or assuming commercial debts simply to create more debt that could be eligible for IDF purchase. The IDF would buy debt starting with the most deeply discounted loans up to the amount targeted to meet the IDF objectives.

The IDF would purchase this debt with zero-coupon bonds which it would issue. These negotiable bonds would mature at the end of the program period agreed to with the debtor country. The bonds' market value when issued would be equal to the value set voluntarily by the bank in its offer of sale to the IDF.

At the end of the program period, the debtor country would agree to refinance the face value of the debt that was purchased by the IDF by issuing fixed rate market interest bonds. These bonds may have to be sold at a slight discount (higher effective interest rate for the buyer) but under reasonable assumptions should provide the IDF sufficient funds to redeem the maturing ZCBs.

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Section III: Illustration - A Case Study of Argentina

For purposes of illustrating this proposal, we will describe how this could be implemented for Argentina. The Interest Reduction Scenario (Table III-1) lays out in some detail the operations of the IDF for Argentina. (The table looks much more complex than it actually is.) It examines a "what if" for the fourteen years following the date in the upper right hand corner (12/31/88). All of the numbers in the table are computed from the assumptions listed at the top of the table (above the dates) and a few base year numbers listed for 1989 (placed in boxes).

Column 1 of the assumptions at the top lists the interest rate on medium/long term debt to commercial banks (LIBOR plus spread); assumptions on nominal growth rates for GDP and exports with the IDF program in place; and information on the acquisition cost of Argentina's bank debt by the IDF. The second column indicates the long-term USG bond rate at which the ZCBs issued by the IDF would accumulate interest; the maturity date of the ZCBs (based on the length of program); the projected value of Argentine debt at the end of the program; and the range for the amount of Argentine debt to be held by the IDF during the program. The latter items can be used to examine the effect of the IDF buying different quantities of debt, e.g., the break-even amount or all the debt.

The third column describes a typical scenario that could be negotiated between the IDF and Argentina. Given the target debt relief of approximately $14 billion calculated in Appendix A, the IDF and Argentina could agree that Argentina would benefit from a 10 year program, where interest payments to commercial banks on medium/long term credits would be limited to 1 percent of GDP for 5 years and would gradually be increased annually by .3 percent of GDP. The value to Argentina at the beginning of this program of this relief from paying full interest is given on line 10 under the first text column, labelled "Now."

Currently, Argentina is spending about 4.6 percent of its GDP simply paying interest on its medium/long term bank debt, as reflected in line 5. This line is based on the interest payment calculated on line 4, which in turn is simply the interest rate assumption at the top applied to the medium/long term debt listed on line 3. Note that this figure (line 4) is assumed to be static for the purposes of examining this scenario. We would expect that this figure would increase as the country borrowed additional funds for growth enhancing purposes. Lines 1 and 2 show GDP and exports growing at the rate assumed at the top of the table. These growth assumptions

INTERNATIONAL DEBT FACILITY

INTEREST REDUCTION SCENARIO

TABLE III-1

ARGENTINA

Assumptions

Libor	0.075	Long-term USG bond rate	9.0%	Length of Program (yrs)	10	Now: December 31,	1988
Spread	0.01	Year ZCB matures	1998	Avg End of Prg Dbt Value	1.01		
GDP % growth	7.0%	Projected debt val 1998	0.6	Target Bank Int/GDP	1.0		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	5.0		
Secondary Market Debt Value	0.27	Maximum Debt Held by IDF	40.6	Ann Incr to phase out	0.3		
Avg Debt Acquisition Value	0.43						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP ($)		74.6	79.6	85.2	91.1	97.5	104.3	111.7	119.5	127.8	136.8	146.4	156.6	167.6	179.3
2. Projected Exports ($)		9.2	9.8	10.5	11.3	12.1	12.9	13.8	14.8	15.8	16.9	18.1	19.4	20.7	22.2
3. Medium & Long-term Debt-banks		40.6	40.6	40.6	40.6	40.6	40.6	40.6	40.6	40.6	40.6	40.6	40.6	40.6	40.6
4. Projected Interest on (3)		3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45	3.45
5. Projected Bank Interest/GDP		4.6	4.3	4.1	3.8	3.5	3.3	3.1	2.9	2.7	2.5	2.4	2.2	2.1	1.9
6. Projected Bank Interest/Exports		37.5	35.1	32.8	30.6	28.6	26.7	25.0	23.4	21.8	20.4	19.1	17.8	16.7	15.6
7. Target Bank Interest/GDP		1.0	1.0	1.0	1.0	1.0	1.3	1.6	1.9	2.2	2.5	2.4	2.2	2.1	1.9
8. Int Payment Req to Meet (7)		0.744	0.796	0.852	0.911	0.975	1.357	1.786	2.270	2.812	3.420	3.451	3.451	3.451	3.451
9. Int Savings Req to Meet (7)		2.71	2.65	2.60	2.54	2.48	2.09	1.66	1.18	0.64	0.03	0.00	0.00	0.00	0.00
10. Present Value of (9)	13.90	2.52	2.30	2.09	1.90	1.72	1.36	1.00	0.66	0.33	0.02	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	29.7														
11b. Debt Required to Meet (9) with no cash outlay	31.8														
11c. Market Value of (11b)	13.6														
12. Principal with banks		8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8	8.8
13. Principal with IDF		31.8	31.8	31.8	31.8	31.8	31.8	31.8	31.8	31.8	31.8	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)												31.8	31.8	31.8	31.8
14a. Funds to IDF from refinancing											25.5				
15. Interest Paid to Banks		0.744	0.744	0.744	0.744	0.744	0.744	0.744	0.744	0.744	0.744	3.451	3.451	3.451	3.451
16. Interest Paid to or by (-) IDF		0.000	0.052	0.108	0.167	0.231	0.613	1.042	1.526	2.068	2.676	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.052	0.164	0.344	0.601	1.258	2.395	4.100	6.476	2.931	3.151	3.387	3.641	3.914
18. Total Interest Paid		0.744	0.796	0.852	0.911	0.975	1.357	1.786	2.270	2.812	3.420	3.451	3.451	3.451	3.451
19. Calc Interest/GDP		1.0	1.0	1.0	1.0	1.0	1.3	1.6	1.9	2.2	2.5	2.4	2.2	2.1	1.9
20. Other Debt		17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0	17.0
21. Interest on Other Debt		1.445	1.445	1.445	1.445	1.445	1.445	1.445	1.445	1.445	1.445	1.445	1.445	1.445	1.445
22. Interest/GDP on Other Debt		1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.1	1.0	0.9	0.9	0.8
23. Overall Interest/GDP (Pre-IDF)		6.6	6.2	5.7	5.4	5.0	4.7	4.4	4.1	3.8	3.6	3.3	3.1	2.9	2.7
24. Overall Interest/GDP (Post-IDF)		2.9	2.8	2.7	2.6	2.5	2.7	2.9	3.1	3.3	3.6	3.3	3.1	2.9	2.7

are critical to the effectiveness of this debt relief strategy, which has Argentina growing its way out of its debt problems. The 7 percent growth assumptions include 3 percent real growth and 4 percent dollar inflation.

With the interest to GDP targets listed on line 7, the table computes on line 8 the interest that Argentina can pay to meet these targets. The difference between the interest Argentina would pay under this plan and the interest owed (line 4) is the required interest savings (line 9). Line 10 computes the value "now" of the future interest savings (each interest payment is assumed to be made at the end of the year). These present values show the amount of money, which, if invested "now" in a bank paying LIBOR as the interest rate, would grow to the interest savings listed at the end of the year in question. The sum of the present value calculations for each year is given under the "now" column ($13.9 billion) and is the value to Argentina of this debt relief.

In order for the IDF to reduce Argentina's interest to one percent of its GDP in the first year of the program with no IDF cash outlays, it must acquire $31.8 billion (line 13) of Argentine commercial debt, leaving $8.8 billion with the commercial banks (line 12). Since Argentina need pay only $.744 billion to the banks on debt remaining with the banks over the life of this program (line 15), additional interest payments can be made to the IDF (line 16) and still leave Argentina within the limits of interest payments agreed to on line 7. The IDF would reinvest interest payments it receives from all participating countries in a special fund at LIBOR. Argentina's portion of this fund is given on line 17. These funds would accumulate and be used as partial funding for retiring the ZCBs used to pay for the bank debt acquired by the IDF.

At the end of the program period in 1998, the zero coupon bonds mature. Based on the average acquisition value and the length of the program period (10 years), the IDF would have to pay investors on average 1.01 times the value of the debt purchased; in this case 1.01 times 31.8 is 32.1 billion dollars. The IDF has in its Argentina account the interest accumulated up to the end of 1997 ($6.476 billion) plus the interest accrued during 1998 ($.486 billion, not shown on table) plus the interest Argentina pays to the IDF during 1998 ($2.676 billion) for a total reserve of $9.638 billion.

Part of the arrangement with Argentina was that Argentina would reissue the debt that was purchased by the IDF ten years earlier. Argentina could meet this obligation by issuing bonds (say fixed interest at the then current market rates with a 20 year maturity) and offering these bonds to investors. Since

investors would (according to this scenario) still see some additional risk in Argentine paper, they would demand higher than market interest rates, thereby paying less than 100 percent of the value of the debt issued. The third item in column 2 of the assumptions lists a value (.8) which reflects the expected creditworthiness of Argentina at the end of 1998 after the reforms have taken place. Using this value, we assume that Argentina would be able to sell its debt at 80 cents on the dollar.

Line 14a shows the funds raised by Argentina at the end of 1998 ($25.5 billion). These funds are then turned over to the IDF which, with the accumulated reserves (of $9.6 billion), gives the IDF a fund of $35.0 billion. After the IDF redeems the zero coupon bonds for $32.1 billion it has a "profit" of $2.9 billion. This profit can be used to fund possible losses in programs for other countries.

Line 20 shows Argentina's debt to other (official and short term commercial) creditors. The last two lines show the pre- and post-IDF ratios for Argentina's total external indebtedness.

Section IV: Background - Critical Considerations

Why such a plan is needed: The premise of the Program for Sustained Growth is that middle-income debtor countries can grow out of their debt burden with the right combination of economic reforms supported by external financing. $20 billion in support for structural adjustment from commercial banks was anticipated during the 1986-88 period, but more than half of this has materialized in only a few countries with the largest absolute debt levels. However, while these new money facilities have been established, most banks have increased their loan loss reserves and have reduced wherever possible their exposure to heavily indebted countries.

The net financial flow is now directed out at an alarming rate. The outflow from heavily indebted (World Bank 17) countries, which began in 1983, reached $24.8 billion in 1986 and continues at about $20 billion per year. This sum, which represents disbursements of medium and long-term external loans minus interest and amortization payments on medium and long-term debt, is additional to the vast sums which have left the region during this decade in the form of capital flight because of inappropriate economic policies and poor investment climate.

For their part, many debtor countries have begun the process of economic reform, but domestic political concerns and cultural factors, combined with real economic constraints,

still impede implementation of the more difficult structural adjustments. IMF and World Bank policy-based lending programs cannot compensate fully for shortfalls in commercial bank financing and domestic costs of structural reforms.

A solution to this dilemma, at least for countries meeting the objective criteria of per capita income and recent changes in per capital income and in terms of trade (outlined in Appendix A), is a temporary respite from debt service payments. This relief is equivalent to an inflow of capital that can promote growth and is conditioned upon implementation of necessary economic reforms. This respite would permit time and resources needed for adjustment and renewed growth. With renewed growth the country would resume interest payments at the contractual rate and realize an increase in creditworthiness, laying the groundwork for future external financing.

Some argue that a government debt relief initiative is neither necessary nor appropriate; that a "market workout" has been taking place and will continue. But economic analysis and empirical evidence is to the contrary. "Market" schemes tried to date have failed to produce significant real debt relief because they have been based on swapping one risky asset (bank loan) for another risky asset (bond). Attempts to capture a "discount" on LDC debt as a vehicle for debt relief cannot succeed without an intermediary because the asset for which the debt is swapped carries its own market discount associated with the continued risk of nonpayment. Acting in its allocative capacity, government can serve as an intermediary - in this proposal, via an international debt facility - to facilitate actions by a debtor country leading to an increase in creditworthiness, which results in an increased value of outstanding debt owed by the country, and to ensure that the debtor country captures the benefits of this increase.

Why a debt plan is needed now: The experience of Latin America, where 78 percent of global middle income debt is located, demonstrates clearly why this plan is needed, but the plan could also be applied to middle-income debtors outside this region. In Latin America, fragile new democracies are facing the sixth year of a period of disappointing growth, and a round of presidential elections. As a number of countries, such as Ecuador, Bolivia, Mexico, and Argentina, have experienced and continue to grapple with painful economic circumstances, domestic pressures are building against administrations which have taken a responsible attitude towards debt management and which have tried to fight against long-entrenched cultural and political obstacles in order to implement sound economic policies. Failure to recognize these pressures and failure to deal realistically with the underlying problems makes it likely that less moderate and less

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cooperative leaders will gain power throughout the region. For example, a left-wing candidate in Mexico won a substantial number of votes with an anti-debt campaign, and statist candidates who might attempt moratoria on debt payments are gaining ground in presidential sweepstakes next year in Brazil and Argentina.

With the significant reserves recently taken by some banks, writedowns taken by others, and the gradual rebuilding of capital, the international banks are far more secure than in 1982 and 1983 when the debt crisis appeared more threatening to the system. Also, many of these banks have made clear through their actions that they are willing to participate in innovative approaches to debt management, including debt relief. For example, Chairman Robinson of American Express and others have examined or are actively formulating plans for dealing with the debt situation. Given growing support for debt relief in academia, the World Bank, and Congress, it seems inevitable that debt relief will come. It is most important that it be done right. An analytic foundation must be laid to ensure that whatever debt relief strategy is adopted will best meet both our domestic and foreign policy concerns.

Costs: An IDF could be run in several different ways, with different cost ramifications. The proposal outlined in this paper would involve no cost and no outlays by taxpayers of creditor countries. The IDF would be funded by creditor countries through callable capital. Paid-in capital, which is a current budget outlay, may not be necessary if the administrative mechanism of the IDF could be kept small enough to be handled within existing World Bank staff and office resources. (Callable capital is a promise to meet obligations of the IDF in the future and becomes a budget outlay only if "called.")

It may be desirable to have a small amount of paid-in capital supplied by the creditor countries (say 5%) which could be returned with interest at the termination of the IDF in 12 years. The total amount of callable capital needed to back the zero-coupon bonds (ZCBs) issued by the IDF would be determined by the number of countries entering the program, the amount of medium and long term commercial debt offered by banks, and the discount at which banks offer the debt.

The scenario described in this paper covering 10 Latin American countries would require about $150 billion of total capital of which only $7.5 would be paid-in. The IDF would receive interest payments from debtor countries over the life of the program, and redeem maturing ZCBs from the accumulated interest fund and from proceeds of bonds issued by the debtor country. Appendix Table C-2 summarizes the IDF-held account

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for the 10 countries examined in this study and shows a small surplus at the termination of the IDF after 12 years

There is a small risk to the suppliers of callable capital for the IDF in that a country which begins an IDF program may not see the program through entirely. A major political shakeup, for instance, might cause a new government to renounce the IDF program. We view pulling out of the program as very unlikely, however, because a defaulting country would face the sanction of ineligiblity for further IFI lending, thereby losing access to IFI programs as well as future commercial lending.

If the IDF had to utilize a part of its callable capital because of withdrawal of a country from the program, it would not affect the World Bank because the IDF debt relief activities would be fenced off from regular Bank operations. The existence of the IDF would not affect the credit rating of the World Bank because its borrowing would be backed by the creditor countries. The World Bank owes its excellent credit rating not to the quality of its loans but because they are guaranteed by the full faith and credit of the OECD countries.

Willingness of Banks to Participate: Willingness of banks to participate in this program could vary greatly from bank to bank. Banks which expect to be working with a debtor country in the long run will be less willing to sell debt at a discount than banks which have no desire to lend new money to the country. Banks with a strong capital base are more likely to be willing to take the loss associated with a sale than a poorly capitalized bank. Both kinds of banks, however, may have a real incentive to exchange existing loans with uncertain payments for an asset with certain payments. On the whole, the offers made by banks in the Mexican debt restructuring plan support this view, that banks would be willing to exchange assets at a price which represented a break-even point for the individual bank.

We would expect that at low prices, very few banks would willingly offer their LDC debt into the market for sale, while at some high price, all banks would make such an offer. The relationship between the quantity of debt that would willingly be offered and the price is discussed in more detail in Appendix B. We assume that banks which choose not to sell their debt to the IDF because of prevailing low market prices stand to gain significantly from the implicit capital gains in the increased value of their debt as the debtor country carries out significant economic reform under IDF auspices. To avoid this "free rider" problem, regulatory changes may be desirable (see Appendix B for discussion of possible changes).

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It should be noted that the scenario set forth in this paper is based on completely voluntary participation by the banks. We assume that the IDF would expect countries to service fully the existing debt which the IDF does not purchase, as well as any new debt. Even in this case, the plan works, with minimal or no capital outlays by creditor countries. The plan might work even better with a greater capital outlay so that the IDF could purchase all outstanding debt. Alternatively, some observers have noted that the plan could work better, both in helping to avoid the "free rider" problem and in encouraging new lending, if regulatory changes made new debt service senior to existing debt. Another alternative would be for the IDF to encourage the debtor country (and the banks) to negotiate reduction in debt service owed on existing debt not purchased by the IDF.

Regulatory changes might also be considered because of the existing accounting structure used by banks. For instance, some banks may prefer to continue to receive some stream of income (as in interest-bearing bonds) after selling their debt to the IDF, rather than receive in exchange zero-coupon bonds with a relatively long maturity.

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Appendix A

Criteria for Participation

Criteria independent of the secondary market value of the commercial debt should be used to determine the level of debt relief. Debt relief based on the secondary market value could encourage countries to stop servicing their debt and thereby drive down the secondary market value of their debt. This is called the moral hazard problem. As an example of objective criteria, we have chosen to use per capita income, change in per capita income, and change in the terms of trade.

Table A-1 demonstrates one method of using these criteria to provide debt relief targets for each country, which we have used throughout this paper. The method involves assigning a weight, which appears at the top of Table A-1, which in combination with factors generated by the three criteria determines the maximum amount of debt relief for each country. The debt relief target gives the present value (PV) of temporary interest reduction. The weight 85 was chosen to provide the largest amount of debt relief consistent with the IDF not incurring a net loss under the assumptions in this study.

Figure A-1 shows how the factor is determined for each category. In each case, the value of the criterion for a country is located on the horizontal axis; the value of the factor is then read as the height of the graph at that point.

- The factor for per capita income is assigned along the linear function giving a value of 85 for a country with a zero per capita income and a value of zero for a country with a per capita income of $3,010, the World Bank graduation level for FY 1988 programs. The factor for a country with a per capita income greater than $3,010 is negative.

- In the case of the criterion change in per capita income, the value of 85 was assigned to a country with a -20 percent change (chosen as close to the lowest per capita growth in the Latin American countries examined in this study). A country with no change in per capita income is assigned a factor of zero. Increases in per capita income produces a negative value for this factor.

- Finally, for the terms of trade criterion, the value of 85 was associated with a terms of trade value of -40 percent (close to the lowest in our sample). A zero is assigned if there was no change. Countries with improved terms of trade are assigned a negative value.

Table A-2 shows the calculation of changes in the terms of trade based on a comparison of the average terms of trade for 1975-79 and for 1983-1987.

The average debt reduction factor is a simple arithmetic mean of the three factors. This factor is then applied to the stock of medium/long term bank debt (column 2) to determine the last column, the target debt reduction.

