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RESOLVING THE GLOBAL DEBT CRISIS



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## RESOLVING THE GLOBAL DEBT CRISIS

### INTRODUCTION.

The external debt of developing countries amounted to over US\$900 billion at the end of 1985, up from US\$812 billion in 1984. This represents 163% of exports of goods and services from these countries and 38.1% of their GDP debt service payments amounted to US\$122.6 billion in 1984, with interest payments accounting for US\$75 billion. This is not surprising, since nearly 56% of the debt is owed to private creditors, most of it owed to transnational commercial banks. In 1985, the debt service ratio was roughly 25% up from 21.1% in 1984, when there were 34 debt rescheduling arrangements. The seven major debtors, i.e., Argentina, Brazil, Indonesia, Korea, Mexico, the Philippines and Venezuela owed US\$640 billion in 1984, which represented 187% of exports and 44.3% of GDP. The debt service ratio was 29.2% and involved US\$100 billion in debt repayment, with interest payments accounting for over 65%. Low income countries (excluding China and India) owed US\$62.8 billion in 1984, which was 300% of exports and 50% of GDP. The transnational commercial banks, especially U.S. banks, are dangerously exposed to developing countries. Claims on developing countries as a percentage of capital in March 1984, was 164% for all U.S. banks and 263% for the nine (9) largest banks. Indeed, loans to Brazil and Mexico are 90% of the capital of the nine (9) largest U.S. banks. Exposure for the four (4) largest banks in Britain is similarly high. While exposure has been reduced by a cut in lending and increased capital, it is still very high.

The external debt of developing countries and the associated debt servicing now constitute a barrier to economic growth in these countries, a significant constraint on world trade and a serious threat to the viability of the international banking system. This situation encompasses all countries and pervades all sectors and aspects of the world economy. It is potentially disruptive to the world economy, and its growing dimensions means that the present situation is most accurately described as «the debt crisis». The world 'crisis' is defined as a condition which threatens the collapse of or a drastic adverse change in the operation of a system. A crisis must be resolved if the system is to continue functioning either as it did in the past, or in a new way. Whatever scenario develops, will be disruptive on a massive scale. The two extreme possibilities are, as Fidel Castro has argued, «the debt is unpayable and uncollectable», and, second, if the debt is repaid, it will exact costs from both debtors and creditors in a global deflationary spiral. The size of trade surpluses

required if debtors are to pay, would cripple their development and severely cut growth in the developed countries. In 1981-82, U.S. exports to Mexico fell by over US\$10 billion, which is estimated to have resulted in the loss of a quarter million jobs. The economic fate of debtors and creditors and developed and developing countries, are inextricably linked to the resolution of the debt crisis. Left to itself, the international financial system cannot resolve the debt crisis since the natural response of individual banks is to reduce their exposure to debtor countries, but collectively this reduces funds to debtors, and makes their payment difficulties worse. Many debtor countries have made heroic adjustments, e.g., the value of imports in Latin America was reduced by 42% between 1981 and 1984. During this period, imports were reduced by 24% in Brazil, 40% in Venezuela, 43% in Argentina and by 55% in Mexico. Import compression of this magnitude permitted current account surpluses in Mexico, Brazil and Venezuela, but it still was not sufficient to cover debt payments. Many debtors have reached the social and political limits of deflation and further efforts to increase exports are hampered by declining commodity prices and protectionism in the industrialized countries, while further import compression threatens their economic viability.

This paper reviews the emergence, dimensions and main features of the debt crisis of developing countries and discusses proposals for a solution. The discussion is presented in three parts. Part I provides an overview of the emergence of the debt problem of developing countries, and how it escalated into the international debt crisis. Part II examines proposals for resolving the debt crisis, and in Part III, a new proposal is suggested.

## PART I

The years 1973 to 1981, were the period in which the debt problem of developing countries emerged. Since then, the situation has intensified to become a debt crisis, signalled by Mexico's default in August, 1982. The escalation of the debt problem into the debt crisis is evident in the number of rescheduling arrangements and the number of countries involved. The number of reschedulings increased from an average of five (5) per annum during 1975-1980, to 13 in 1981, and to 31, involving 21 countries, in 1983 and to 34 in 1984.

### THE EMERGENCE OF THE DEBT PROBLEM.

The non-oil developing countries borrowed heavily during the decade following the increase in oil prices in 1973. The total external debt of non-oil developing countries increased from US\$96.8 billion in 1973 to US\$560 billion in 1981. Outstanding debt to private financial institutions

grew from US\$14 billion in 1973 to US\$154.7 billion in 1981. The share of external debt owed to private financial institutions increased from 14.5% in 1973, to 27.6% in 1981. By 1982, outstanding external debt as a ratio of GDP was 27.1% and as a ratio of exports of goods and services was 122.5% compared to 16.6% and 88.7% respectively in 1973. Debt servicing rose from US\$15.3 billion in 1973 to US\$97.2 billion in 1981, while the debt service ratio stood at 21.3% in 1981.

The most important feature of the increase in the debt of developing countries is that over one-half of the debt is owed to transnational commercial banks. The rapid growth in loans from transnational banks to developing countries after 1973, occurred because of the coincidence of a number of factors. On the supply side, there were two main factors. (1) The capacity of transnational banks to lend to developing countries increased significantly after 1973, because loan demand in