TABLE A-1

INTERNATIONAL DEBT FACILITY
EXAMPLE OF OBJECTIVELY DETERMINED DEBT RELIEF TARGETS

Maximum Percentage Debt Reduction for each Factor: 85

Country	Total Foreign Debt 1988 *	Med/Lt Public Bank Debt 1988 *	Mkt Value of Debt **	Per Capita GNP 1986 ***	Factor Maximum Income 3010	Percent Change PCGDP 80-87 ****	Factor Maximum at -20	Terms of Trade 83-87/ 75-79 Pct Change ****	Factor Maximum at -40	Avg PV of Int Reductn Factor	PV of Int Reducn Target
Brazil	114,484	66,864	53	1,840	33.0	3.8	-16.2	-34.6	73.5	30.1	20,152
Mexico	105,117	64,289	32	1,850	32.8	-9.1	38.7	15.2	-32.3	13.0	8,386
Argentina	57,659	48,641	27	2,360	18.4	-14.7	62.5	-9.9	21.0	34.0	13,800
Venezuela	34,157	29,516	56	2,830	5.1	-20.4	86.7	37.9	-80.5	3.7	882
Chile	19,178	11,489	61	1,320	47.7	-2.4	10.2	-24.5	52.1	36.7	4,285
Peru	16,029	4,799	6	1,130	53.1	-4.2	17.9	13.2	-28.1	14.3	686
Colombia	16,286	9,130	66	1,230	50.3	9.2	-39.1	-11.0	23.4	11.5	591
Ecuador	9,918	6,397	28	1,160	52.2	-7.3	31.9	10.2	-21.7	20.5	1,313
Costa Rica	4,199	1,810	12	1,380	46.0	-11.0	46.8	-10.5	22.3	38.4	694
Uruguay	4,339	2,519	61	1,710	36.7	-10.0	42.5	-1.1	2.3	27.2	684
TOTAL	381,343	227,650								22.6	51,473

Sources: * - DRI, "Latin American Review, 2nd Quarter 1988" and Dept. estimates for Costa Rica
** - Salomon Brothers, as of 6/15/88
*** - IBRD, "Per Capita Income Guidelines for Operational Purposes," 8/27/87
**** - "Economic Survey of Latin America and the Caribbean, 1987: Advance Summary," ECLAC, April 12, 1988

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TABLE A-2

TERMS OF TRADE

Index, 1980=100

	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984	1985	1986	1987	Avg 75-79	Avg 83-87
Brazil	126.7	137.7	149.6	130	118.5	100	85	79	78	86	84	96	89	132.5	86.6
Mexico	64.3	70	74.8	72.2	80.6	100	97	82	79	86	98	73	81	72.4	83.4
Argentina	106.9	94.4	91.6	84.8	86.1	100	96	85	81	99	81	79	78	92.8	83.6
Venezuela	69.5	63.6	87.6	60.7	78.7	100	109	104	99	116	108	65	81	68.0	93.8
Chile	108.6	116.9	104.7	101.6	109	100	86	76	83	78	73	82	92	106.1	81.6
Peru	79.3	82.6	77.9	68.2	89.4	100	85	79	82	94	98	85	88	79.0	89.4
Colombia	64.3	93.2	150.3	130	102.6	100	84	85	92	101	92	114	84	108.5	96.6
Ecuador	66.9	79.4	82	72.3	89.1	100	100	98	81	95	96	75	78	77.1	85.0
Costa Rica	81.3	98	127	104.6	102.9	100	86	83	85	90	88	106	91	102.8	92.0
Uruguay	92.6	91.5	99.3	104.1	106.8	100	101	96	92	98	89	103	107	98.9	97.8

Data from ECLAC, for 1975-1983 FOB/CIF, for 1984-1987 FOB/FOB

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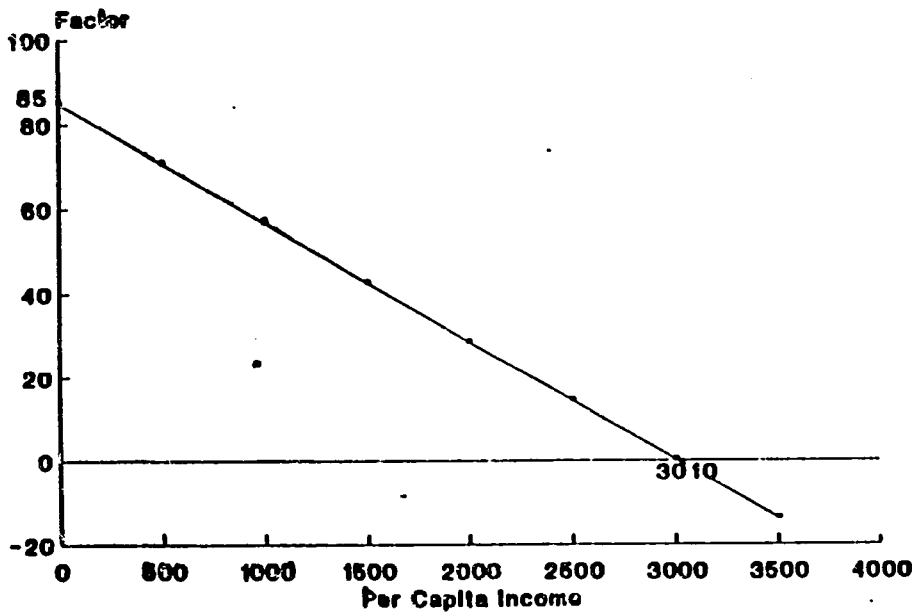
FIGURE A-1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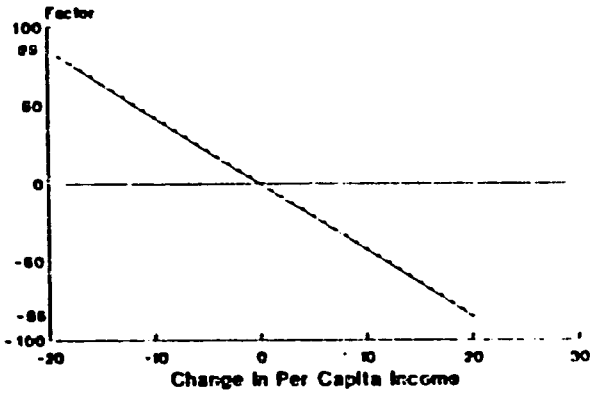
3010
0
500
1000
1500
2000
2500
3000
3500
4000
Per Capita Income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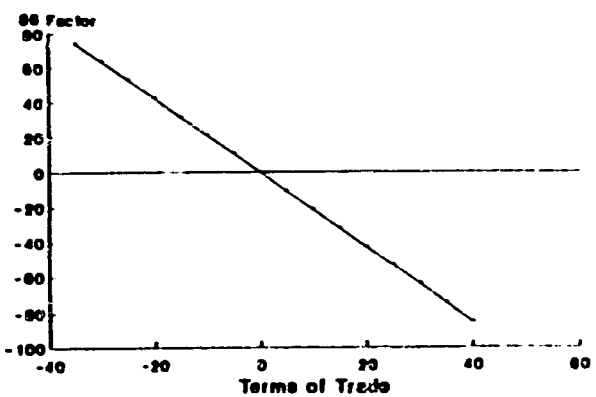
-50
-100
-30
-10
0
10
20
30
Change in Per Capita Income


Factor
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60
40
20
0
-20
-40
-60
-80
-100
-40
-20
0
20
40
60
Terms of Trade

Appendix B

Cost of Acquiring Bank Debt

We assume that each bank faces different considerations which affect its willingness to sell LDC debt at a discount. Banks which expect to be working with the debtor country in the long run will be less willing to sell than banks which want to exit from lending to the country. Banks with more capital are more likely to be willing to take the loss associated with such a sale than a poorly capitalized bank.

At low prices, very few banks would willingly offer to sell their LDC debt, while at some high price, all banks would do so. The relation between the quantity of debt that would be offered willingly and price is called the offer curve for debt.

The current secondary market value for LDC debt is based on an equilibrium between this offer curve and a demand curve. Currently, the demand curve is based on investors who want LDC debt for debt-equity swaps and a few speculators. Assuming this demand is relatively small for most countries, the current market price is close to the low end of the offer curve. Figure B-1 shows the assumed offer curve for Argentina with a hypothetical demand curve. We assume both functions are linear. Note that we placed the beginning (vertical intercept) of the offer curve at the current secondary market value for Argentine debt of 27 cents on the dollar.

For the purposes of this analysis, we have further assumed that the slope of the offer curve is 0.4. This means that all banks would offer to sell their LDC debt at a price 40 cents higher than the current secondary market value. For Argentina therefore, we are assuming that all banks would be willing to sell all their debt for cash at 67 cents on the dollar.

The offer curve used in this study can be considered a pre-IDF offer curve. It is probable that the offer curve would shift upward with the announcement of a "program for growth" with a debtor country. Banks which believe the debtor country would really undertake the proposed reforms are likely to decide to hold out for a higher price for their debt. Thus, at any given price for a country's debt, a smaller quantity would be offered for sale to the IDF. Such a shift would increase the cost of acquiring debt and reduce the effectiveness of the IDF.

This problem was addressed in the Robinson/American Express proposal. Robinson concluded that a debt facility should purchase all outstanding bank debt. An alternative is to reduce, by administrative and regulatory action, the incentives for banks to retain their debt in an attempt to capture the increased value due to the IDF. This could be done by:

-- Removing the connection between full servicing on the unpurchased debt and IFI lending.

-- IFI condoning of partial payments on the debt not tendered to the IDF.

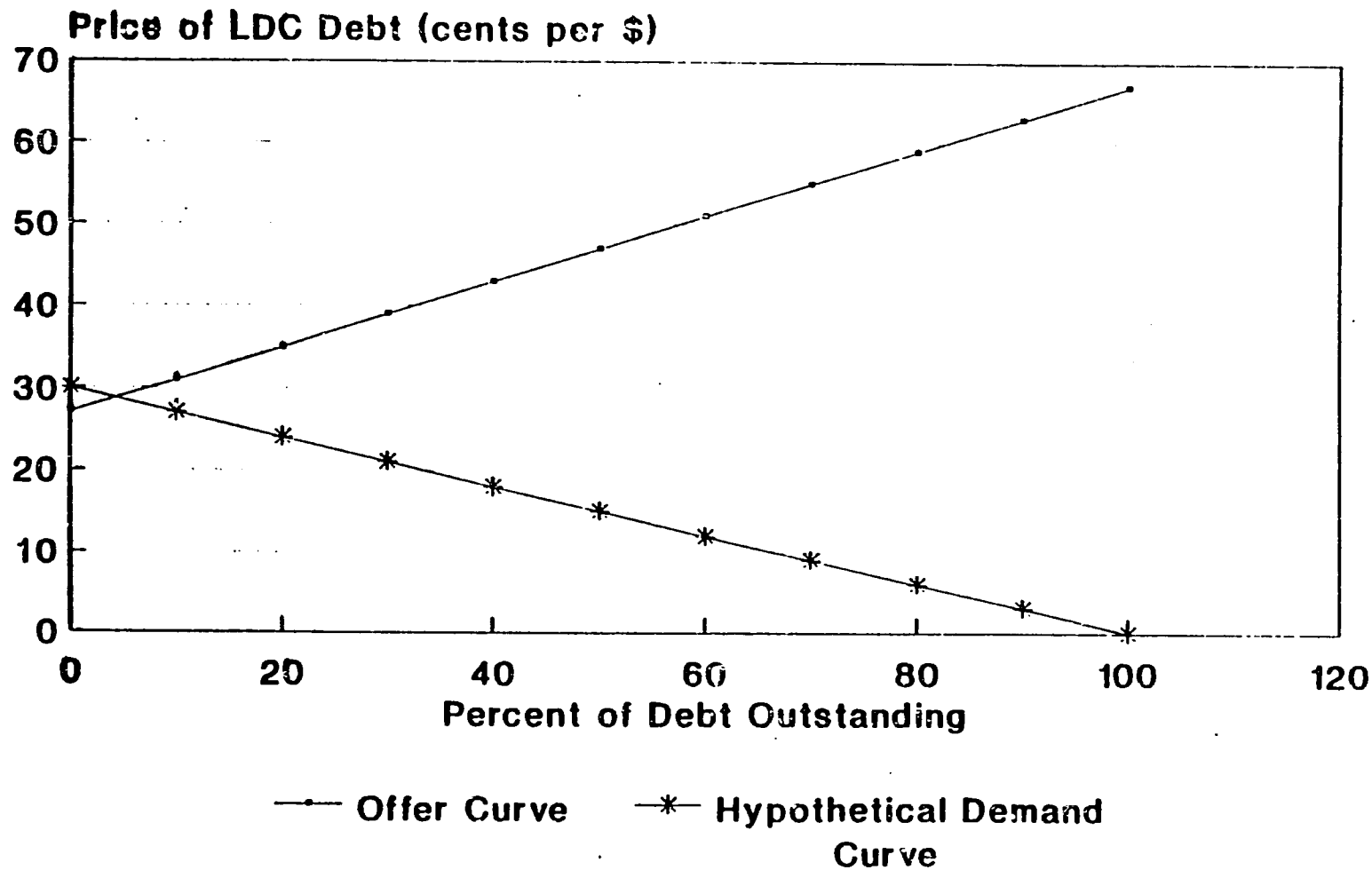
-- Regulatory changes which make bank loans made after an IDF program senior to loans made earlier.

If some or all of these steps are taken, the offer curve might well have a lower slope with a significantly improved ability for the IDF to offer deep interest relief with little or no cost to the creditor countries backing it.

Banks will be asked to offer their debt to the IDF by sealed bids. This method is used by Treasury to sell T-bills and was used in the Morgan-Mexico debt exchange. This should permit the IDF to purchase debt "along" the offer curve, i.e., acquire debt at a low price (high discount) from some banks and at a higher price (smaller discount) from other banks. This will minimize the IDF's cost of acquiring debt.

The average acquisition cost to the IDF is simply the price on the offer curve halfway between the origin and the percent of debt outstanding acquired by the IDF. To illustrate, in the Interest Reduction Scenario for Argentina, the IDF purchases about 75% of the medium/long term bank debt. At the point half way between 0 and 75 (37.5) on the horizontal axis on Figure B-1, the height of the offer curve is 43, the average acquisition cost of Argentine debt. Since different banks will be selling their debt at different prices, the zero coupon bonds with which they will be paid will have varying redemption values for each dollar of debt sold. This is reflected in the Interest Reduction Scenario tables for each country as the average end of program debt value (Avg End of Prg Dbt Value).

FIGURE B-1
Illustrative Offer Curve for Argentina



Appendix C

Terminating the IDF Role

This paper assumes the IDF will go out of business at the end of its 12th year of operation after helping many middle-income developing countries resolve their debt crisis. This is accomplished by having the participating debtor country issue fixed interest 20-year bonds at the end of the program period with the same face value as the debt originally purchased by the IDF. These bonds have the same spread as the country is currently paying over LIBOR (on floating interest debt) with the prevailing 20-year USG rate used as the example of a riskless interest rate. Since the risk associated with the new bonds is likely to be somewhat higher than 100 basis points above USG debt, they will be sold at a discount, providing the purchaser with a higher rate of return. The proceeds of this refinancing are turned over to the IDF to help it pay the zero-coupon bonds at maturity. A participating country ends up with exactly the same stock of debt as was purchased by the IDF at the beginning of the program but with an increased capacity to service it. Thus debt reduction by the IDF takes the form of interest reduction only.

For example, we have assumed Argentina would receive 80% of the value of the bonds issued. If the USG 20-year rate were 9% and Argentina issued fixed interest bonds at 10%, then an investor which paid only 80 cents on the dollar for these bonds would be getting a 13% rate of return. To show this, Table C-1 contains the present value calculations on a 20-year bond with semi-annual interest payments at 10%, discounted at 13%. The present value of such a bond is $81 per $100 of face value.

As discussed in Section IV, the IDF shows a surplus in its Argentine account at the end of 1998. Various assumptions for the other countries in this analysis are shown in Appendix D. Table C-2 summarizes the net financing of the IDF based on those assumptions. It shows the IDF almost $1 billion in the black at the end of 1998 when most of the programs are complete. Any surplus could go to fund IFI development programs when the IDF is phased out.

We have assumed a participating country would issue the new bonds in one offering. It might, however, make sense to spread out refinancing over several years. The country could either start refinancing two years before its program ends or the IDF could borrow in international capital markets with the country repaying it over the two-year period.

Alternatively the IDF could continue for another 10 to 20 years. During this time the IDF would issue its own 20-year bonds in international capital markets. The country would reimburse the IDF for its interest cost. Meanwhile, the interest accrued in the IDF account would continue to grow, providing a reserve fund to assure repayment of the debt.

TABLE C-1

ANALYSIS OF REFINANCING IDF HELD DEBT

SPREAD: 0.01 Long bond yld: 0.09 Yield on refinanced bond 0.13

Face Value of Bond: 100

Period	0.5	1	1.5	2	2.5	3	3.5	4	4.5	5
Payment	5	5	5	5	5	5	5	5	5	5
Discount Rate	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
Present Value	4.703604	4.424778	4.162481	3.915733	3.683612	3.465250	3.259833	3.066593	2.884808	2.713799

Period	5.5	6	6.5	7	7.5	8	8.5	9	9.5	10
Payment	5	5	5	5	5	5	5	5	5	5
Discount Rate	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
Present Value	2.552927	2.401592	2.259228	2.125303	1.999317	1.880799	1.769307	1.664424	1.565758	1.472941

Period	10.5	11	11.5	12	12.5	13	13.5	14	14.5	15
Payment	5	5	5	5	5	5	5	5	5	5
Discount Rate	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
Present Value	1.385627	1.303488	1.226218	1.153529	1.085149	1.020822	0.960309	0.903382	0.849931	0.799453

Period	15.5	16	16.5	17	17.5	18	18.5	19	19.5	20	20
Payment	5	5	5	5	5	5	5	5	5	5	100
Discount Rate	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13	0.13
Present Value	0.752062	0.707481	0.665542	0.626089	0.588975	0.554061	0.521217	0.490319	0.461254	0.433911	8.678229

Sum of Present Values: 81.13905

ARA/ECP 8/1/88 IDFREF.WK1

TABLE C-2

International Debt Facility

Accumulated Interest ($ billion)

	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Brazil	0.000	0.096	0.303	0.973	2.196	4.074	6.722	10.272	-11.015	-11.841	-12.729	-13.683	-14.710	-15.813
Mexico	0.000	0.176	0.553	2.186	5.303	8.654	12.256	5.954	6.401	6.881	7.397	7.952	8.548	9.189
Argentina	0.000	0.052	0.164	0.344	0.601	1.258	2.395	4.100	6.476	2.931	3.151	3.387	3.641	3.914
Venezuela	0.000	0.620	1.438	2.318	3.264	4.280	5.373	3.812	4.098	4.405	4.735	5.090	5.472	5.883
Chile	0.000	0.009	0.027	0.056	0.205	0.497	0.961	1.628	2.535	-4.802	-5.162	-5.549	-5.966	-6.413
Peru	0.000	0.012	0.037	0.160	0.400	0.670	0.961	1.273	1.608	2.475	2.661	2.861	3.075	3.306
Colombia	0.000	0.014	0.043	0.281	0.541	0.820	1.120	1.442	1.789	-0.054	-0.058	-0.062	-0.067	-0.072
Ecuador	0.000	0.010	0.087	0.245	0.500	0.868	1.337	1.842	1.287	1.384	1.488	1.599	1.719	1.848
Costa Rica	0.000	0.002	0.005	0.010	0.018	0.029	0.069	0.146	0.265	0.281	0.302	0.325	0.349	0.375
Uruguay	0.000	0.004	0.012	0.026	0.067	0.142	0.256	0.417	0.605	-0.696	-0.748	-0.804	-0.864	-0.929
Total	0	0.994	2.669	6.599	13.094	21.291	31.449	30.886	14.050	0.965	1.037	1.115	1.199	1.289

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Appendix D

Technical Documentation for Analyses of Nine Other Countries

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Brazil	D-1
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Colombia	D-3
Costa Rica	D-4
Ecuador	D-5
Mexico	D-6
Peru	D-7
Uruguay	D-8
Venezuela	D-9

INTERNATIONAL DEBT FACILITY

INTEREST REDUCTION SCENARIO

TABLE D-1

BRAZIL

Assumptions

Libor	0.075	Long-term USG bond rate	9.0%	Length of Program (yrs)	9	Now: December 31,	1988
Spread	0.01	Year ZCB matures	1997	Avg End of Prg Dbt Value	1.46		
GDP % growth	7.0%	Projected debt val 1997	0.95	Target Bank Int/GDP	0.5		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	3.0		
Secondary Market Debt Valu	0.53	Maximum Debt Held by IDF	66.9	Ann Incr to phase out	0.1		
Avg Debt Acquisition Value	0.67						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP ($)		275.4	294.7	315.3	337.4	361.0	386.3	413.3	442.2	473.2	506.3	541.8	579.7	620.3	663.7
2. Projected Exports ($)		30.8	33.0	35.3	37.7	40.6	43.2	46.2	49.5	52.9	56.6	60.6	64.8	69.4	74.2
3. Medium & Long-term Debt-banks		66.9	66.9	66.9	66.9	66.9	66.9	66.9	66.9	66.9	66.9	66.9	66.9	66.9	66.9
4. Projected Interest on ($)		5.69	5.69	5.69	5.69	5.69	5.69	5.69	5.69	5.69	5.69	5.69	5.69	5.69	5.69
5. Projected Bank Interest/GDP		2.1	1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.0	1.0	0.9	0.9
6. Projected Bank Interest/Exports		18.5	17.3	16.1	15.1	14.1	13.2	12.3	11.5	10.7	10.0	9.4	8.8	8.2	7.7
7. Target Bank Interest/GDP		0.5	0.5	0.5	0.6	0.7	0.8	0.9	1.0	1.1	1.1	1.0	1.0	0.9	0.9
8. Int Payment Req to Meet (7)		1.377	1.473	1.577	2.024	2.527	3.090	3.720	4.422	5.205	5.687	5.687	5.687	5.687	5.687
9. Int Savings Req to Meet (7)		4.31	4.21	4.11	3.66	3.16	2.60	1.97	1.26	0.48	0.00	0.00	0.00	0.00	0.00
10. Present Value of (9)	19.73	4.01	3.65	3.31	2.74	2.20	1.68	1.19	0.71	0.25	0.00	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	64.3														
11b. Debt Required to Meet (9) with no cash outlay	50.7														
11c. Market Value of (11b)	34.1														
12. Principal with banks		16.2	16.2	16.2	16.2	16.2	16.2	16.2	16.2	16.2	16.2	16.2	16.2	16.2	16.2
13. Principal with IDF		50.7	50.7	50.7	50.7	50.7	50.7	50.7	50.7	50.7	0.0	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)											50.7	50.7	50.7	50.7	50.7
14a. Funds to IDF from refinancing										48.2					
15. Interest Paid to Banks		1.377	1.377	1.377	1.377	1.377	1.377	1.377	1.377	1.377	5.6865	5.6865	5.6865	5.6865	5.6865
16. Interest Paid to or by (-) IDF		0.000	0.096	0.200	0.647	1.150	1.713	2.343	3.045	3.828	0.000	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.096	0.303	0.973	2.196	4.074	6.722	10.272	-11.015	-11.841	-12.729	-13.683	-14.710	-15.81
18. Total Interest Paid		1.377	1.473	1.577	2.024	2.527	3.090	3.720	4.422	5.205	5.687	5.687	5.687	5.687	5.68
19. Calc Interest/GDP		0.5	0.5	0.5	0.6	0.7	0.8	0.9	1.0	1.1	1.1	1.0	1.0	0.9	0.
20. Other Debt		47.6	47.6	47.6	47.6	47.6	47.6	47.6	47.6	47.6	47.6	47.6	47.6	47.6	47.
21. Interest on Other Debt		4.046	4.046	4.046	4.046	4.046	4.046	4.046	4.046	4.046	4.046	4.046	4.046	4.046	4.04
22. Interest/GDP on Other Debt		1.5	1.4	1.3	1.2	1.1	1.0	1.0	0.9	0.9	0.8	0.7	0.7	0.7	0.
23. Overall Interest/GDP (Pre-IDF)		3.3	3.3	3.1	2.9	2.7	2.5	2.4	2.2	2.1	1.9	1.8	1.7	1.6	1.
24. Overall Interest/GDP (Post-IDF)		2.0	1.9	1.8	1.8	1.8	1.8	1.9	1.9	2.0	1.9	1.8	1.7	1.6	1.

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CHILE

INTERNATIONAL DEBT FACILITY
INTEREST REDUCTION SCENARIO

TABLE D-2

Assumptions

Libor	0.075	Long-term USG bond rate	9.0%	Length of Program (yrs)	10	Now: December 31,	1988
Spread	0.01	Year ZCB matures	1998	Avg End of Prg Dbt Value	1.77		
GDP % growth	7.0%	Projected debt val 1998	0.95	Target Bank Int/GDP	0.6		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	4.0		
Secondary Market Debt Valu	0.61	Maximum Debt Held by IDF	11.7	Ann Incr to phase out	0.4		
Avg Debt Acquisition Value	0.75						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP ($)		20.3	21.7	23.2	24.9	26.6	28.5	30.5	32.6	34.9	37.3	39.9	42.7	45.7	48.9
2. Projected Exports ($)		7.2	7.7	8.2	8.8	9.4	10.1	10.8	11.6	12.4	13.2	14.2	15.2	16.2	17.4
3. Medium & Long-term Debt-banks		11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7	11.7
4. Projected Interest on (3)		0.99	0.99	0.99	0.99	0.99	0.99	0.99	0.99	0.99	0.99	0.99	0.99	0.99	0.99
5. Projected Bank Interest/GDP		4.9	4.6	4.3	4.0	3.7	3.5	3.3	3.1	2.9	2.7	2.5	2.3	2.2	2.0
6. Projected Bank Interest/Exports		13.8	12.9	12.1	11.3	10.5	9.8	9.2	8.6	8.0	7.5	7.0	6.6	6.1	5.7
7. Target Bank Interest/GDP		0.6	0.6	0.6	0.6	1.0	1.4	1.8	2.2	2.6	2.7	2.5	2.3	2.2	2.0
8. Int Payment Req to Meet (7)		0.122	0.130	0.139	0.149	0.266	0.399	0.548	0.717	0.907	0.995	0.995	0.994	0.995	0.995
9. Int Savings Req to Meet (7)		0.87	0.86	0.86	0.85	0.73	0.60	0.45	0.28	0.09	0.00	0.00	0.00	0.00	0.00
10. Present Value of (9)	4.24	0.81	0.75	0.69	0.63	0.51	0.39	0.27	0.16	0.05	0.00	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	17.8														
11b. Debt Required to Meet (9) with no cash outlay	10.3														
11c. Market Value of (11b)	7.7														
12. Principal with banks		1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4	1.4
13. Principal with IDF		10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3	10.3	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)												10.3	10.3	10.3	10.3
14a. Funds to IDF from refinancing											9.8				
15. Interest Paid to Banks		0.1218	0.1218	0.1218	0.1218	0.1218	0.1218	0.1218	0.1218	0.1218	0.1218	0.9945	0.9945	0.9945	0.9945
16. Interest Paid to or by (-) IDF		0.000	0.009	0.018	0.027	0.144	0.277	0.427	0.595	0.785	0.873	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.009	0.027	0.056	0.205	0.497	0.961	1.628	2.535	-4.802	-5.162	-5.549	-5.966	-6.413
18. Total Interest Paid		0.122	0.130	0.139	0.149	0.266	0.399	0.548	0.717	0.907	0.995	0.995	0.994	0.995	0.995
19. Calc Interest/GDP		0.6	0.6	0.6	0.6	1.0	1.4	1.8	2.2	2.6	2.7	2.5	2.3	2.2	2.0
20. Other Debt		7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5	7.5
21. Interest on Other Debt		0.64	0.64	0.64	0.64	0.64	0.64	0.64	0.64	0.64	0.64	0.64	0.64	0.64	0.64
22. Interest/GDP on Other Debt		3.1	2.9	2.7	2.6	2.4	2.2	2.1	2.0	1.8	1.7	1.6	1.5	1.4	1.3
23. Overall Interest/GDP (Pre-IDF)		8.0	7.5	7.0	6.6	6.1	5.7	5.4	5.0	4.7	4.4	4.1	3.8	3.6	3.3
24. Overall Interest/GDP (Post-IDF)		3.7	3.5	3.3	3.2	3.4	3.6	3.9	4.2	4.4	4.4	4.1	3.8	3.6	3.3

ARA/ECP 8/01/88 ZCBCHI.WK1

COLOMBIA

INTERNATIONAL DEBT FACILITY
INTEREST REDUCTION SCENARIO

TABLE D-3

Assumptions

Libor	0.075	Long-term USG Bond rate	9.0%	Length of Program (yrs)	10	Now: December 31,	1988
Spread	0.01	Year ZCB matures	1998	Avg End of Prg Dbt Value	1.74		
GDP % growth	7.0%	Projected debt val 1998	0.95	Target Bank Int/GDP	0.5		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	3.0		
Secondary Market Debt Valu	0.66	Maximum Debt Held by IDF	5.1	Ann Incr to phase out	0.4		
Avg Debt Acquisition Valu	0.73						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP ($)		39.0	41.7	44.7	47.8	51.1	54.7	58.5	62.6	67.0	71.7	76.7	82.1	87.8	94.0
2. Projected Exports ($)		7.9	8.5	9.0	9.7	10.4	11.1	11.9	12.7	13.6	14.5	15.5	16.6	17.8	19.0
3. Medium & Long-term Debt-banks		5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1	5.1
4. Projected Interest on (3)		0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43	0.43
5. Projected Bank Interest/GDP		1.1	1.0	1.0	0.9	0.8	0.8	0.7	0.7	0.6	0.6	0.6	0.5	0.5	0.5
6. Projected Bank Interest/Exports		5.5	5.1	4.8	4.5	4.2	3.9	3.7	3.4	3.2	3.0	2.8	2.6	2.4	2.3
7. Target Bank Interest/GDP		0.5	0.5	0.5	0.9	0.8	0.8	0.7	0.7	0.6	0.6	0.6	0.5	0.5	0.5
8. Int Payment Req to Meet (7)		0.195	0.209	0.223	0.430	0.433	0.433	0.433	0.434	0.434	0.433	0.433	0.433	0.433	0.433
9. Int Savings Req to Meet (7)		0.24	0.22	0.21	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10. Present Value of (9)	0.59	0.22	0.19	0.17	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	2.5														
11b. Debt Required to Meet (9) with no cash outlay	2.8														
11c. Market Value of (11b)	2.1														
12. Principal with banks		2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3	2.3
13. Principal with IDF		2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)												2.8	2.8	2.8	2.8
14a. Funds to IDF from refinancing											2.7				
15. Interest Paid to Banks		0.195	0.195	0.195	0.195	0.195	0.195	0.195	0.195	0.195	0.195	0.4335	0.4335	0.4335	0.4335
16. Interest Paid to or by (-) IDF		0.000	0.014	0.028	0.235	0.238	0.238	0.238	0.239	0.239	0.238	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.014	0.043	0.281	0.541	0.820	1.120	1.442	1.789	-0.054	-0.058	-0.062	-0.067	-0.072
18. Total Interest Paid		0.195	0.209	0.223	0.430	0.433	0.433	0.433	0.434	0.434	0.433	0.433	0.433	0.433	0.433
19. Calc Interest/GDP		0.5	0.5	0.5	0.9	0.8	0.8	0.7	0.7	0.6	0.6	0.6	0.5	0.5	0.5
20. Other Debt		11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2
21. Interest on Other Debt		0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95	0.95
22. Interest/GDP on Other Debt		2.4	2.3	2.1	2.0	1.9	1.7	1.6	1.5	1.4	1.3	1.2	1.2	1.1	1.0
23. Overall Interest/GDP (Pre-IDF)		3.6	3.3	3.1	2.9	2.7	2.5	2.4	2.2	2.1	1.9	1.8	1.7	1.6	1.5
24. Overall Interest/GDP (Post-IDF)		2.9	2.8	2.6	2.9	2.7	2.5	2.4	2.2	2.1	1.9	1.8	1.7	1.6	1.5

ARA/ECP 8/31/88 ZCBCOL.WK1

COSTA RICA

INTERNATIONAL DEBT FACILITY
INTEREST REDUCTION SCENARIO

TABLE D-4

Assumptions

Libor	0.079	Long-term USG bond rate	9.0%	Length of Program (yrs)	10	Now: December 31,	1988
Spread	0.01	Year ZCB matures	1998	Avg End of Prg Dbt Value	0.69		
GDP % growth	7.0%	Projected debt val 1998	0.6	Target Bank Int/GDP	0.5		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	6.0		
Secondary Market Debt Valu	0.12	Maximum Debt Held by IDF	1.8	Ann Incr to phase out	0.4		
Avg Debt Acquisition Value	0.29						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP ($)		4.5	4.8	5.2	5.5	5.9	6.3	6.8	7.2	7.7	8.3	8.9	9.5	10.1	10.8
2. Projected Exports ($)		1.6	1.7	1.8	2.0	2.1	2.2	2.4	2.6	2.7	2.9	3.1	3.4	3.6	3.9
3. Medium & Long-term Debt-banks		1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
4. Projected Interest on (3)		0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15	0.15
5. Projected Bank Interest/GDP		3.4	3.2	3.0	2.8	2.6	2.4	2.3	2.1	2.0	1.8	1.7	1.6	1.5	1.4
6. Projected Bank Interest/Exports		9.6	8.9	8.4	7.8	7.3	6.8	6.4	6.0	5.6	5.2	4.9	4.5	4.2	4.0
7. Target Bank Interest/GDP		0.5	0.5	0.5	0.5	0.5	0.5	0.9	1.3	1.7	1.8	1.7	1.6	1.5	1.4
8. Int Payment Req to Meet (7)		0.023	0.024	0.026	0.028	0.029	0.032	0.061	0.094	0.131	0.153	0.153	0.153	0.153	0.153
9. Int Savings Req to Meet (7)		0.13	0.13	0.13	0.13	0.12	0.12	0.09	0.06	0.02	0.00	0.00	0.00	0.00	0.00
10. Present Value of (9)	0.69	0.12	0.11	0.10	0.09	0.09	0.08	0.06	0.03	0.01	0.00	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	1.4														
11b. Debt Required to Meet (9) with no cash outlay	1.5														
11c. Market Value of (11b)	0.4														
12. Principal with banks		0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
13. Principal with IDF		1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	1.5	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)												1.5	1.5	1.5	1.5
14a. Funds to IDF from refinancing											0.9				
15. Interest Paid to Banks		0.0225	0.0225	0.0225	0.0225	0.0225	0.0225	0.0225	0.0225	0.0225	0.0225	0.153	0.153	0.153	0.153
16. Interest Paid to or by (-) IDF		0.000	0.002	0.003	0.005	0.007	0.009	0.038	0.071	0.109	0.131	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.002	0.005	0.010	0.018	0.029	0.069	0.146	0.265	0.281	0.302	0.325	0.349	0.375
18. Total Interest Paid		0.023	0.024	0.026	0.028	0.029	0.032	0.061	0.094	0.131	0.153	0.153	0.153	0.153	0.153
19. Calc Interest/GDP		0.5	0.5	0.5	0.5	0.5	0.5	0.9	1.3	1.7	1.8	1.7	1.6	1.5	1.4
20. Other Debt		2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4	2.4
21. Interest on Other Debt		0.204	0.204	0.204	0.204	0.204	0.204	0.204	0.204	0.204	0.204	0.204	0.204	0.204	0.204
22. Interest/GDP on Other Debt		4.5	4.2	4.0	3.7	3.5	3.2	3.0	2.8	2.6	2.5	2.3	2.2	2.0	1.9
23. Overall Interest/GDP (Pre-IDF)		7.9	7.4	6.9	6.5	6.1	5.7	5.3	4.9	4.6	4.3	4.0	3.8	3.5	3.3
24. Overall Interest/GDP (Post-IDF)		5.0	4.7	4.5	4.2	4.0	3.7	3.9	4.1	4.3	4.3	4.0	3.8	3.5	3.3

ARA/ECP 8/01/88 ZCBCR.WK1

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INTERNATIONAL DEBT FACILITY

INTEREST REDUCTION SCENARIO

TABLE D-5

ECUADOR

Assumptions

Libor	0.075	Long-term USG bond rate	9.0%	Length of Program (yrs)	9	Now: December 31,	1988
Spread	0.01	Year ZCB matures	1997	Avg End of Prg Dbt Value	0.93		
GDP % growth	7.0%	Projected debt val 1997	0.7	Target Bank Int/GDP	2.0		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	2.0		
Secondary Market Debt Valu	0.28	Maximum Debt Held by IDF	6.4	Ann Incr to phase out	0.7		
Avg Debt Acquisition Value	0.43						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP ($)		7.0	7.5	8.0	8.6	9.2	9.8	10.5	11.2	12.0	12.9	13.8	14.7	15.8	16.9
2. Projected Exports ($)		3.2	3.4	3.7	3.9	4.2	4.5	4.8	5.1	5.5	5.9	6.3	6.7	7.2	7.7
3. Medium & Long-term Debt-banks		6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4	6.4
4. Projected Interest on (3)		0.54	0.54	0.54	0.54	0.54	0.54	0.54	0.54	0.54	0.54	0.54	0.54	0.54	0.54
5. Projected Bank Interest/GDP		7.8	7.3	6.8	6.3	5.9	5.5	5.2	4.8	4.5	4.2	4.0	3.7	3.5	3.2
6. Projected Bank Interest/Exports		17.0	15.9	14.8	13.9	13.0	12.1	11.3	10.6	9.9	9.2	8.6	8.1	7.5	7.1
7. Target Bank Interest/GDP		2.0	2.0	2.7	3.4	4.1	4.8	5.2	4.8	4.5	4.2	4.0	3.7	3.5	3.2
8. Int Payment Req to Meet (7)		0.140	0.150	0.216	0.292	0.376	0.471	0.544	0.544	0.544	0.544	0.544	0.544	0.544	0.544
9. Int Savings Req to Meet (7)		0.40	0.39	0.33	0.25	0.17	0.07	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10. Present Value of (9)	1.33	0.38	0.34	0.26	0.19	0.12	0.05	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	3.6														
11b. Debt Required to Meet (9) with no cash outlay	4.8														
11c. Market Value of (11b)	2.0														
12. Principal with Banks		1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
13. Principal with IDF		4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	0.0	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)											4.8	4.8	4.8	4.8	4.8
14a. Funds to IDF from refinancing										3.3					
15. Interest Paid to Banks		0.14	0.14	0.14	0.14	0.14	0.14	0.14	0.14	0.14	0.544	0.544	0.544	0.544	0.544
16. Interest Paid to or by (-) IDF		0.000	0.010	0.076	0.152	0.236	0.331	0.404	0.404	0.404	0.000	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.010	0.087	0.245	0.500	0.868	1.337	1.842	1.287	1.384	1.488	1.599	1.719	1.848
18. Total Interest Paid		0.140	0.150	0.216	0.292	0.376	0.471	0.544	0.544	0.544	0.544	0.544	0.544	0.544	0.544
19. Calc Interest/GDP		2.0	2.0	2.7	3.4	4.1	4.8	5.2	4.8	4.5	4.2	4.0	3.7	3.5	3.2
20. Other Debt		3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
21. Interest on Other Debt		0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30	0.30
22. Interest/GDP on Other Debt		4.3	4.0	3.7	3.5	3.2	3.0	2.8	2.6	2.5	2.3	2.2	2.0	1.9	1.8
23. Overall Interest/GDP (Pre-IDF)		12.0	11.2	10.5	9.8	9.2	8.6	8.0	7.5	7.0	6.5	6.1	5.7	5.3	5.0
24. Overall Interest/GDP (Post-IDF)		6.3	6.0	6.4	6.9	7.3	7.8	8.0	7.5	7.0	6.5	6.1	5.7	5.3	5.0

ARA/ECP 8/01/88 ZCBECUA.WK1

INTERNATIONAL DEBT FACILITY

INTEREST REDUCTION SCENARIO

TABLE D-6

MEXICO

Assumptions

Libor	0.075	Long-term USG bond rate	9.0%	Length of Program (yrs)	8	Now: December 31,	1988
Spread	0.61	Year ZCB matures	1996	Avg End of Prg Dbt Value	1.24		
GDP % growth	7.0%	Projected debt val 1996	0.95	Target Bank Int/GDP	1.5		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	3.0		
Secondary Market Debt Valu	0.52	Maximum Debt Held by IDF	64.3	Ann Incr to phase out	0.5		
Avg Debt Acquisition Value	0.62						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP ($)		187.5	179.2	191.8	205.2	219.6	234.9	251.4	269.0	287.8	307.9	329.5	352.6	377.2	403.6
2. Projected Exports ($)		32.7	35.0	37.4	40.1	42.9	45.9	49.1	52.5	56.2	60.1	64.3	68.8	73.6	78.8
3. Medium & Long-term Debt-banks		64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.3	64.3
4. Projected Interest on (3)		5.47	5.47	5.47	5.47	5.47	5.47	5.47	5.47	5.47	5.47	5.47	5.47	5.47	5.47
5. Projected Bank Interest/GDP		3.3	3.0	2.9	2.7	2.5	2.3	2.2	2.0	1.9	1.8	1.7	1.6	1.4	1.4
6. Projected Bank Interest/Exports		16.7	15.6	14.6	13.6	12.8	11.9	11.1	10.4	9.7	9.1	8.5	7.9	7.4	6.9
7. Target Bank Interest/GDP		1.5	1.5	1.5	2.0	2.5	2.3	2.2	2.0	1.9	1.8	1.7	1.6	1.4	1.4
8. Int Payment Req to Meet (7)		2.513	2.688	2.877	4.104	5.466	5.466	5.466	5.465	5.466	5.466	5.466	5.466	5.466	5.466
9. Int Savings Req to Meet (7)		2.95	2.78	2.59	1.36	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10. Present Value of (9)	8.29	2.75	2.40	2.08	1.02	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	24.5														
11b. Debt Required to Meet (9) with no cash outlay	34.7														
11c. Market Value of (11b)	21.7														
12. Principal with banks		29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6	29.6
13. Principal with IDF		34.7	34.7	34.7	34.7	34.7	34.7	34.7	34.7	0.0	0.0	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)										34.7	34.7	34.7	34.7	34.7	34.7
14a. Funds to IDF from refinancing									33.0						
15. Interest Paid to Banks		2.5125	2.5125	2.5125	2.5125	2.5125	2.5125	2.5125	2.5125	5.4655	5.4655	5.4655	5.4655	5.4655	5.4655
16. Interest Paid to or by (-) IDF		0.000	0.176	0.364	1.591	2.953	2.953	2.953	2.953	0.000	0.000	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.176	0.553	2.186	5.303	8.654	12.256	5.954	6.401	6.881	7.397	7.952	8.548	9.189
18. Total Interest Paid		2.513	2.688	2.877	4.104	5.466	5.466	5.466	5.465	5.466	5.466	5.466	5.466	5.466	5.466
19. Calc Interest/GDP		1.3	1.5	1.5	2.0	2.5	2.3	2.2	2.0	1.9	1.8	1.7	1.6	1.4	1.4
20. Other Debt		40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8	40.8
21. Interest on Other Debt		3.468	3.468	3.468	3.468	3.468	3.468	3.468	3.468	3.468	3.468	3.468	3.468	3.468	3.468
22. Interest/GDP on Other Debt		2.1	1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1	1.1	1.0	0.9	0.9
23. Overall Interest/GDP (Pre-IDF)		5.3	5.0	4.7	4.4	4.1	3.8	3.6	3.3	3.1	2.9	2.7	2.5	2.4	2.2
24. Overall Interest/GDP (Post-IDF)		3.6	3.4	3.3	3.7	4.1	3.8	3.6	3.3	3.1	2.9	2.7	2.5	2.4	2.2

ARA/ECP 8/01/88 ZCBMEX.WK1

INTERNATIONAL DEBT FACILITY

INTEREST REDUCTION SCENARIO

TABLE D-7

PERU

Assumptions

Libor	0.075	Long-term USG bond rate	9.0%	Length of Program (yrs)	10	Now: December 31,	19
Spread	0.01	Year ZCB matures	1998	Avg End of Prg Dbt Value	0.42		
GDP % growth	7.0%	Projected debt val 1998	0.6	Target Bank Int/GDP	1.0		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	3.0		
Secondary Market Debt Valu	0.06	Maximum Debt Held by IDF	4.8	Ann Incr to phase out	0.4		
Avg Debt Acquisition Valu	0.18						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	20
1. Projected GDP ($)		16.8	18.0	19.2	20.6	22.0	23.6	25.2	27.0	28.9	30.9	33.0	35.4	37.8	40
2. Projected Exports ($)		3.7	4.0	4.2	4.5	4.8	5.2	5.6	5.9	6.4	6.8	7.3	7.8	8.3	8
3. Medium & Long-term Debt-banks		4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.8	4.
4. Projected Interest on (3)		0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.41	0.
5. Projected Bank Interest/GDP		2.4	2.3	2.1	2.0	1.9	1.7	1.6	1.5	1.4	1.3	1.2	1.2	1.1	1
6. Projected Bank Interest/Exports		11.0	10.3	9.6	9.0	8.4	7.9	7.3	6.9	6.4	6.0	5.6	5.2	4.9	4
7. Target Bank Interest/GDP		1.0	1.0	1.0	1.4	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.2	1.1	1
8. Int Payment Req to Meet (7)		0.168	0.180	0.192	0.288	0.396	0.408	0.408	0.408	0.408	0.408	0.408	0.408	0.408	0.4
9. Int Savings Req to Meet (7)		0.24	0.23	0.22	0.12	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.
10. Present Value of (9)	0.69	0.22	0.20	0.17	0.09	0.01	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.
11a. Break-even Debt Purchase	1.5														
11b. Debt Required to Meet (9) with no cash outlay	2.8														
11c. Market Value of (11b)	0.5														
12. Principal with banks		2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2
13. Principal with IDF		2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	2.8	0.0	0.0	0.0	0
14. Country Refinancing of (13)												2.8	2.8	2.8	2
14a. Funds to IDF from refinancing											1.7				
15. Interest Paid to Banks		0.168	0.168	0.168	0.168	0.168	0.168	0.168	0.168	0.168	0.168	0.408	0.408	0.408	0.4
16. Interest Paid to or by (-) IDF		0.000	0.012	0.024	0.120	0.228	0.240	0.240	0.240	0.240	0.240	0.000	0.000	0.000	0.0
17. Accumulated Interest on (16)		0.000	0.012	0.037	0.160	0.400	0.670	0.961	1.273	1.608	2.475	2.661	2.861	3.075	3.3
18. Total Interest Paid		0.168	0.180	0.192	0.288	0.396	0.408	0.408	0.408	0.408	0.408	0.408	0.408	0.408	0.4
19. Calc Interest/GDP		1.0	1.0	1.0	1.4	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.2	1.1	1
20. Other Debt		11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11.2	11
21. Interest on Other Debt		0.952	0.952	0.952	0.952	0.952	0.952	0.952	0.952	0.952	0.952	0.952	0.952	0.952	0.9
22. Interest/GDP on Other Debt		5.7	5.3	4.9	4.6	4.3	4.0	3.8	3.5	3.3	3.1	2.9	2.7	2.5	2
23. Overall Interest/GDP (Pre-IDF)		8.1	7.6	7.1	6.6	6.2	5.8	5.4	5.0	4.7	4.4	4.1	3.8	3.6	3
24. Overall Interest/GDP (Post-IDF)		6.7	6.3	5.9	6.0	6.1	5.8	5.4	5.0	4.7	4.4	4.1	3.8	3.6	3

ARA/ECP 8/01/88 ZCBPERU.WK1

URUGUAY

INTERNATIONAL DEBT FACILITY
INTEREST REDUCTION SCENARIO

TABLE D-8

Assumptions

Libor	0.075	Long-term USG bond rate	9.0%	Length of Program (yrs)	10	Now: December 31,	1987
Spread	0.01	Year ZCB matures	1998	Avg End of Prg Dbt Value	1.72		
GDP % growth	7.0%	Projected debt val 1998	0.9	Target Bank Int/GDP	1.0		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	4.0		
Secondary Market Debt Valu	0.61	Maximum Debt Held by IDF	2.5	Ann Incr to phase out	0.3		
Avg Debt Acquisition Value	0.72						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP ($)		5.6	6.0	6.4	6.9	7.3	7.9	8.4	9.0	9.6	10.3	11.0	11.8	12.6	13.5
2. Projected Exports ($)		1.8	1.9	2.1	2.2	2.4	2.5	2.7	2.9	3.1	3.3	3.5	3.8	4.1	4.3
3. Medium & Long-term Debt-banks		2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
4. Projected Interest on (3)		0.21	0.21	0.21	0.21	0.21	0.21	0.21	0.21	0.21	0.21	0.21	0.21	0.21	0.21
5. Projected Bank Interest/GDP		3.8	3.5	3.3	3.1	2.9	2.7	2.5	2.4	2.2	2.1	1.9	1.8	1.7	1.6
6. Projected Bank Interest/Exports		11.8	11.0	10.3	9.6	9.0	8.4	7.9	7.4	6.9	6.4	6.0	5.6	5.2	4.9
7. Target Bank Interest/GDP		1.0	1.0	1.0	1.0	1.3	1.6	1.9	2.2	2.2	2.1	1.9	1.8	1.7	1.6
8. Int Payment Req to Meet (7)		0.056	0.060	0.064	0.069	0.095	0.126	0.160	0.198	0.212	0.213	0.213	0.213	0.213	0.213
9. Int Savings Req to Meet (7)		0.16	0.15	0.15	0.14	0.12	0.09	0.05	0.01	0.00	0.00	0.00	0.00	0.00	0.00
10. Present Value of (9)	0.68	0.15	0.13	0.12	0.11	0.08	0.06	0.03	0.01	0.00	0.00	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	2.8														
11b. Debt Required to Meet (9) with no cash outlay	1.8														
11c. Market Value of (11b)	1.3														
12. Principal with banks		0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7	0.7
13. Principal with IDF		1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)												1.8	1.8	1.8	1.8
14a. Funds to IDF from refinancing											1.7				
15. Interest Paid to Banks		0.056	0.056	0.056	0.056	0.056	0.056	0.056	0.056	0.056	0.056	0.2125	0.2125	0.2125	0.2125
16. Interest Paid to or by (-) IDF		0.000	0.004	0.008	0.013	0.039	0.070	0.104	0.142	0.157	0.157	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.004	0.012	0.026	0.067	0.142	0.256	0.417	0.605	-0.696	-0.748	-0.804	-0.864	-0.929
18. Total Interest Paid		0.056	0.060	0.064	0.069	0.095	0.126	0.150	0.198	0.212	0.213	0.213	0.213	0.213	0.213
19. Calc Interest/GDP		1.0	1.0	1.0	1.0	1.3	1.6	1.9	2.2	2.2	2.1	1.9	1.8	1.7	1.6
20. Other Debt		1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8	1.8
21. Interest on Other Debt		0.153	0.153	0.153	0.153	0.153	0.153	0.153	0.153	0.153	0.153	0.153	0.153	0.153	0.153
22. Interest/GDP on Other Debt		2.7	2.6	2.4	2.2	2.1	1.9	1.8	1.7	1.6	1.5	1.4	1.3	1.2	1.1
23. Overall Interest/GDP (Pre-IDF)		6.5	6.1	5.7	5.3	5.0	4.7	4.3	4.1	3.8	3.6	3.3	3.1	2.9	2.7
24. Overall Interest/GDP (Post-IDF)		3.7	3.6	3.4	3.2	3.4	3.5	3.7	3.9	3.8	3.6	3.3	3.1	2.9	2.7

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VENEZUELA

INTERNATIONAL DEBT FACILITY
INTEREST REDUCTION SCENARIO

TABLE D-9

Assumptions

Libor	0.079	Long-term USG bond rate	9.0%	Length of Program (yrs)	8	Now: December 31,	1988
Spread	0.01	Year ZCS matures	1996	Avg End of Prg Dbt Value	1.25		
GDP % growth	7.0%	Projected debt val 1996	0.95	Target Bank Int/GDP	2.7		
Exports % growth	7.0%	Minimum Debt Held by IDF	0	No. of yrs for target	1.0		
Secondary Market Debt Valu	0.56	Maximum Debt Held by IDF	25.5	Ann Incr to phase out	1.1		
Avg Debt Acquisition Value	0.63						

	Now	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. Projected GDP (8)		45.4	48.6	52.0	55.6	59.5	63.7	68.1	72.9	78.0	83.5	89.3	95.6	102.2	109.4
2. Projected Exports (9)		13.3	14.2	15.2	16.3	17.4	18.7	20.0	21.4	22.9	24.5	26.2	28.0	30.0	32.1
3. Medium & Long-term Debt to Banks		23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5	23.5
4. Projected Interest on (3)		2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00	2.00
5. Projected Bank Interest/GDP		4.4	4.1	3.8	3.6	3.4	3.1	2.9	2.7	2.6	2.4	2.2	2.1	2.0	1.8
6. Projected Bank Interest/Exports		15.0	14.0	13.1	12.3	11.5	10.7	10.0	9.4	8.7	8.2	7.6	7.1	6.7	6.2
7. Target Bank Interest/GDP		2.7	3.8	3.8	3.6	3.4	3.1	2.9	2.7	2.6	2.4	2.2	2.1	2.0	1.8
8. Int Payment Req to Meet (7)		1.226	1.846	1.998	1.998	1.998	1.998	1.997	1.998	1.998	1.997	1.998	1.998	1.998	1.998
9. Int Savings Req to Meet (7)		0.77	0.15	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
10. Present Value of (9)	0.85	0.72	0.13	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
11a. Break-even Debt Purchase	3.0														
11b. Debt Required to Meet (9) with no cash outlay	9.1														
11c. Market Value of (11b)	5.7														
12. Principal with banks		14.4	14.4	14.4	14.4	14.4	14.4	14.4	14.4	14.4	14.4	14.4	14.4	14.4	14.4
13. Principal with IDF		9.1	9.1	9.1	9.1	9.1	9.1	9.1	9.1	0.0	0.0	0.0	0.0	0.0	0.0
14. Country Refinancing of (13)										9.1	9.1	9.1	9.1	9.1	9.1
14a. Funds to IDF from refinancing									8.6						
15. Interest Paid to Banks		1.2258	1.2258	1.2258	1.2258	1.2258	1.2258	1.2258	1.2258	1.9975	1.9975	1.9975	1.9975	1.9975	1.9975
16. Interest Paid to or by (-) IDF		0.000	0.620	0.772	0.772	0.772	0.772	0.772	0.772	0.000	0.000	0.000	0.000	0.000	0.000
17. Accumulated Interest on (16)		0.000	0.620	1.438	2.318	3.264	4.280	5.373	3.812	4.098	4.405	4.735	5.090	5.472	5.883
18. Total Interest Paid		1.226	1.846	1.998	1.998	1.998	1.998	1.997	1.998	1.998	1.997	1.998	1.998	1.998	1.998
19. Calc Interest/GDP		2.7	3.8	3.8	3.6	3.4	3.1	2.9	2.7	2.6	2.4	2.2	2.1	2.0	1.8
20. Other Debt		10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6	10.6
21. Interest on Other Debt		0.901	0.901	0.901	0.901	0.901	0.901	0.901	0.901	0.901	0.901	0.901	0.901	0.901	0.901
22. Interest/GDP on Other Debt		2.0	1.9	1.7	1.6	1.5	1.4	1.3	1.2	1.2	1.1	1.0	0.9	0.9	0.8
23. Overall Interest/GDP (Pre-IDF)		6.4	6.0	5.6	5.2	4.9	4.6	4.3	4.0	3.7	3.5	3.2	3.0	2.8	2.6
24. Overall Interest/GDP (Post-IDF)		4.7	5.7	5.6	5.2	4.9	4.6	4.3	4.0	3.7	3.5	3.2	3.0	2.8	2.6

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101st Congress
1st Session

COMMITTEE PRINT

REPORT

OF THE

TASK FORCE

ON

FOREIGN ASSISTANCE

TO THE

COMMITTEE ON FOREIGN AFFAIRS
U.S. HOUSE OF REPRESENTATIVES

FEBRUARY 1989

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FOREWORD

HOUSE OF REPRESENTATIVES,
COMMITTEE ON FOREIGN AFFAIRS,
Washington, DC, February 1, 1989.

This document is the report of the Task Force on Foreign Assistance to the House Committee on Foreign Affairs, as presented to the committee on February 1, 1989.

The Task Force was organized in January, 1988 at the request of Chairman Dante Fascell and Ranking Minority Member William Broomfield. Representatives Lee Hamilton and Ben Gilman co-chaired the task force, which was open to all members of the committee. The task force reviewed U.S. foreign assistance programs, with emphasis on bilateral development assistance economic support fund, and military assistance programs.

The following report was presented to the committee for further study and review. It does not necessarily represent the views of all members of the committee. Its purpose is to serve as a starting point for action on foreign assistance authorizing legislation.

DANTE B. FASCELL, *Chairman.*

SUMMARY OF FINDINGS AND RECOMMENDATIONS

During the second session of the 100th Congress, Chairman Dante B. Fascell established a task force to conduct a review of U.S. foreign assistance programs and activities. The task force was chaired by Representatives Hamilton and Gilman, with all Members of the Committee invited to participate in the review, which included extensive meetings with executive branch officials and non-governmental experts. The process also included a review of pertinent studies and reports and written submissions requested by the task force.

The following is a summary of the principal findings and recommendations of the task force:

FINDINGS

The task force concluded that foreign assistance is vital to promoting U.S. foreign policy and domestic interests, but that the program is hamstrung by too many conflicting objectives, legislative conditions, earmarks, and bureaucratic red tape.

RECOMMENDATIONS

ECONOMIC ASSISTANCE

The Committee should consider the:

—Enactment of a new international economic cooperation act to replace the existing Foreign Assistance Act and sundry amendments thereto;

—Creation of a restructured foreign aid implementing agency to replace AID;

—Identification of four principal objectives (economic growth, environmental sustainability, poverty alleviation, and democratic and economic pluralism);

—Provision of greater flexibility in the implementation of assistance programs;

—Provision of more effective accountability focused on results rather than on allocations alone;

—Improving coordination with other U.S. international economic policies, with other donors, and within country programs.

SECURITY ASSISTANCE

The Committee should consider the:

—Separation of the grant and concessional military assistance from cash sales authorities;

—Creation of a new defense trade and export control act to replace the Arms Export Control Act;

—Establishment of one military assistance account;

—Provision of more effective accountability, again focused on results;
—Phasing out over a five year period of military assistance as a quid pro quo for base access rights.

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I. Overview of Foreign Assistance

A. THE CURRENT PROGRAM

For Fiscal Year 1989, total U.S. economic and military aid is about $15 billion. The major components are:

Development Assistance, (DA) accounting for 15.9% of the total. The aim of DA is to promote long term economic development through programs that help a host country use its resources more effectively. Currently, the Agency for International Development (A.I.D.) administers over 2000 projects in the fields of: Agriculture; Rural Development and Nutrition; Population; Health; Child Survival; AIDS Prevention and Control; Education and Human Resources Development; and Private Sector, Environment and Energy.

Economic Support Fund, (ESF) accounting for 23.9% of foreign assistance. It is allocated according to special economic, political and security needs. It is programmed in three ways: as cash transfers to provide balance of payments and budget support to countries facing urgent foreign exchange requirements; as commodity import programs to fund imports from the U.S.; and as project assistance, supporting development projects.

The ESF program is currently focused on the promotion of economic stability and political security in the Middle East and Central America.

Food Aid, accounting for 9.9% of foreign assistance. Under Public Law 480, surplus American agricultural goods are transferred to needy countries through low interest loans and direct donations. The bulk of food aid is provided under Title I, as concessional sales in exchange for specific self-help development activities. Under Title II, food is donated for humanitarian purposes, including child nutrition and emergency disaster relief. Since 1954, the Food for Peace program has delivered 303 million metric tons of food to more than 1.8 billion people in over 100 countries.

Military Aid, accounting for 35.8% of total assistance. It comprises grants and some concessional rate loans for equipment, and military training, provided to friendly nations.

Multilateral Assistance, accounting for 9.9% of all assistance. It includes contributions to multilateral development banks, such as the World Bank, and Inter-American Development Bank, and contributions to economic and development programs of international organizations, such as specialized U.N. agencies working in health, food, agriculture, and the environment.

Other aid flows include International Disaster Assistance, funding for the Peace Corps, the Trade and Development Program, Migration and Refugee Assistance, the Inter-American Foundation, the African Development Foundation, and the American Schools and Hospitals Abroad program.

The real dollar amounts for these programs during the most recent three years are shown in Table 1.

TABLE 1.—U.S. FOREIGN ASSISTANCE, 1987–89, BY MAJOR PROGRAM

[illegible]

	[illegible]			
	[illegible]	[illegible]	[illegible]	[illegible]
[illegible]	$2.4	$2.5	$2.4	$2.3
[illegible]	3.2	3.2	3.5	3.2
[illegible]	1.6	1.5	1.5	1.4
[illegible]	5.5	5.5	5.4	5.7
[illegible]	1.6	1.5	1.5	1.6
[illegible]	.7	.5	.7	.9
[illegible]	15.0	14.3	15.1	15.3

[illegible]

B. ORGANIZATION

The Agency for International Development is the principal U.S. bilateral economic aid agency. It is responsible for the implementation of most Development Assistance and Economic Support Fund programs. The geographical allocation of ESF is decided by the State Department in conjunction with A.I.D. The geographic allocation of development assistance is proposed by A.I.D., with State Department concurrence.

A.I.D. was established in 1961 as a relatively autonomous agency under the State Department. The A.I.D. Administrator has the rank of Deputy Secretary of State. Currently 90 countries host A.I.D. economic assistance programs of over $1 million. There are A.I.D. missions in 46 countries, representational offices in 23, and 13 regional development offices abroad. In 1988 A.I.D. had 4,700 employees, down from 6,000 in 1980 and 17,500 in 1968 at the height of A.I.D. activity in Southeast Asia. About 52% of AID employees are stationed overseas, of which slightly less than half are foreign nationals. In carrying out its projects, A.I.D. also employs about 7,700 contractor personnel and detailees from other federal agencies.

The Department of Defense is responsible for most military assistance. Within DOD, the Defense Security Assistance Agency administers in Foreign Military Sales and Credit Programs and the Military Assistance Program. Other branches of DOD participate in planning and oversight of military aid, and in training and peacekeeping activities. The State Department approves military sales proposals to friendly countries, and is in charge of assistance for anti-terrorism and peacekeeping operations, which come under military aid.

Responsibility for Food Aid is shared by A.I.D., the Department of Agriculture, the Department of State, and the Department of the Treasury. USDA has principal responsibility for determining quantities, selection, procurement, and shipping. A.I.D. is responsible for administering the program in the field, including negotiating food aid agreements and allocating grants. The Department of State plays a major role in country allocation. The Treasury De-

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partment overseas credit arrangements. Food aid is coordinated through an inter-agency committee, the Development Coordinating Committee subcommittee on food aid, which operates on a consensus basis.

Responsibility for Multilateral Assistance is shared. The Treasury Department shapes U.S. policy toward multilateral development banks (MDB's), including nominating and supervising the U.S. executive directors. The State Department leads in policy-making and budget determination concerning the United Nations and other international organizations. A.I.D. coordinates country programs with the MDB's and provides advice to U.S. representatives on proposed MDP projects. In addition, A.I.D. is involved in the developmental and technical assistance activities of the U.N. specialized agencies. Other U.S. agencies are involved in the work of appropriate multilateral agencies. For example, USDA participates in the work of the Food and Agriculture Organization, and the Environmental Protection Agency in the activities of the U.N. Environmental Program.

Many of the programs counted under Other Economic Aid, such as the Inter-American Foundation, Peace Corps, and the Trade and Development Program are autonomous or semi-autonomous. International narcotics programs are the responsibility of the Department of State, and the Drug Enforcement Agency. Refugee assistance programs are handled by the Department of State.

The following table shows the number of countries receiving U.S. assistance in 1987 and 1988:

TABLE 2.—NUMBER OF COUNTRIES RECEIVING U.S. ASSISTANCE IN FISCAL YEARS 1987 AND 1988

	Economic Assistance			Net total economic	Military assistance	Total all programs
	DA and ESF	PL 480	Peace Corps and Narcotics			
Fiscal year						
1987	77	71	58	99	97	116
1988	77	69	57	97	100	117

Note.—In columns including two types of assistance, each country only counts once even if it receives both types of assistance

II. Trends in U.S. Foreign Assistance

A. TOTAL ASSISTANCE

The level of total U.S. foreign assistance has fluctuated considerably over the past 13 years. In constant 1989 dollars, the program shrank from $22.6 billion in FY 1979 to $14.6 billion in 1980. It then rose again to $20.6 billion in FY 1985 before declining to the current level of about $15.1 billion in FY 1989.

(Note: all figures used will be in constant 1989 dollars, unless otherwise noted and amounts represent obligations of U.S. assistance. Amounts for FY 1989, which are estimates.)

Figure 1 depicts levels of total foreign assistance, in nominal and real terms for the period FY 1977 to FY 1989.

Special circumstances in the two peak years, 1979 and 1985, are worth noting.

The $22.6 billion for 1979 includes a $4.8 billion supplemental in additional security assistance, provided to Israel and Egypt under the Camp David Peace Accords.

The $20.6 billion in 1985 reflects the growth of overall funding during the early 1980s, but also includes large (economic) supplementals for Israel, Egypt and Jordan, to deal with short-term debt problems, and emergency food and relief for famine-stricken countries in Africa.

Severe budget constraints have influenced the decline in aid levels in the last four years, bringing the total available for 1989 back down to the level of aid provided in 1977.

As a percentage of Gross National Product U.S. foreign assistance has declined steadily from between 2 and 3 percent of GNP in the late 1940s, to 1 percent in the late 1950s, down to less than three tenths of one percent today.[1] Within the last 13 years, aid levels as a percentage of GNP follow a similar trend to that of dollar levels: peaking in 1979 and 1985, and steadily decreasing since 1985. The percentage figure for 1989 will be an all-time low.

A comparison with other donors reveals that the U.S. has been the world's leading donor of economic assistance, in terms of dollar amounts of Official Development Assistance (as defined by OECD). However, as aid from other donors rises, the U.S. contribution as a percentage of all ODA [Official Development Assistance) is falling.

Figure 2 compares U.S. aid levels with the combined total of the other 16 Western nations of the OECD DAC (Development Assistance Committee). During the period 1977-1987, American ODA accounted for 36% of assistance from all DAC members. In 1987 it accounted for about 22% of all ODA. It is estimated that in 1989 Japan will surpass the U.S. as the world's leading ODA contributor.

[1] Two-tenths of one percent of GNP based on DAC figures, which exclude military assistance.

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Figure 1

Total U.S. Assistance
FY 1977 - FY 1989

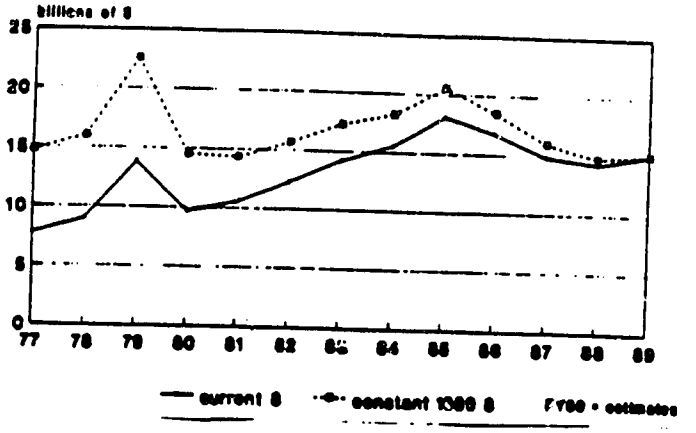
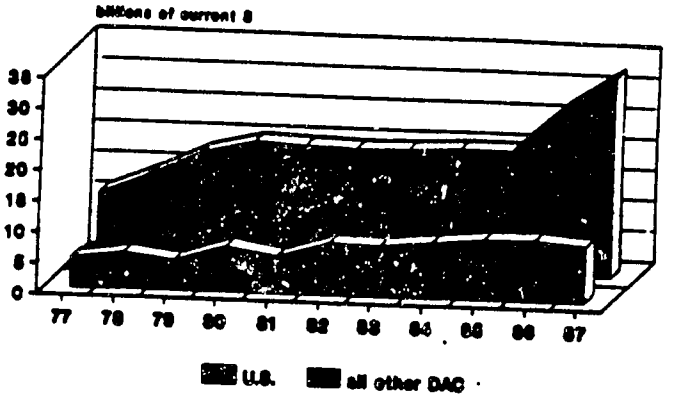


Figure 2

Major Donor Economic Assistance
1977 - 1987



In terms of aid as a percentage of GNP, the U.S. ranks lowest among DAC members. Table 3 gives the 1986-7 levels of ODA in dollars and as a share of GNP for all DAC members. The table also shows that the largest share of U.S. ODA goes to low income countries, but this share is not as large as most other donors.

TABLE 3

AID PROFILES OF OECD DEVELOPMENT ASSISTANCE COMMITTEE MEMBERS
Net Disbursements; 1986-87 average

	Total ODA ($)	ODA as % of GNP	Share of Total DAC ODA (%)	Allocations (%) of ODA to: Multilaterals	LICs*	LMICs**	UMICs***
Australia	$600	.39%	1.0%	24.0%	15.4%	39.7%	10.7%
Austria	$197	.19%	.3%	24.7%	39.1%	9.1%	13.1%
Belgium	$618	.48%	1.6%	21.2%	60.0%	9.4%	9.6%
Canada	$1,790	.47%	4.4%	39.4%	50.0%	11.7%	3.3%
Denmark	$777	.09%	2.0%	40.9%	46.0%	10.2%	3.3%
Finland	$373	.46%	.9%	39.6%	46.2%	7.9%	3.0%
France	$5,815	.73%	14.9%	11.5%	35.6%	11.9%	37.3%
Germany	$4,112	.41%	10.5%	18.4%	54.9%	16.2%	14.0%
Ireland	$57	.34%	.1%	24.0%	58.7%	8.5%	9.5%
Italy	$2,509	.37%	6.4%	23.7%	71.0%	10.2%	5.0%
Japan	$6,544	.30%	16.7%	30.5%	64.6%	14.0%	6.5%
Netherlands	$1,917	.99%	4.9%	24.4%	64.4%	10.5%	9.7%
New Zealand	$85	.27%	.2%	21.6%	29.6%	25.0%	11.1%
Norway	$864	1.12%	2.2%	40.4%	43.4%	8.0%	3.0%
Sweden	$1,234	.87%	3.2%	32.1%	61.2%	8.2%	3.1%
Switzerland	$488	.30%	1.2%	25.5%	61.5%	7.9%	4.7%
United Kingdom	$1,881	.29%	4.8%	24.9%	63.1%	8.0%	9.2%
United States	$9,258	.21%	23.7%	21.1%	43.0%	16.7%	19.9%
TOTAL DAC	$39,097	.30%	100.0%	23.6%	53.9%	13.7%	19.3%

* LICs = Low Income Countries with per capita income in 1985 of below $700.
Includes imputed multilateral ODA.

** LMICs = Lower Middle-Income Countries with per capita income in 1985 between $700 and $1,300.

*** UMICs = Upper Middle-Income Countries with per capita income in 1985 of more than $1,300.

SOURCE: OECD Development Cooperation Report, 1988.

A. Composition by Program

Table 4 shows dollar levels of major components of U.S. aid since 1977.

Table 4

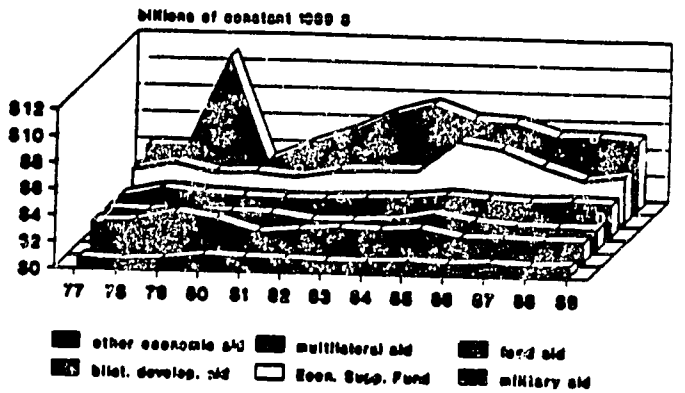
U.S. Foreign Aid, 1977-1990, by Major Programs
(in billions of constant 1989 dollars)

Year	Development Assistance	Food Aid	Other Economic	Multi lateral Asst.	Economic Support Fund	Military Aid	Total
1977	$2.2	$2.3	$ .5	$2.3	$3.3	$4.1	$14.7
1978	2.9	2.2	.4	2.4	3.9	4.2	16.0
1979	2.6	2.1	.6	3.1	3.2	11.0	22.6
1980	2.4	2.2	.9	2.6	3.3	3.2	14.6
1981	2.3	2.1	.8	1.7	3.0	4.6	14.5
1982	2.3	1.7	.7	1.9	3.5	5.5	15.6
1983	2.4	1.7	.6	2.1	3.6	6.9	17.3
1984	2.5	1.8	.6	2.0	3.7	7.7	18.3
1985	2.8	2.3	.7	2.2	6.0	6.6	20.6
1986	2.6	1.8	.6	1.6	5.4	6.4	18.4
1987	2.4	1.6	.7	1.6	4.2	5.5	16.0
1988	2.5	1.5	.6	1.5	3.2	5.5	14.8
1989(est)	2.4	1.5	.7	1.5	3.6	5.4	15.1
1990(req)	2.3	1.4	.9	1.8	3.2	5.7	15.3

These shares and trends are portrayed in Figure 3.

Figure 3

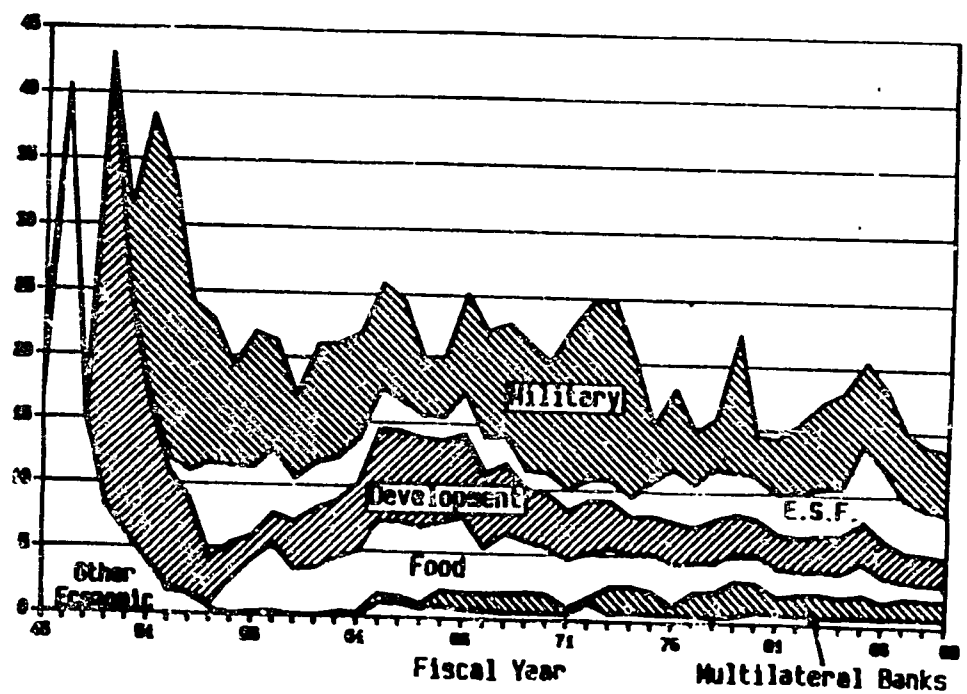
Program Composition of U.S. Aid
FY 1977 - FY 1989



FY88 = estimates

Figure 4

U.S. FOREIGN AID, 1946-89, BY MAJOR PROGRAM



NOTE: The Development category includes U.S. voluntary contributions to international development organizations and programs.

Finally, military aid has been the largest aid category during much of the post-war period. Peaks appear in the early 1950s because of Greece, Taiwan, and Korea, again in the early 1970s because of Vietnam, and the most recent peak occurred in 1985.

Grants versus loans

In the 1970s, approximately one half of the total U.S. assistance program comprised grants, and the other half loans. Today, over 90% of the program is grant, largely in recognition of the growing world debt crisis. In particular, military aid has switched from being mostly loans in the 1970s to nearly all grants today. Figure 5 illustrates this trend since 1977.

C. REGIONAL COMPOSITION

Figure 6 shows the regional composition of U.S. aid.

The Middle East has dominated U.S. regional allocations during the past 13 years, as Figure 6 shows. U.S. assistance to the region ranged between $5 billion and $6.5 billion annually, excluding the Camp David-related support in 1979 and special supplemental in 1985/6. In most years, the Middle East received over half of all U.S. bilateral aid.

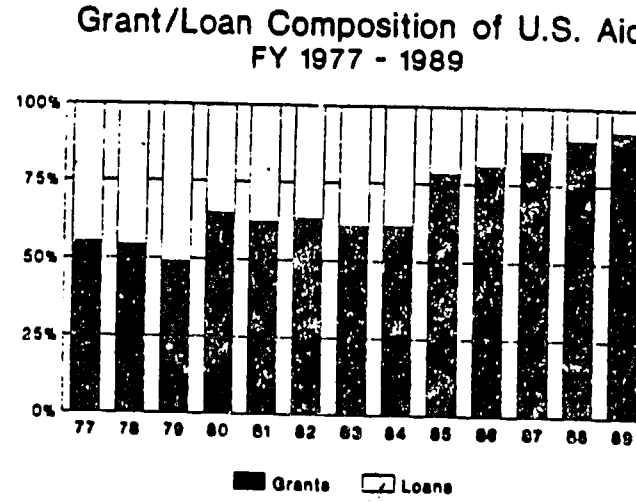
Asia and Europe have received the next two largest shares of U.S. aid during this period. Aid to Asia was a little over $2 billion a year up to 1987. With the graduation of South Korea as an aid recipient, along with the general decline in budget levels, the region will receive only about $1.6 billion in fiscal year 1989.

Aid to Europe, where most U.S. assistance supports military base agreements, grew from about $1.2 billion in FY 1977 to a peak in the mid-1980s of $2.3 billion. Since then, it has declined to just over $1 billion, largely due to the graduation of Spain as an aid recipient.

Latin America had been the smallest recipient at the beginning of the period, with less than $1 billion a year. But in FY 1982, aid to El Salvador and others in Central America began to grow. By 1985, total aid to the region averaged over $2 billion. Budget pressures have forced amounts back down to about $1.4 billion in FY 1989.

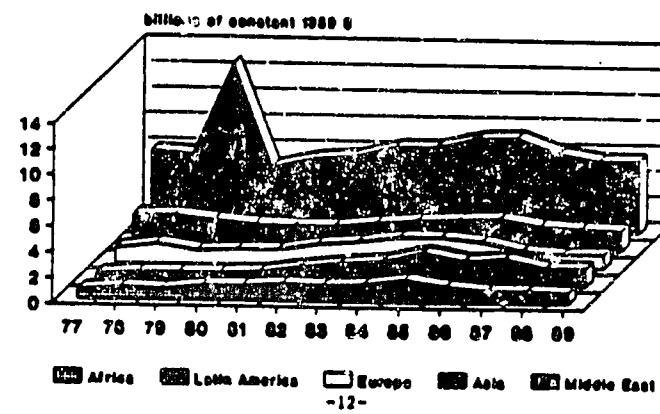
Sub-Saharan Africa has received between $800 million and $1.4 billion in U.S. assistance annually since 1977. Famine relief in 1985 pushed the total up to nearly $2 billion for that year, but it fell down to about $900 million by FY 1989.

Figure 5



FY89 = estimates

Figure 6 Regional Composition of U.S. Aid
FY 1977 - FY 1989



FY89 = estimate

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The ten individual countries receiving the largest amount of aid since 1977 can be seen in Figure 7. Israel and Egypt have been by far the leading recipients, accounting for 47% of all bilateral assistance over the period. Together, the ten countries have received about 70% of all American bilateral aid since 1979. With the exception of India, all have a strong security relationship with the United States. In the cases of Turkey, Greece, Spain and the Philippines, this includes military base agreements.

Figure 8 shows the current major recipients. Israel and Egypt feature even more strongly, while Spain and South Korea are no longer aid recipients, and India receives relatively little aid now.

Figure 7

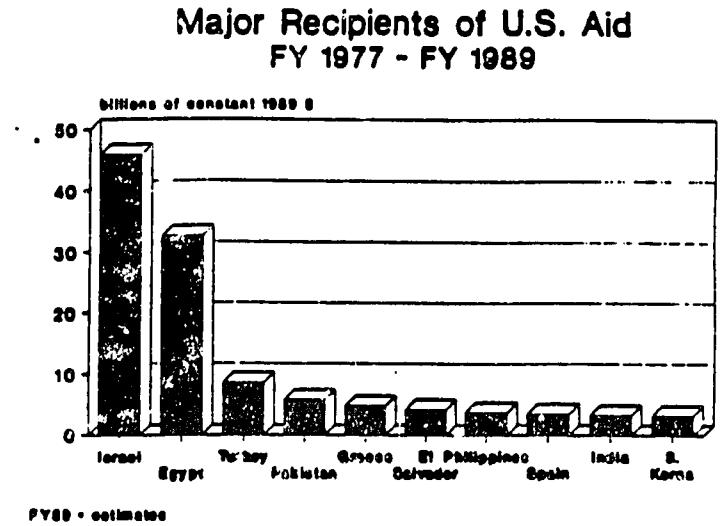


Figure 8

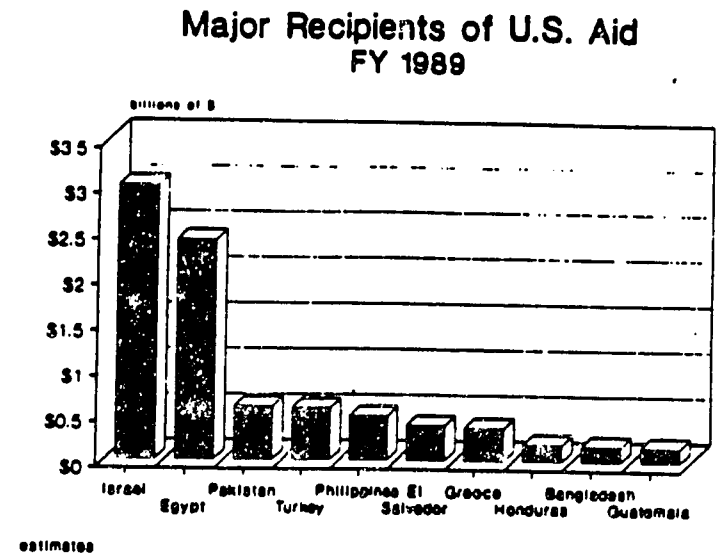


Figure 9 shows the changing regional composition of U.S. post-war assistance.

The early focus on Europe is evident. In 1989 dollar equivalents, aid to Europe peaked at around $28 billion per year in 1950 and 1951. The emphasis on Greece and Turkey increased in the 1950s, as it did again in 1980s.

Asia was the major recipient in the 1954-75 period. Aid peaked in the early 1970s, then fell off abruptly after Vietnam.

The Middle East was a modest recipient until 1972-73, but has been the largest recipient since 1976-77. Since the 1978 Camp David Accords aid to Israel and Egypt has been a major factor in the U.S. aid program.

Figure 9 also clearly shows the marginal roles of Africa and Latin America as aid recipients, although aid to Latin America grew during 1962-67 under the Alliance for Progress, and during the 1980s with the re-emergence of aid to Central America.

An analysis of the real value of total aid over 44 years shows three major periods that roughly correspond to the shifts in regional emphasis. In 1989 dollars, total annual assistance:

—Averaged about $32 billion between 1946 and 1952 when Europe was the major recipient;

—Averaged about $22 billion between 1953 and 1974, when aid was focused on Asia;

—Averaged about $17 billion since 1974, while the Middle East, primarily Israel and Egypt, have been the primary recipients.

Currently, the focus on the Middle East continues, but budget pressures have pushed the annual budget down to $15 billion since 1986.

D. COMPOSITION OF BILATERAL DEVELOPMENT AID AND MAJOR RECIPIENTS

Most U.S. bilateral development assistance is channelled through five functional accounts: agriculture, population, health, education, and selected activities (projects that cut across the other four accounts, such as science and technology). Funding for these five accounts is shown in Figure 10.

Figure 2

U.S. FOREIGN AID, 1946-89, BY REGION

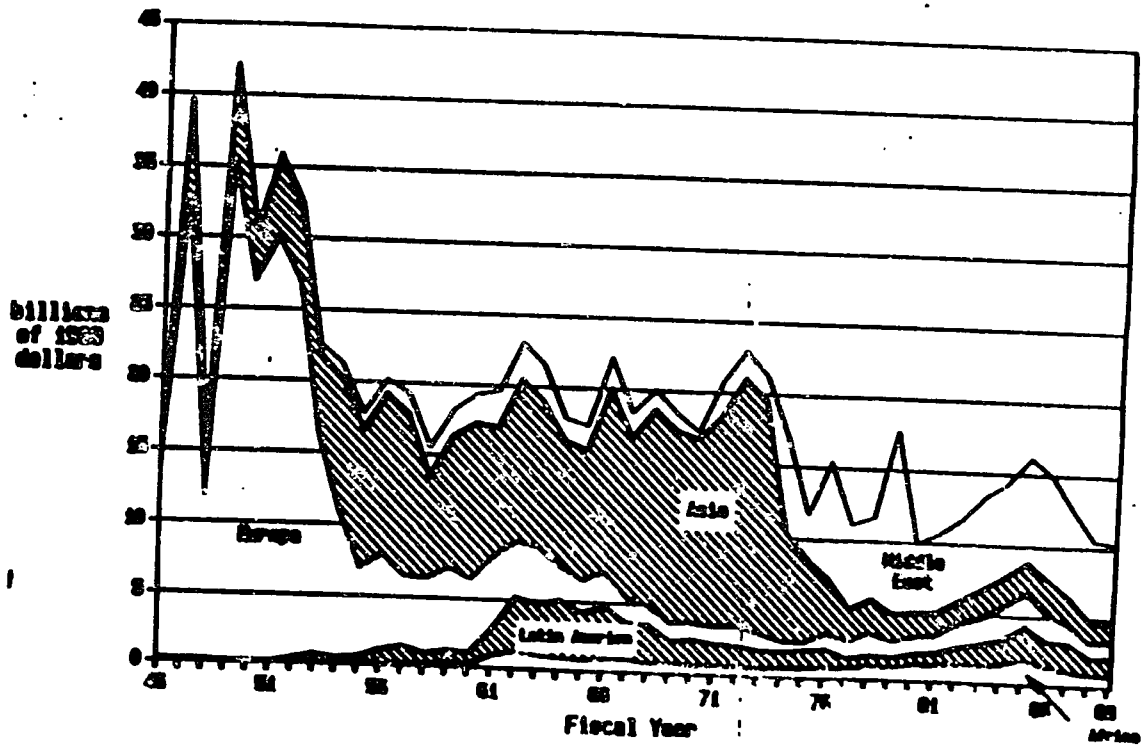
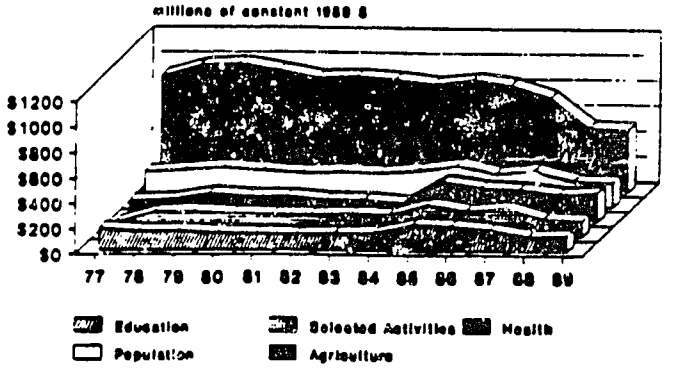


Figure 10

Program Composition of Bilateral Development Aid, FY 1977 - FY 1989



FY89 = estimates

Notes: 1. Funding for Child Survival Activities (since FY 1985) and AIDS programs (since FY 1988) are included in health account levels shown.

2. Amounts illustrated for FY 1988 and 1989 do not include spending for the DFA (Development Fund for Africa), and therefore are not comparable with earlier years.

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Agriculture has been the largest program, totaling about $900 million annually—over 50% of total development spending. More recently, as emphasis on other programs has increased, agriculture's share has fallen to around 40%.

Population programs has been the second largest account for most of the period. Family planning and other population-related activities have been steadily funded in the range of $260 to $300 million.

Health-related programs have received increasing support. In FY 1984 Congress created an additional functional account for Child Survival Activities. In FY 1985 funding for the two accounts was $315 million, double the health budget in FY 1977. Another health account was created in FY 1988 to assist international AIDS research.

The Selected Development Activities account has also been the focus of greater attention, especially programs promoting the private sector in developing countries. Funding increasaed from $105 million in FY 1977 to $257 million in FY 1985.

Education and human resources programs have received between $130 and $160 million annually, except in the case of a few years.

Programs that are not channelled through these five accounts include Peace Corps, and, since FY 1988, the Development Fund for Africa through which all economic assistance for Africa is channelled. Major recipients of U.S. bilateral development assistance since 1977 have been Bangladesh, India, and Indonesia, although currently only Bangladesh continues as a major recipient. The ten major recipients during this period are shown in Figure 11. In the 1980s development assistance has increasingly focused on Central America, particularly El Salvador and Honduras, as can be seen in Figure 12, showing FY 1989 recipients.

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Figure 11

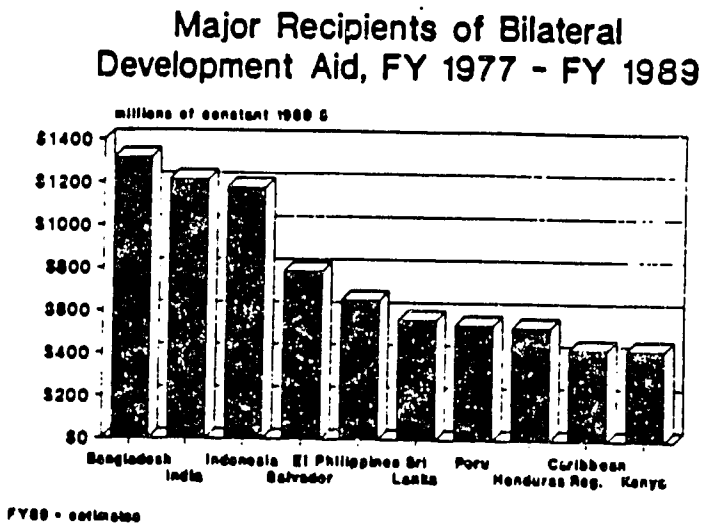

Figure 12

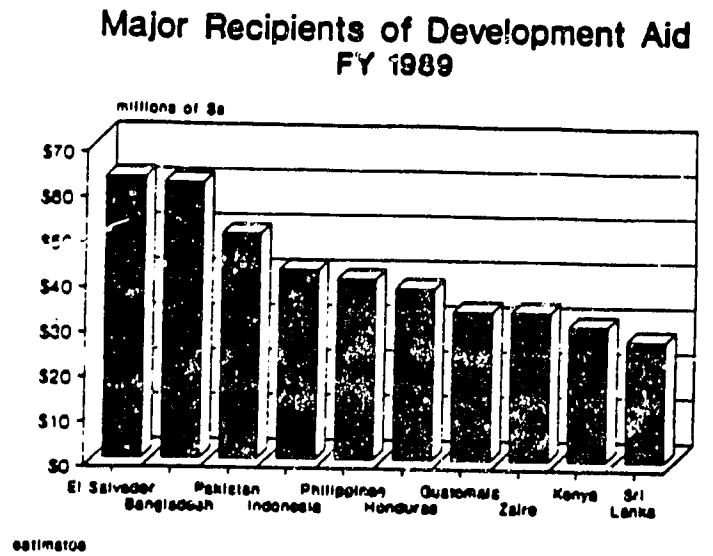

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Figure 13

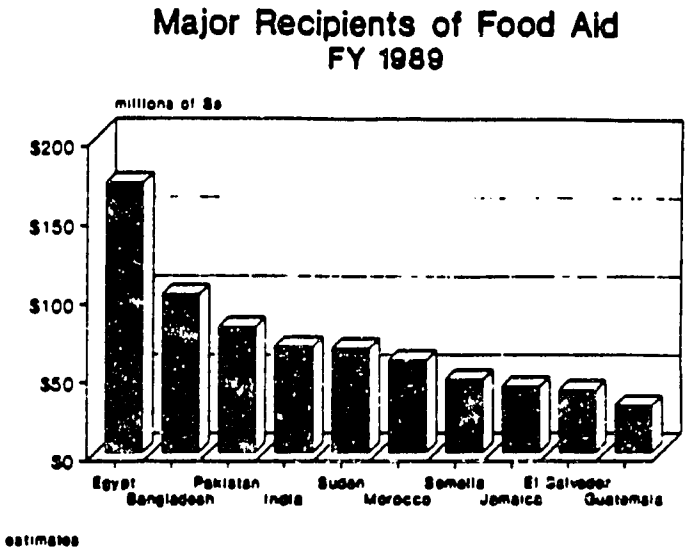
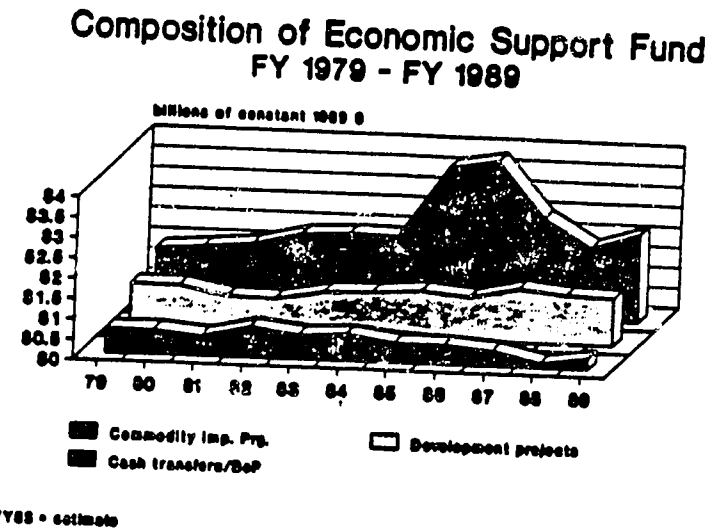


Figure 14



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E. COMPOSITION OF FOOD AID AND MAJOR RECIPIENTS

The share of food aid channelled as loans fell from about 60 percent of the total in 1977 to just over 50 percent by 1985, as grants increased in response to emergency drought and famine conditions. In recent years, as emergency situations subsided in some parts of Africa, loans once again neared 60 percent of the program.

The major recipient of food aid has been Egypt, during the period FY 1977 to 1989. Egypt's $4 billion share accounts for 19% of total food transfers since 1977, and is nearly as much as that for all of sub-Saharan Africa combined ($4.3 billion). South Asia has also been a focus of U.S. food assistance, where India, Bangladesh and Pakistan have received the second, third and fourth largest shares. Other countries in the top ten recipients are Sudan, Morocco, Peru, Indonesia, Sri Lanka, and the Philippines. Among the current, FY 1989 recipients shown in Figure 13, Somalia, El Salvador, Guatemala and Jamaica have replaced Indonesia, Peru, Sri Lanka and the Philippines.

F. COMPOSITION OF THE ECONOMIC SUPPORT FUND AND MAJOR RECIPIENTS

The size, scope and accountability of ESF has been a continuing matter of debate in recent years, because of its flexible nature and potential for responding to multiple policy objectives. In particular, Congress has been concerned over accountability of the cash transfer position of ESF.

Figure 14 shows the division of ESF funds according to use: cash transfers for balance of payments support, commodity import programs, and development project aid. It shows a growing emphasis on the cash transfer component since FY 1979 (the first year for which accurate data are available). The share of ESF programmed as cash transfers increased from 45% of the total to about 60% by the late 1980's. (The even larger share in FY 1985 and 1986 include the special supplemental for Israel, Egypt and Jordan).

The share of ESF going to development projects has remained at between $1 and $1.1 billion annually, in terms of real dollars, but its share of the total program has declined from 35% to about 32%.

Commodity Import Programs, which used to account for about 20% of ESF, have declined sharply and now represent less than 4% of the overall program.

Major recipients of ESF since 1977 are shown in Figure 15. During this period, ESF has been highly concentrated in Egypt and Israel. Combined, they have received over $31 billion, or 64% of total ESF transfers. The other major, but far less significant, recipients, are those with which the U.S. shares a strong security relationship. Today, as Figure 16 shows, Israel and Egypt remain the largest recipients, although the shares of the Philippines, Pakistan and El Salvador have increased.

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Figure 15

Major Recipients-Economic Support Fund
FY 1977 - FY 1989

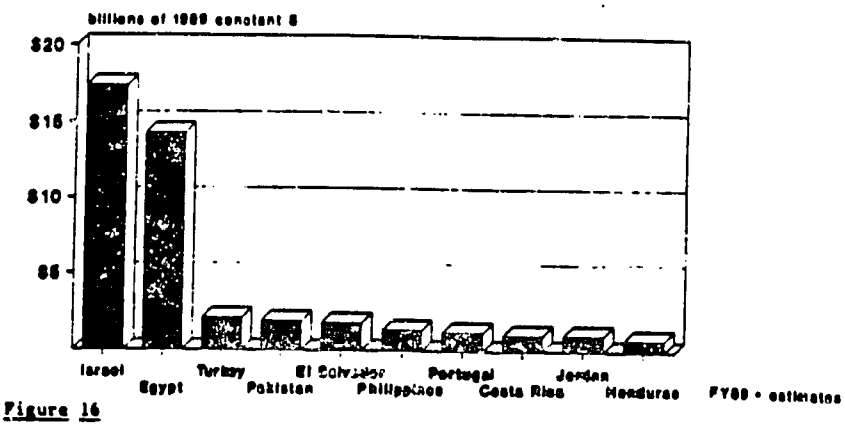
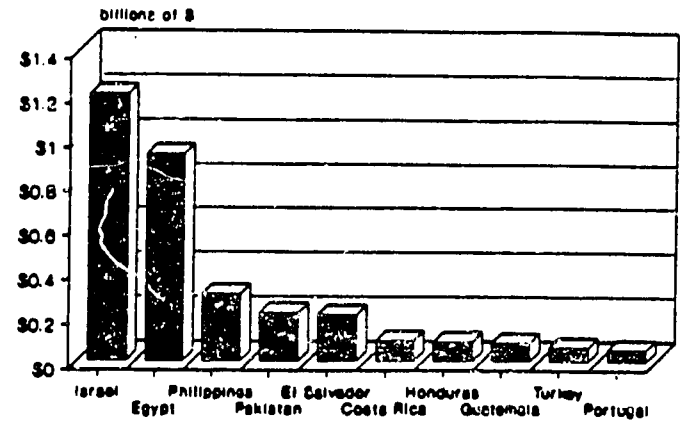


Figure 16

Major Recipients of the Economic Support Fund -- FY 1989



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G. COMPOSITION OF MILITARY ASSISTANCE AND MAJOR RECIPIENTS

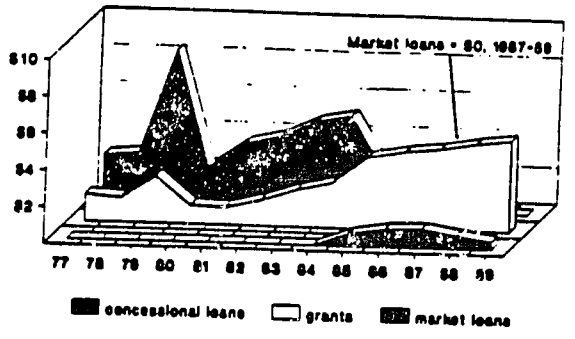
Most military assistance has been programmed in three ways: as loans bearing market interest rates; as concessional loans at about 5% interest (since 1984 only); and as grants. Figure 17 illustrates the division of funds between these three components since 1977.

In the early part of the period, the grant portion was small, comprising less than 25% of the total in FY 1981. Market loans, with interest rates up to 13% made up the rest. Harder loans were preferred by some policymakers, to discourage the growing demand for military transfers. In 1981, as the debt servicing problems of many military aid recipients increased, the grant portion began to grow quickly. When all military aid to Israel and Egypt was converted to grants in FY 1985, and a concessional loan program began, the share taken by market loans fell even more. By FY 1987 market loans had been eliminated entirely. For FY 1989, the Administration requested a grant-only military program, but Congress continued to insist that at least a small portion remain as concessional loans. Currently, grants make up 92% of the program.

The major recipient of military assistance has been Israel. During the period FY 1977 to FY 1989, Israel has received $28.5 billion, or 39% of the total. Egypt has received the second largest amount, although half that of Israel. The remaining major recipients since 1977 have been largely those with which the U.S. maintains military base agreements—Turkey, Greece, Spain, Portugal and the Philippines. Major recipients of military assistance over the past 13 years are shown in Figure 18. Of these, Spain and South Korea no longer receive assistance. As can be seen in Figure 19, showing FY 1989 recipients, El Salvador, Morocco and Honduras have joined the list.

Figure 17

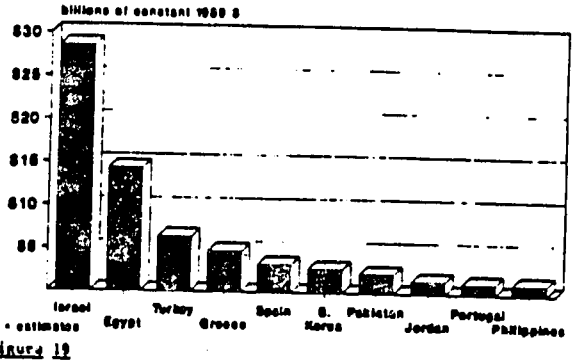
Composition of Military Assistance
FY 1977 - FY 1989



FY89 = estimates

Figure 18

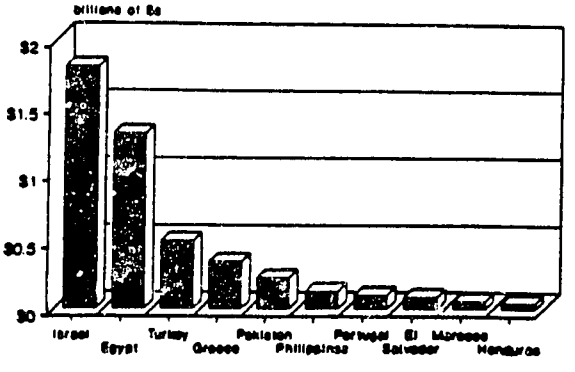
Major Recipients of Military Assistance
FY 1977 - FY 1989



FY89 = estimates

Figure 19

Major Recipients of Military Aid
FY 1989



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III. Principal Findings of the Task Force Review

1. U.S. FOREIGN ASSISTANCE IS IMPORTANT

The U.S. foreign assistance program is an important element of U.S. foreign policy. It serves U.S. foreign policy objectives by promoting the political and economic stability of nations important to U.S. interests. It supports U.S. national security by helping allies maintain adequate defense capabilities and stable economies. It serves U.S. economic interests by stimulating economic reform and growth overseas. It promotes U.S. long-term national interest by sustaining partnerships with other countries and enhancing their capacity to cooperate on issues of global importance. It responds to U.S. humanitarian concerns by helping alleviate suffering from disasters and poverty and by helping to promote more equitable and just societies.

U.S. leadership, expertise, and experience are of great value. Even with limited resources, the program still achieves significant results and contributes much to U.S. development interests and to U.S. relationships with recipient countries. The U.S. foreign assistance program has a positive record of accomplishment, management, and expertise in development. A.I.D.'s overseas missions are a unique asset.

2. THE FOREIGN AID PROGRAM OPERATES IN A CHANGING WORLD

The United States is, and will continue to be affected by development, or lack of it, in other countries. Environmental degradation, deforestation, depletion of the ozone layer, trade deficits, drugs, international debt, immigration, over-population, AIDS, mediterranean fruit fly . . . all affect the well-being of the United States. These problems pose a challenge to U.S. national interests, and must be addressed.

Global tensions have changed. The lessening of tensions between the superpowers and the possibilities for settlement of some regional conflicts create new challenges and opportunities for peace and development.

Economic issues increasingly dominate the international agenda. The budget and trade deficits are priorities for the United States. Non-market economies are focusing on economic reform and efficiency. Developing countries are striving to deal with external debt while promoting domestic growth. The international economic system is being revolutionized by rapidly changing technology, massive international capital flows, and instant communication.

The developing world has become increasingly divergent. For most of Africa, and much of Latin America and the Caribbean, the 1980s has been the "lost decade." Countries in Asia and the Near

East have made significant progress. Meanwhile, newly industrialized countries—Taiwan, Korea, Brazil, Singapore—have gained affluence and become world economic actors.

Increasing institutional and technical capacity in Third World countries facilitates collaborative programs among U.S. and developing country institutions. Even where GNP per capita remains low, institutional growth enables developing countries to be partners in development cooperation, rather than recipients of aid transfers. A.I.D. is beginning to develop collaborative programs in public policy, science, technology and enterprise development. However, A.I.D. procedures and management systems do not encourage collaborative efforts.

Urbanization in developing countries is accelerating. During the next twenty five years, urban populations will increase by 1.2 billion in countries currently eligible for U.S. economic assistance. This growth will have greatest impact in low income countries. By 2000, a majority of the world's poor will be in urban areas. For example, Kenya, with a current urban population of 4.5 million, can expect an additional 38 million urban dwellers by the year 2025. This growth creates both opportunities for more diversified patterns of growth, as well as enormous problems of shelter, sanitation, and transportation. Unmanaged urbanization in the developing world has serious consequences for the global environment, international health, and political stability.

Aid is only one part of complex relations with developing countries. Other economic issues are increasingly important. For example:

—The major obstacle to development at present is the external debt burden of much of the Third World. The resources that are siphoned away from domestic investment into debt payments far outweigh aid flows. Their transfer inhibits development and economic growth, and therefore is beginning to threaten political stability and receptivity to market-oriented policies.

—Trade and investment are increasingly important in relationships between the United States and developing countries.

—The objectives driving military sales have evolved over time so that they are now an element of export promotion.

—Policies on trade, debt, investment, and other issues sometime conflict with, rather than complement, the objectives of the U.S. aid program.

U.S. foreign assistance is a declining world resource. The United States is no longer the major donor country—Japan is surpassing us as the largest donor of bilateral economic aid. Total foreign assistance has declined from 3% of GNP at the height of the Marshall Plan, to 1% in the late 1950s, to less than three tenths of one percent of GNP today [1]—the lowest level of any OECD member.

U.S. institutional and technical resources are highly relevant to current development issues. U.S. strength lies in private enterprise, education, science and technology, and in non-governmental organizations. For developing countries, access to U.S. markets is criti-

[1] Two-tenths of one percent of GNP based on DAC figures, which exclude military assistance.

cal to economic growth. The United States is still the country of choice for students seeking advanced education in science, medicine, and management. Collaborative ventures in science and industry between the United States and developing countries are of mutual benefit, and are necessary to tackle current problems.

The world is increasingly receptive to market-oriented policies. The economic policies being promoted by donor organizations and being adopted by developing countries have become increasingly market-oriented over the last decade, even in non-market economies. This trend widens opportunities for U.S. economic relations and influence.

3. THE ROLE OF THE U.S. AID PROGRAM HAS CHANGED

The theory behind the program has evolved. The program began with an emphasis on large resource transfers during the Marshall Plan, shifted toward technical assistance during Point Four, to infrastructure during the 1960s, to basic human needs during the 1970s, and finally to the role of markets and policy reform during the 1980s. Clearly there is no one path to development. U.S. assistance should focus on those types of assistance which the U.S. can provide most effectively, and which meet the existing development needs of a country.

U.S. foreign assistance is highly concentrated on a few strategically important countries. The major strategic recipients, Israel, Egypt, Pakistan, Turkey, the Philippines, El Salvador, and Greece receive 72% of the $11 billion provided to countries for ESF, military, food, and development assistance. Israel and Egypt alone recieve 50% of this total.

The focus of foreign assistance has changed. Over the past decade, the balance has shifted towards the Middle East, to military assistance, to grants rather than loans, and to bilateral rather than multilateral assistance. ESF is increasingly favored by the Executive branch because of its greater flexibility and faster disbursement.

4. THE DOMESTIC CONTEXT OF THE AID PROGRAM HAS CHANGED

Budget constraints conflict with increasing demands on the aid program. In FY 1990, the budget deficit must be reduced by $35 billion. Yet there are increasing demands on the foreign assistance program: there is the prospect of major new commitments in Afghanistan, Namibia, Philippines, the Middle East, to U.N. peacekeeping forces, and payment of arrears to the UN and MDBs. As the pie shrinks, Members of Congress, interest groups, departments and agencies will each fight to protect their particular interest. In sum, the United States will have to do more with available resources.

The program does not enjoy broad public support. U.S. public support for helping poor people remains strong, but the public does not view the aid program as doing this effectively. The public has very little concept of the aid program as an instrument of foreign policy, used to advance U.S. interests. There is evidence that the public would support development programs focused on key problems affecting the well-being of the United States.

5. CURRENT AID LEGISLATION AND ADMINISTRATION IMPEDE EFFECTIVENESS

There are too many objectives. Scattered through the Foreign Assistance Act are 33 objectives. An A.I.D. document lists 75 priorities for economic assistance. Most, if not all, of these objectives are probably worthy, but they are so numerous that they cannot provide meaningful direction or be effectively implemented. In the field of military assistance, while there are relatively few stated objectives, those objectives are overly politicized, leading us to expect too much in foreign policy terms from what is being provided or sold. Mixing security, military, development, and humanitarian objectives makes evaluation and Congressional oversight difficult.

The program is hampered by numerous reporting requirements, earmarks and restrictions:

Foreign aid legislation contains 288 individual reporting requirements to advise Congress of both one-time and continuing activities. GAO reports that AID's reporting requirements on the $5 billion program it manages is second only to the Defense Department with over $300 billion. These could be substantially reduced, by consolidating similar reports, repealing unnecessary or low-interest requirements, and removing fulfilled or out-of-date provisions.

Earmarks, mostly in the form of specified country allocations in legislation, have increased to unprecedented levels. For FY 1989, 92% of military aid, 98% of ESF, and 49% of development assistance is earmarked. In recent years, the protection of high priority recipients through legislative earmarks has considerably diminished executive branch agencies' discretionary authority over foreign aid allocations. This problem is likely to get worse as budget pressures tighten.

Congress receives over 700 notifications of project changes each year. This level of notifications focuses Congressional attention on project changes, which are inevitable, rather than on policies and programs.

In addition, there are numerous directives, restrictions, conditions, and prohibitions in the foreign aid legislation, and in committee and conference reports, that must be adhered to by implementing agencies and recipients of U.S. aid. The result is an aid program that is driven by process rather than by content and substance.

What all this means is that accountability of U.S. foreign assistance is extensive but ineffective. Accountability is focused on anticipating how assistance will be used, rather than on how effectively it is and has been used. It can take two-and-a-half years to plan and approve a project, by which time conditions have changed, and plans need to be revised. The burden of excessive Congressional and A.I.D./Washington accountability keeps mission staff at their desks rather than in the field, creates a complex bureaucratic process that prevents flexible programming, and turns attention away from the important task of program evaluation. It leaves both Congress and A.I.D. staff focussing on plans not results.

Military assistance also suffers from accountability problems. Accountability has been divested to various services of the military,

resulting in recurring problems in accounting for cash sales and monitoring equipment sold to foreign countries.

The aid program is spread too thin. Military assistance has followed a recurring pattern in which a number of small programs are proposed, then eliminated or drastically reduced due largely to earmarking after the budget cycle is complete, creating raised expectations and ineffective implementation. A.I.D. has 2000 projects in 90 countries. In addition to programs in developing countries, A.I.D. manages programs in Northern Ireland, Poland, Portugal, Cyprus, Italy, and Oman; it manages American Schools and Hospitals Abroad, and special tasks such as humanitarian aid to the Nicaraguan Contras. With 16 disaster relief operations in October and November of 1988, disaster relief alone is a major responsibility. The wide range of foreign operations undertaken by A.I.D. diverts attention from development objectives. In essence, the aid program tries to achieve too much.

There is little coordination of U.S. economic, security, and development policies. As a result, many foreign policy decisions, for example, on tariffs and trade, defense cooperation, debt, environmental protection, science and technology, public health, and immigration, do not take developmental and security considerations into account. The Development Coordination Committee (DCC) seldom meets at a high level, and then principally only for ceremonial purposes. The International Development Cooperation Administration (IDCA) exists in name only. Coordination of policy for economic and military assistance is insufficient. At the field level, the rising coincidence of U.S. international economic interests with development goals requires greater program integration and coordination.

The contribution of non-governmental organizations is important. PVOs (Private Voluntary Organization), universities, cooperatives, research institutions, and other non-governmental organizations have much to contribute to U.S. economic assistance policies and programs. Their expertise, field experience, ability to reach certain target populations, and the diversity of their capabilities and operating modes complement the resources of A.I.D. Some 15% of development assistance and projectized ESF is channeled through PVO's. The research capabilities and developmental and technical expertise of U.S. universities are valuable resources that need to be utilized to deal effectively with today's development issues. The participation of businesses from both host and donor country in development programs can be effective and mutually beneficial. Effective means are needed to ensure that these organizations can be heard by policy makers.

IV. Recommendations

A. ECONOMIC ASSISTANCE

1. Repeal the Foreign Assistance Act of 1961 as amended. Enact a new International Economic Cooperation Act of 1989

Changes in the international environment and the position of the United States, the emergence of global challenges to U.S. well-being, domestic budgetary pressures . . . and the loss of public and Congressional support for the aid program all demand major changes in foreign aid legislation. U.S. foreign assistance needs a new premise, a new framework, and a new purpose to meet the challenges of today. It is time to start anew.

A fresh start is unlikely if Congress simply revises and adds yet more amendments to an already cluttered act. The current 500 pages of foreign assistance legislation, developed over the past 28 years, are strewn with obsolete, ambiguous and contradictory policies, restrictions and conditions.

For example:

Inconsistency.—There is no consistency in the way the Act deals with other foreign policy concerns which affect foreign assistance, such as human rights, terrorism or narcotics. Procedures vary for different concerns and different regions, as do procedures for Presidential waivers and Congressional reviews of those waivers.

Ambiguous.—Section 531 of the Act provides authority to the President to promote "economic or political stability." However, section 531(e) prohibits the President from using funds for military or paramilitary purposes. It is not clear whether nations receiving support under this section are prevented from using those funds to repay United States loans for purchase of military hardware.

Obsolete.—Section 614(b) authorizes the President to use ESF funds for Germany, including West Berlin. This section may have been relevant before Germany became a major foreign assistance donor.

The numerous inconsistencies have increased with each new foreign assistance bill. The difficult task of bringing some coherence to legislation and creating a targeted and effective aid program, that enjoys wide support, requires a new International Economic Cooperation Act.

2. The new International Economic Cooperation Act would specify four main foreign economic policy objectives

(i) *Growth.*—Encouragement of broad based economic growth.

(ii) *Environmental sustainability.*—Improved environmental, natural resource, and agricultural management.

(iii) *Poverty alleviation.*—Human resource development aimed at improving the well-being of the poor and their capacity to become productive citizens.

(iv) *Pluralism.*—Promotion of political, social and economic pluralism.

These four objectives would focus U.S. foreign assistance on four discrete but flexible priorities, which serve the interests of both the United States and recipient countries. They would clarify the purpose of the program. Experience and understanding of the new challenges indicate that these priorities will maximize the benefit to be gained by recipient and donor.

Growth.—Economic growth and development in other countries serves U.S. interests by promoting political stability as as expansion of trade and investment opportunities. Growth is necessary to improve the living standards of the poorest and to enable the developing world to progress out of today's debt, environmental and population problems. Growth must be broad-based to reach the poor; narrow, unbalanced growth is politically and economically unstable. Growth must be subject to the efficiencies imposed by open markets. U.S. policy can encourage the creation of more efficient, more participatory, and more open economic systems.

Environmental sustainability.—Global environmental and natural resource problems have become too obvious and too urgent to ignore. In the developing world, deforestation, pollution, and soil erosion ceaselessly diminish the capacity for sustainable agricultural production. Deforestation and desertification are depleting the ozone layer and threatening the entire world with global warming. The rapid depletion of energy resources will affect the availability and price of future energy worldwide. The degradation of the resource base is affecting the capacity of the agriculture sector to keep pace with rising food demand. These are pressing problems which will require international cooperation. The U.S. can assist in the development and implementation of improved policies, technologies, and management systems necessary for more efficient and sustainable systems of agriculture and resource management. Environmental concerns should be integrated into every program. Environmental and other policies must be finely tuned to balance the needs of growth with the sustainability of the resource base.

Poverty alleviation.—Although much progress has been made in reducing the worst conditions of poverty through improved public health, better food production and distribution systems, and expanded literacy and family planning programs, the fact remains that a staggering 2 billion people still live in poverty, increasingly in urban areas. Thirty years of development experience tell us that people can rise from poverty if they are healthy and educated and have the opportunity to participate in the economy. Such investment in human capacity requires careful targeting and long term commitment. It can result in personal well-being, a more productive economy, and a more pluralistic and stable policy. These benefits, along with the additional consequences in terms of better public health, more stable population, and expanded international markets, all promote the interests of the United States.

Pluralism.—The United States stands for political and economic freedom. U.S. foreign assistance promotes these values both explicitly and implicitly. This can be achieved through many institutional forms. The advancement and protection of these freedoms require responsive local government, and a well-informed and active

citizenry. Internationally-oriented American PVOs and citizens groups in the Third World increasingly are pursuing the expansion of choice and participation to those traditionally least involved. It should be U.S. policy to encourage the growth of both non-governmental capacity and of effective national and local government.

These four objectives are interrelated and mutually reinforcing. In pursuing them the United States can be true to U.S. values and interests, without imposing preconceived solutions on others. The key to progress in meeting these objectives is to recognize that they will require time, flexibility, and a system of problem solving based on genuine cooperation and reciprocity of benefits between nations. Foreign assistance must be coordinated with other policies in pursuing these goals and encouraging others to pursue them.

Identifying these four basic objectives for U.S foreign economic assistance does not mean that the 33 objectives currently in the Foreign Assistance Act are to be rejected. Many of them are subsumed under these four priorities; for example, biological diversity is one principle of improved environmental policies. Others indicate the preferred modes of operation and manner in which these ulimate objectives are pursued; for example, concern for the role of women in development becomes an integral part of all development programs. A.I.D.'s reporting of program results would include explanations of how biological diversity was affected, and why or why not women participated and benefited.

3. The new act would draw clear distinctions among various types of economic assistance

The lack of a clear distinction between development assistance and ESF causes a confusion of objectives and responsibilities and makes evaluation more difficult. In keeping with the aim of clarifying the purpose and key objectives of the economic assistance program, the new act would provide a clear distinction between development assistance and ESF. Where currently one type of assistance is used for the purpose of the other, the funds would be transferred into the other account.

ESF would be allocated to countries to support immediate U.S. political, economic, and security interests. After initial allocation decisions are made, ESF should be programmed so as to support the four objectives of economic assistance.

The allocation of development assistance would be justified in terms of the four policy objectives, reflecting the increased importance of these objectives in supporting U.S. national interests. DA should be made a more flexible intrument.

4. The act would allow maximum flexibility in developing strategies and programs for pursuing the four objectives

The new act would set down operational and policy parameters for U.S. economic assistance programs and policies. It would avoid most of the conditions, restrictions, directives, and earmarks of the current act.

—Congressional notifications would be required for changes in country levels but not for project changes.

—Reporting requirements would be kept to a minimum.

—Appropriation of DA funds would not be divided into functional accounts.

—Funds would be appropriate on a no-year basis, thereby removing pressure to obligate funds hurriedly at the end of the fiscal year.

The agency would inform the Congress about specific country programs and strategies it proposes, and demonstrate to the satisfaction of the responsible committees why those strategies have been selected.

It is probably unrealistic to expect to eliminate all restrictions, conditions, and directives from the bilateral aid program. However, the present system is unworkable and increasingly irrelevant. If every worthy condition and directive that is proposed is accepted, as in the past, the result is confusion, ambiguity and bureaucratic gridlock. The cumulative impact is a program that simply does not work.

The present system results in a program that focuses on process, on meeting legislative and administrative deadlines and filing forms and reports, not on the substance of activities. Currently, administrators must find a distribution of development assistance funds that fits in with country, functional, and special program earmarks, and still bear some relation to the needs and circumstances of each particular country. ESF is earmarked almost completely on a country basis. Earmarks deny the flexibility needed to respond to changing needs during the fiscal year. They reduce U.S. policy leverage because recipients know that funds will eventually be forthcoming. With extensive earmarking, A.I.D.'s experienced and committed personnel do not have responsibility for the program, and cannot utilize their talent and creativity. In contrast, given today's new challenges, the premium should be on ideas, leverage, and long-term problem-solving. This requires flexibility, better use of talent, and concentration on central, long term, issues.

5. The act would require an accountability system based on the measurement and evaluation of process toward the achievement of the legislative mandate

Accountability would be based on careful Congressional oversight and Executive evaluation of the impact and result of U.S. foreign assistance rather than on compliance with a multitude of restrictions, directives, and earmarks.

The present Congressional and bureaucratic system focuses on how much, where, and how, the executive branch plans to spend economic assistance dollars. Just as the requirements are too extensive to give effective direction to A.I.D. so the reports are too voluminous to be read by Congress. The accountability burden turns attention away from what has and had not been achieved. In spite of 1,300 pages of Congressional presentation, over 700 Congressional notifications annually, and innumerable reports, Congress does not know what actual progress is being made towards the solution of serious global problems. Congress must be freed from dealing with near-term operating activities, in order to focus on critical issues of national priority, program balance, and post-appraisal of results.

There are three elements to a new system of accountability.

(i) Clear and realistic objectives must be established.

(ii) Reporting must be results-oriented and appropriate for assessing policies and programs.

(iii) Both Congress and the Executive branch must know who is responsible.

This will require the administrating agency to give greater priority to evaluation of projects and programs. In addition to ongoing evaluation by A.I.D. and GAO, a full country review could be undertaken periodically, (perhaps every five years) by a team composed of agency evaluation personnel and other experts from government agencies (such as GAO [General Accounting Office] and OTA [Office of Technology and Assessment]) and from outside government. Such a review would cover all U.S. assistance activities in a country.

Responsibility should be concentrated at the level of the head of the U.S. mission in a country, the head of particular programs, and the agency administrator.

For its part, Congress must engage in more rigorous oversight. The House Foreign Affairs Committee oversight responsibility could be centered in a Foreign Assistance Oversight Subcommittee or an ad hoc group with a strong staff dedicated soley to the task of oversight. The subcommittee or group would be the key point for oversight of foreign assistance programs and policies, and for legislative changes, working closely with subcommittees of the House Foreign Affairs Committee and with other committees that have authorizing and appropriating responsibilities for the foreign assistance program. It would also consult extensively with the executive branch. The Congressional-Executive consultations over the implementation of the Africa Development Fund offer the beginnings of a model of a more collaborative relationship.

6. The act would establish a new economic cooperation agency to administer U.S. economic cooperation programs

The most effective way to remove bureaucratic cobwebs and take up the new mandate is to create a new entity to allocate and administer economic assistance. The more precise and flexible mandate of the International Economic Cooperation Act requires an appropriate structure—an Economic Cooperation Agency (ECA), as the successor to A.I.D.

There is no one ideal structure that will resolve the numerous organizational and administrative issues. Various organizational models have been proposed. These should be discussed during committee deliberations and in extensive discussions with the executive branch.

There are, however, key requirements which should guide the design of a new structure:

(i) operational flexibility and decentralization of responsibility to encourage innovative, responsive programs that seek long term progress on development priorities.

(ii) authority and flexibility to allocate and implement assistance in order to maximize achievement of the four objectives of economic assistance.

(iii) credible and strategically focused evaluation systems to assess, analyze, and communicate progress toward the four objectives to the Agency and the Congress.

(iv) the need to attract talented personnel into the aid program, both as permanent staff and in short-term positions.

(v) greater opportunities for collaboration in working toward resolution of global problems. For example, technical institutes could be set up, each focusing on a major issue such as resource management, and comprising experts from relevant government and private entities in the U.S. and developing countries. They would deal with global issues, in tandem with the field missions' country-specific strategies. This would bring in the technical capability necessary to problem-solving, and encourage the cooperation and support of individuals and organizations outside the government. They would also support selected long-range research programs.

(vi) recognition of the important role of PVO's, universities, cooperatives, and other non-governmental organizations in the U.S. economic cooperative program. Officials responsible for economic assistance should have regular and easy access to the expertise and experience of such organizations, and be able to draw on their capabilities in implementing programs.

(vii) administration of a portion of the U.S. cooperation program through regional foundations such as the Inter-American Foundation and the African Development Foundation, which focus on grassroots community development.

The act will require greater coordination

Coordination is required at three levels:

(i) *International Coordination.*—U.S. assistance should be coordinated with programs of other international donors. This becomes increasingly important as the internationalization of development problems continues, and as other donors expand their assistance programs. The U.S. share of worldwide economic assistance is large enough to be important to efforts to coordinate international programs. U.S. development experience is a valuable asset for collaboration with newer donor countries, such as Japan and Korea.

(ii) *Policy Coordination.*—U.S. assistance should be coordinated with other aspects of U.S. policy. Given the increasing complexity and inter-relation of international problems, coordination of policies on aid, trade, Third World debt, drugs, the environment, international financial stability, and fiscal and monetary policy are essential. None of these issues can be dealt with in isolation.

The most commonly proposed solution is to locate responsibility for coordination in the White House. The various proposals include: a special Presidential Advisor with a small staff; a Deputy National Security Advisor; reestablishment of the Council on International Economic Policy; a Presidential advisor who chairs an International Development Cooperation Council with oversight over all agencies and programs involved in foreign economic cooperation.

Alternatively, coordination could occur at the cabinet level, through a cabinet committee, or by giving one cabinet department overall responsibility. Or, a new foreign economic cooperation administering agency could be given the role. Whatever the new structure, the Administrator of the ECA would be closely involved in coordination.

There have been many failed experiments at coordination. The important issue is not how, but that coordination occurs. Success will ultimately depend on the commitment of the Executive branch and the officials involved. The new coordination structure must be formulated jointly by Congress and the Administration, and mesh with the organizational structure of the new Administration and the ECA. The new legislation must identify a clear coordination authority which can be held accountable by the Congress and the President.

(iii) *Field Coordination.*—U.S. programs and policies should be coordinated at the field mission level. For example, coordination could be improved between A.I.D. private sector programs, the Foreign Commercial Service, the Trade and Development Program, and the Overseas Private Investment Corp and between A.I.D. agricultural programs, P.L. 480 assistance, and the work of the agricultural attache.

8. The act would require a simpler procurement regime for the economic assistance program

U.S. economic assistance programs are covered by federal acquisition regulations. These regulations are designed for agencies which operate in the United States, not overseas. Exemption for particular procurement is possible but only through a time-consuming paperwork process. The cumbersome procurement process discourages some individuals from participating in U.S. development assistance programs and makes it more difficult for A.I.D. to work jointly with other donors and institutions.

A simpler, more flexible system, designed for an agency which operates overseas, would enable a more timely response to existing needs and conditions, thereby increasing the effectiveness of the foreign assistance program.

9. The act would require modes of operation that maximize aid effectiveness in tackling today's problems

Key principles in increasing the effectiveness of the economic assistance program are:

(i) Focus on global problem-solving—dealing with problems common to many countries. It is in the primary interests of the United States to focus on easing problems which affect many nations, such as environmental degradation, AIDS, rapid urbanization, arid agricultural production, and barriers to market forces. Therefore, while much foreign assistance would continue to be carried out on a bilateral basis, the program would aim to deal with constraints to the achievement of key objectives. This approach rests on cooperation and reciprocity of benefits, rather than one-way transfers of aid.

(ii) Utilize U.S. comparative advantage. The impact of U.S. assistance is maximized by drawing on those areas in which

the United States has most to offer: education and training, research, public and private management expertise, technical assistance, agricultural development and food aid, and private enterprise.

(iii) Emphasize project sustainability. Too often development projects stop the day that foreign donor funding and participation end—or before. To maximize U.S. impact on development problems, the act would require A.I.D. to focus on program and project sustainability, particularly by seeking the broadest participation appropriate, in both design and implementation. To further encourage sustainable projects, the new organizational structure must provide the necessary degree of flexibility for projects to adapt to local conditions.

(iv) Use economic assistance, both development assistance and ESF, to promote sound economic policies. To ensure that U.S. assistance is used effectively to mutual benefit, the act would require that it be programmed to promote appropriate economic policies at all levels. Economic assistance should serve as a vehicle for joint policy dialogue, and as a means of improving the technical and administrative capacity of governments to devise and implement suitable policies.

In addition, the act would require that the ability and willingness of the recipient to use assistance efficiently be taken into account in deciding where and how funds should be programmed. Countries willing to adopt necessary policies should be supported. This requires the establishment of specific criteria to measure country performance, as under the Fund for Africa.

If U.S. assistance is used wastefully, siphoned off by corruption, or used to support bad and inefficient policies, it cannot achieve the purposes for which it was intended. This is more likely to hinder economic growth and to be economically and politically destabilizing, and therefore be antithetical to U.S. economic and political interests and objectives.

(v) Adapt the foreign assistance program to the debt situation. Success in pursuing the four objectives of U.S. economic assistance depends on the resolution of the debt crisis. The debt burden has stymied economic growth and brought considerable economic and social adjustment and suffering. Continued economic stagnation and adjustment threatens not just economic stability but also political stability, particularly in countries with nascent democratic institutions.

There is no single solution, but foreign assistance can contribute towards easing the problems caused by the debt burden. U.S. assistance should be provided on a grant basis, as has been the case in the last several years. In keeping with this policy, reflows from previous foreign assistance loans should be allowed to be redirected into development activities in the debtor country, rather than returned to the U.S. Treasury. Such use of reflows should be used to reward countries which implement necessary domestic policy reforms.

Authority should also be given for the use of U.S. economic assistance funds to purchase debt at discount, with the local

currencies then used for development projects which require local expenditures.

U.S. government officials should be encouraged to work with host country officials, other donors, international organizations, U.S. commercial banks, and with various non-governmental organizations that are seeking innovative mechanisms to reduce the debt burden of developing countries.

10. The act would authorize cooperative development relationships with advanced developing countries [ADCs]

Advanced developing countries, such as Morocco, Jordan, and Costa Rica, are approaching the point where they may no longer require concessional assistance. Others, such as Taiwan, Korea, Brazil, and Argentina have already "graduated" from the U.S. aid program. However, many have important development problems and their participation is important in solving global problems. For example, deforestation cannot be dealt with without the cooperation of Brazil; the U.S. cannot seek regional cooperation on drugs and immigration without working with Mexico. Continued cooperation with potential aid graduates, such as India and Thailand may lead to breakthroughs in health and agricultural science.

It does not serve U.S. interests to spend 20 to 30 years building up development relationships with a country, and then to suddenly drop them when concessional assistance is no longer required. This means cutting those links just when the other country is most able to contribute to the partnership, and when U.S. benefits from governmental, university, and private sector are increasing.

The Economic Cooperation Agency would be authorized to develop new ways to sustain and nurture those well-developed relationships. This could be done through bilateral commissions, science and technology foundations, or joint working groups focused on key development issues. The development of relations with ADCs is an important part of the shift that the United States must make from "foreign aid" to cooperation with developing countries.

B. MILITARY ASSISTANCE

1. Consolidate military assistance into one funding source

Consideration of military assistance will be more focused if the Foreign Military Sales (FMS) financing and the grant Military Assistance Program (MAP) share the same funding source. At present, cash arms sales and FMS financing are contained in the Arms Export Control Act (AECA). The grant MAP program comes under the Foreign Assistance Act.

There is no compelling operational or political need for two separate military assistance accounts, particularly as both are now almost completely grant programs. One funding source would allow clearer analysis of the aid request and the conditions attached to military aid for each country. Putting FMS with MAP would separate sales that use assistance dollars from cash arms sales. Under the merged account, terms, conditionality, and eligibility for credit and grant countries would be clearly established. Standards would be set based on economic conditions and ability to repay. The single

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account would better enable Congress to separate countries that need grants from those that only need credits.

2. Replace the Arms Export Control Act with a new Defense Trade and Export Control Act

A new Defense Trade and Export Control Act would complement the consolidation of assistance funding. Creation of a new act recognizes that cash arms sales which are consistent with foreign policy and national security objectives should be removed from the political linkages attached to military assistance and should be part of an overall export promotion and control effort. This approach would be more appropriate to expanding trade and defense cooperation activities with our NATO allies and other friendly nations. The new act would remove unnecessary restrictions and simplify the licensing procedures under the International Traffic in Arms Regulations, so as to reduce export delays.

This approach would not take the lid off arms sales. The act would retain all the appropriate arms export control aspects of the AECA, as well as requirements to give prior notification of arms sales to Congress. In addition to the current purpose of restraining arms races, the new act would focus on military objectives, including close cooperation with our allies in arms research, development and production. It would clarify U.S. policy for providing defense equipment to friendly countries consistent with national interests.

3. Clarify the goals of the Military Aid Program

The military assistance program should meet political and strategic objectives but it should also promote military goals, such as enhanced training and equipment utilization, pre-positioning of U.S. stocks for use in crises, and joint research and development of defense systems. Military assistance and sales are frequently oversold on political grounds. What is needed is judgments about how military assistance and sales programs fulfill *military* objectives.

Focusing program goals and Congressional oversight on narrower military objectives would help provide a basis for improved accountability on the uses of military assistance and sales programs cannot and should not be entirely eliminated, but Congressional oversight has often focused on unrealistic political linkages, particularly when the amount of assistance is small, or recipients are attempting to buy arms for cash. A return to traditional oversight of how money is being spent, and whether military objectives are being advanced would increase the effectiveness of the program.

4. Improve accountability for the use of military assistance

Past experience and current practices suggest that accountability needs to be improved dramatically. The Defense Department is unable to account for hundreds of millions of dollars in cash sales in its multiple service-based accounting systems. There is inadequate tracking of third-country transfers arising out of licensing and co-production agreements. Action is seldom taken even when illicit transfers are discovered. Corruption is endemic in dealing with agents and firms designated by Third World countries to transact arms sales.

Reform of the system should include:

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(i) Establishment of a genuinely centralized accounting system within DOD for military sales. Full accounting of all expenditures requires a system that accesses data from all three accounting systems in the military services and that serves as a authoritative data source for accounting and information on military sales.

(ii) Greater monitoring of military assistance and sales assets in foreign countries. In recent years, military advisory groups have increasingly focused on providing information on U.S. produced systems and promoting other military objectives, but program monitoring has suffered. In some instances this has resulted in illicit third-country tranfers of U.S.-supplied equipment.

(iii) Establishment of appropriate sanctions for illicit third-country transfers by recipients of military assistance and sales, and participants in weapons co-production agreements. The detection of such transfers requires improved controls, management, and intelligence. Effective sanctions are necessary to deal with violations, as diplomatic protests have often been ineffective. These sanctions should include suspension of coproduction agreements for other pending arms sales.

(iv) Prohibition of the use of military assistance funds for direct or indirect offsets, unless specifically authorized by Congress, and negotiation of bilateral or multilateral agreements concerning the range of permissible direct and indirect offsets involving military assistance and sales. Trade offsets, a problem for many years, are only likely to increase, given that they are a major reason for many countries' purchase of American made defense articles. While commercial offsets may in many instances be a fact of life, U.S. government funds should not be used to promote the business interests of one company over that of another.

(v) Tighter controls on the selection and use of private individuals and companies receiving military assistance funds designated for foreign governments. When foreign governments designate their own freight forwarders and purchasing agents for military assistance transactions, more stringent eligibility standards, and fiscal and accounting controls are necessary.

(vi) Requirements that American companies use Federal Acquisition Regulations (FAR) regarding price, profit, quality assurance, and payment, if their commercial arms sales involve FMS credits. Currently, commercial contracts financed with FMS credits are not governed by the FAR, as government to government FMS sales are, and controls over these sales need to be improved.

5. Reduce, if not eliminate earmarking

Currently, 98% of the FMS account and two thirds of MAP account are earmarked. The inflexibility created by earmarking hampers the program in several ways: first, it limits the ability to meet contingencies and to implement programs smoothly. Secondly, it undermines attempts to influence recipients through military assistance, as they are assured of the level of aid they will receive. Therefore, as a means for Congress to secure some political lever-

age, it is ultimately self-defeating. Thirdly, the inflexibility created by earmarks, along with general budget pressures, results in the expectations of smaller recipients being raised and then dashed, because their programs are squeezed out by the big earmarks. Removing earmarks would enable more effective Congressional oversight, because Congress could focus on program results rather than relying on earmarks and associated prohibitions, conditions and reporting requirements.

Limiting earmarking requires discussions among legislative and executive branch leadership, to establish an informal understanding that politically inevitable earmarks will go forward, in exchange for holding the line on other earmarks. Along the lines of the bipartisan budget agreement, Congress should meet early on with the new administration to reach a foreign policy leadership agreement to resist earmarking.

6. Replace small military aid programs in individual countries with an unearmarked regional contingency fund

Operational requirements in less vital countries could be met from a flexible regional contingency fund. This would create the flexibility necessary to fund specific needs in regions such as Africa or Latin America, while avoiding spreading funds and across many small countries. Small case-by-case requests could be met without establishing a country program. This would be far preferable to the present situation in which small programs are cut altogether due to earmarking for large recipients and overall budget cuts. A contingency fund would provide the Executive branch with flexibility to meet the needs of smaller countries, while still ensuring fiscal discipline through the authorization and appropriation of such contingency funds, and through prior notification to Congress of the use of such funds. The needs of smaller countries could be met without sacrificing fiscal and policy oversight by the Congress.

7. Establish a separate base rights account

A base rights line item in the military aid budget could fund existing commitment on a one-time multi-year basis, of say, five years while making it clear that such military assistance would end after that period. This type of agreement was established with Spain and appears to be satisfactory.

Congress has confronted growing shortfalls in military aid appropriations for base rights countries. A number of base rights agreements in the early 1980's resulted in a doubling and tripling of this aid.

After the five year funding period, the ending of assistance given specifically for base rights could be eased through other forms of non-appropriated assistance, such as revolving fund using cash sales receipts, the use of the Special Defense Acquistion Funds (SDAF), programs not linked to base rights could be continued.

The United States should also consider establishing a multilateral base rights fund with NATO for bases in Europe, and with Japan for bases in the Philippines. The relationship with NATO should be considered in the light of the larger alliance-wide regional security framework, with base rights access being a legitimate element of burden-sharing.

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A separate account with clear funding limits is an important step in the U.S. strategy for securing base rights access. The U.S. must, over time, develop defense relationships that are not based on economic or military assistance, or "rent", but on mutual security concerns.

8. Create a separate line item for police training

A separate line item for police training would enable the legislative and executive branches to establish appropriate objectives and guidelines for police training.

Separate funding would segregate military training for police forces from civilian training, leaving the latter to agencies other than DOD and State. Currently, the prohibition on the use of assistance for police training (Section 660 of the Foreign Assistance Act) is accompanied by numerous exceptions. Such an approach is misleading, and hinders effective legislative oversight as to what type of support for police training is appropriate and under what circumstances.

9. Encourage aid graduation

Military assistance concessional sales and credit programs should permit and encourage graduation to a fully cash sales relationship.

For this to occur, it is essential that a credit component remain in the authorization process, so that countries near the graduation point in economic development can make a gradual transition to cash arms sales. Portugal, Greece, and Turkey are currently approaching this point, and Spain and Korea recently graduated.

In addition, military assistance funds should be used for licensing and co-production agreements, including offshore procurement of low and medium technologies. This would enable recipients to establish a rudimentary defense industrial base, while protecting and controlling more sophisticated technology.

10. Examine alternative financing

The establishment of an alternative system for financing military assistance should be considered, although the evidence of the efficiency of such financing is mixed and the political obstacles are significant. As with the economic assistance program, the likelihood of shrinking funds requires creative uses of alternative financing to stretch available resources.

There are many possible alternatives that can be explored. For example, the prohibition in the Arms Export Control Act on the use of Ex-Im-Bank financing for military sales is outdated and does not appear to be serving any apparent "fiscal watchdog" function. In addition, the use of private credit markets has already begun. The Foreign Assistance appropriations law for fiscal year 1988 authorizes the blending of government and commercial credit to refinance past FMS credit. We should explore this option of blending credit for future FMS financing. Finally, some in the Executive branch have advocated a return to the use of government-guaranteed loans to finance military sales.

11. Coordinate military assistance with other foreign policy

Military assistance should be included within the new structure designed to coordinate foreign policies, mentioned under recommendations on economic assistance. At present, the military assistance program is not adequately coordinated with other aspects of U.S. policy towards recipient countries. U.S. embassies and military advisory groups do not coordinate. The Departments of Defense, State and A.I.D. do not formulate a comprehensive coordinated strategy that integrates economic and military assistance.

V. Reservations of Representative Benjamin A. Gilman

The Task Force Report contains a succinct—yet thorough—description of the range of foreign assistance programs. It also outlines many thoughtful findings and recommendations for legislative action. Many of the recommendations have a great deal of merit and I believe that Congress and the Administration should consider them carefully.

I must, however, identify some of the differences I have with the report. First, one of my major concerns in the security assistance area is the Chairman's recommendation that we establish a temporary base rights fund, but that this fund will be phased out over (5) five years. While I believe that it is important to remove ourselves from the current "rental relationship" with certain base rights countries, I also believe it is unrealistic to think that some of these countries will be able to do without military assistance in the foreseeable future. I am convinced that it is in our national interest to continue to target strategically important countries which have U.S. bases as priority security assistance recipients. I am not opposed to ending this "rental relationship" with base rights countries, as long as everyone recognizes that this does not mean that we will end military assistance to these strategically important countries as well.

Second, the report calls for the reduction if not elimination of all earmarking. In my view, there should be a limited number of exceptions to this proposal. I believe that earmarks in current law for Greece, Egypt and Israel must be maintained to make clear our unequivocal support for the security of those countries, as well as our continuing support for the Middle East peace process in the latter two countries. There should be consultation with the Administration at the highest levels regarding core earmarks which enjoy a consensus of support in the Congress and in the Executive Branch. Beyond this, I do agree that we should attempt to sharply curtail the number of erarmarks in the law.

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FY 1989 Foreign Assistance Appropriations Act

President of U.S.

(b) MAINTENANCE OF BALANCE.—Accordingly, the President shall ensure that, for each fiscal year, the ratio of—

(1) the value of excess defense articles made available for Turkey under this section, to

(2) the value of excess defense articles made available for Greece under this section, closely approximates the ratio of—

(A) the amount of military assistance and financing provided for Turkey, to

(B) the amount of military assistance and financing provided for Greece.

(c) EXCEPTION TO REQUIREMENT.—Subsection (b) shall not apply if either Greece or Turkey ceases to be eligible to receive excess defense articles.

DETENTION OF CHILDREN

SEC. 570. It is the sense of the Congress that the practice of detaining children without charge or trial is unjust, inhumane, and is an affront to civilized principles. The Congress further believes that it should be the policy of the United States to make the ending of the practice of detaining children without charge or trial a matter of the highest priority. Therefore, the Congress believes the Secretary of State should convey to all international organizations that ending the practice of detaining children without charge or trial should be a policy of the highest priority for those organizations.

MILITARY ASSISTANCE TO MOZAMBIQUE

SEC. 571. Notwithstanding any other provision of law, none of the funds appropriated or otherwise made available pursuant to this Act may be used to provide military assistance to Mozambique.

RELATIVELY LEAST DEVELOPED COUNTRIES

22 USC 2151 note.

SEC. 572. During fiscal years 1990 and 1991, the President may use the authority of paragraphs (A) and (B) of section 124(c)(1) of the Foreign Assistance Act of 1961 with respect to such aggregate amounts of principal and interest payable during each of these fiscal years as the President may determine, or at any time after September 30, 1989, the President may, if he determines it is in the national interest to do so, use the authority of those paragraphs with respect to such aggregate amounts of outstanding principal and interest payable at any time after that date as the President may determine. The authority provided in this section may be exercised with respect to any country described in the last sentence of this section and may be exercised notwithstanding section 124(c)(2) of that Act. In exercising the authority provided in this section, the President may waive the requirement that equivalent amounts of local currencies be deposited into local currency accounts in accordance with paragraph (A) of section 124(c)(1) of that Act, to the extent that the President determines that sufficient local currencies are otherwise available to achieve development objectives. This section applies with respect to any relatively least developed country, or any country in Sub-Saharan Africa (without regard to whether that country is a relatively least developed country within the meaning of section 124(a) of that Act), if—

(1) an International Monetary Fund standby agreement is in effect with respect to that country; or

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(2) a structural adjustment program of the International Bank for Reconstruction and Development or of the International Development Association is in effect with respect to that country; or

(3) a structural adjustment facility or enhanced structural adjustment facility with the International Monetary Fund is in effect with respect to that country.

HONDURAS—RAMIREZ CASE

SEC. 574. It is the sense of the Congress that, pursuant to the procedures contained in section (j) under the heading "Assistance for Central America" enacted in Public Law 100-71, the Honduran Government appears to have made a reasonable and good faith settlement offer based on a factual analysis by third parties, and the owner of the property in question is strongly encouraged to accept the proposed settlement. Therefore, notwithstanding the provisions of such section, $5,000,000 of the Economic Support Funds made available by Public Law 100-71 for Honduras but withheld from expenditure shall be available for expenditure upon enactment of this Act: *Provided*, That if a settlement is reached on the property in question, then the additional $15,000,000 withheld from expenditure pursuant to such section shall then be available for expenditure.

CONGRESSIONAL PRESENTATION FOR SECURITY ASSISTANCE PROGRAMS

SEC. 575. Unless the fully printed final version of the fiscal year 1990 Congressional Presentation for Security Assistance Programs is received by the Congress by March 1, 1989, $10,000,000 of the funds appropriated by this Act for the Military Assistance Program shall be returned immediately to the General Fund of the United States Treasury.

SOUTH AFRICA—SCHOLARSHIPS

SEC. 576. Of the funds made available by this Act under the heading "Economic Support Fund", not less than $10,000,000 shall be made available for scholarships for disadvantaged South Africans: *Provided*, That these funds shall be in addition to funds earmarked under such heading for Sub-Saharan Africa.

THIRD PARTY TRANSFER

SEC. 577. Section 3(d) of the Arms Export Control Act is amended— 22 USC 2753.

(1) in paragraph (2)(A), by striking out "law" and inserting in lieu thereof "joint resolution, as provided for in sections 36(b)(2) and 36(b)(3) of this Act"; and

(2) in paragraph (3), by adding at the end thereof "Such consent shall become effective then only if the Congress does not enact, within a 30-day period, a joint resolution, as provided for in sections 36(c)(2) and 36(c)(3) of this Act prohibiting the proposed transfer.".

NARCOTICS CONTROL PROGRAM

SEC. 578. (a)(1) Of the funds appropriated by this Act under the heading "Economic Support Fund" $61,000,000 shall be made avail-

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Section 564 also directs the Secretary of the Treasury to instruct the U.S. representatives to the MDB's to vote against any loan to Panama unless the President certifies to the conditions listed above. (Note, as well, that section 565 of the Act reallocates to other countries, the sugar quota applicable to Panamanian exports to the United States if the President is not able to make certain certifications regarding the restoration of freedom of the press and other constitutional guarantees.)

25. Sec. 566. Prohibition on Bilateral Assistance to Terrorist Countries. Section 568 prohibits the obligation or expenditure of funds for "bilateral assistance" for any country "listed in" section 6(j) of the Export Administration Act of 1979. In the event funds have been expended prior to October 1, 1988 for the delivery of assistance to such a country from the United States or by U.S. nationals, then no such delivery may be made. The section, by its terms, does not apply to assistance provided for humanitarian purposes.

Section 6(j) of the Export Administration Act of 1979 does not contain a list of countries which practice or condone terrorism. Instead, section 6(j), in part, authorizes the Secretary of State to make a determination (for purposes of approving certain export licenses) that a country has "repeatedly provided support for acts of international terrorism." To date, the Secretary has determined that Libya, Iran, South Yemen, Syria, North Korea, and Cuba have provided such support for acts of international terrorism.

Note, as well, that section 567 of the Act requires the Secretary of the Treasury to instruct the U.S. representatives to the MDB's to vote against any loans or other uses of funds to or for a country for which the Secretary of State has made a section 6(j) determination.

26. Sec. 572. Relatively Least Developed Countries. Section 572 provides authority to implement the retroactive terms adjustment provisions of FAA section 124.

- During FY 1990 and FY 1991 the authority of section 124 may be exercised by the President with regard to interest and principal payable in each of these years.

- At any time after September 30, 1989, if the President determines it is in the U.S. national interest, the authority of this section may be used regarding the aggregate amount of principal and interest payable at any time by an eligible country.

- The President may waive the requirement to deposit equivalent amounts of local currencies into accounts for use in development activities if he determines that sufficient local currencies are otherwise available for development purposes.

- This authority applies, notwithstanding section 124, to all countries in Sub-Saharan Africa and all RLDC's for which (1) an IMF standby agreement is in effect, (2) an IDA or IBRD structural adjustment program is in effect, or (3) an IMF structural adjustment facility or enhanced structural adjustment facility is in effect.

The Statement of Managers further explains this provision:

"At any time after September 30, 1989, if certain conditions are met, section 572 would permit the President to allow relatively least developed countries and countries in sub-Saharan Africa to repay in local currencies the aggregate of outstanding principal and interest owed on loans made under chapter 1 of Part I and chapter 4 of Part II of the Foreign Assistance Act of Part II of the Foreign Assistance Act of 1961 or any predecessor legislation. This authority may be used in any fiscal year beginning with fiscal year 1990 for loan arrearages or payments owed in such fiscal year, or for any payments that may be owed in future fiscal years. The provision also permits the President to forgo the repayment of aggregate outstanding principal and interest entirely in some cases. The committees expect to be kept informed regarding plans to implement this provision."

27. Sec. 574. Ramirez. As noted earlier, the Act allows the release of $5 million of the $20 million of ESF withheld from disbursement for Honduras as a result of the Ramirez case.

28. Sec. 583. Assistance for Poland. Section 583 permits the use of up to $500,000 of non-convertible and convertible Polish currencies for the reconstruction, renovation, and maintenance of the Research Center on Jewish History and Culture of the Jagiellonian University of Krakow, Poland.

29. Sec. 584. Competitive Insurance. Section 584 requires all A.I.D. direct contracts and solicitations (and subcontracts entered into under those contracts) to include a clause requiring U.S. marine insurance companies have a fair opportunity to bid for marine insurance when such insurance is necessary or appropriate.

Foreign Assistance Act of 1961 (FAA)

this part may, on a case-by-case basis, waive the restriction established by this subsection, after taking into account the effectiveness of the overseas development activities of the organization, its level of volunteer support, its financial viability and stability, and the degree of its dependence for its financial support on the agency primarily responsible for administering this part.

(h)[85] The Congress recognizes that, in addition to their role in social and economic development, cooperatives provide an opportunity for people to participate directly in democratic decisionmaking. Therefore, assistance under this chapter shall be provided to rural and urban cooperatives which offer large numbers of low- and middle-income people in developing countries an opportunity to participate directly in democratic decisionmaking. Such assistance shall be designed to encourage the adoption of self-help, private sector cooperative techniques and practices which have been successful in the United States.

Sec. 124.[86] Relatively Least Developed Countries.—(a) Relatively least developed countries (as determined on the basis of criteria comparable to those used for the United Nations General Assembly list of "least developed countries") are characterized by extreme poverty, very limited infrastructure, and limited administrative capacity to implement basic human needs growth strategies. In such countries special measures may be necessary to insure the full effectiveness of assistance furnished under this part.

(b) For the purpose of promoting economic growth in these countries, the President is authorized and encouraged to make assistance under this chapter available on a grant basis to the maximum extent that is consistent with the attainment of United States development objectives.

(c)[87] (1) The Congress recognizes that the relatively least developed countries have virtually no access to private international capital markets. Insofar as possible, prior assistance terms should be consistent with present grant assistance terms for relatively least developed countries. Therefore, notwithstanding section 620(r) of this Act and section 321 of the International Development and Food Assistance Act of 1975 but subject to paragraph (2) of this subsection, the President on a case-by-case basis, taking into account the needs of the country for financial resources and the commitment of the country to the development objectives set forth in sections 101 and 102— *

Presidential waiver authority

(A) may permit a relatively least developed country to place amounts, which would otherwise be paid to the United States as payments on principal or interest on liability incurred by that country under this part (or any predecessor legislation) into local currency accounts (in equivalent amounts of local currencies as determined by the official exchange rate for United States dollars) for use by the relatively least developed country, with the concurrence of the Administrator of the

[85] 22 U.S.C. 2151v. Sec. 124 was added by sec. 112(a)(1) of the International Development and Food Assistance Act of 1978 (Public Law 95-424; 92 Stat. 948).

[87] Sec. 112(a)(2) of the International Development and Food Assistance Act of 1978 (92 Stat. 949) stated that the authority granted by subsec. (c) shall not become effective until Oct. 1, 1979.

agency primarily responsible for administering this part, for activities which are consistent with section 102; and

(B) may waive interest payments on liability incurred by a relatively least developed country under this part (or any predecessor legislation) if the President determines that that country would be unable to use for development purposes the equivalent amounts of local currencies which could be made available under subparagraph (A).

requires appropriation

(2) The aggregate amount of interest waived and interest and principal paid into local currency accounts under this subsection in any fiscal year may not exceed the amount approved for such purpose in an Act appropriating funds to carry out this chapter for that fiscal year, which amount may not exceed the amount authorized to be so approved by the annual authorizing legislation for development assistance programs. Amounts due and payable during fiscal year 1981 to the United States from relatively least developed countries on loans made under this part (or any predecessor legislation) are authorized to be approved for use, in accordance with the provisions of paragraph (1) of this subsection, in an amount not to exceed $10,845,000.[88]

(3) In exercising the authority granted by this subsection, the President should act in concert with other creditor countries.

(d) The President may on a case-by-case basis waive the requirement of section 110(a) for financial or "in kind" contributions in the case of programs, projects, or activities in relatively least developed countries.

(e) Section 110(b) shall not apply with respect to grants to relatively least developed countries.

Sec. 125.[89] Project and Program Evaluation.—(a) The Administrator of the agency primarily responsible for administering this part is directed to improve the assessment and evaluation of the programs and projects carried out by that agency under this chapter. The Administrator shall consult with the appropriate committees of the Congress in establishing standards for such evaluations.

(b)[90] * * * [Repealed—1981]

Sec. 126.[91] Development and Illicit Narcotics Production.—(a) The Congress recognizes that illicit narcotics cultivation is related to overall development problems and that the vast majority of all individuals employed in the cultivation of illicit narcotics reside in the developing countries and are among the poorest of the poor in these countries and that therefore the ultimate success of any effort to eliminate illicit narcotics production depends upon the

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[88] This sentence was added by sec. 109 of the International Development Cooperation Act of 1979 (Public Law 96-53; 93 Stat. 363). The authorization figure for fiscal year 1981 was substituted in lieu of the fiscal year 1980 authorization ($12,000,000) by sec. 303 of the International Security and Development Cooperation Act of 1980 (Public Law 96-533; 94 Stat. 3147).

[89] 22 U.S.C. 2151w. Sec. 125 was added by sec. 113 of the International Development and Food Assistance Act of 1978 (Public Law 95-424; 92 Stat. 960). The responsibility of the Administrator mentioned in this section was transferred to the Director of IDCA, pursuant to sec. 6 of Reorganization Plan No. 2 of 1979 (establishing IDCA).

[90] Subsec. (b), which required the President to report to Congress on improvements to the evaluation of projects and programs conducted by the international financial institutions and the United Nations Development Program, was repealed by sec. 724(a)(1) of the International Security and Development Cooperation Act of 1981 (Public Law 97-113; 95 Stat. 1560). Such report was submitted on Mar. 26, 1979.

[91] 22 U.S.C. 2151x. Sec. 126 was added by sec. 110 of the International Development Cooperation Act of 1979 (Public Law 96-53; 93 Stat. 363).

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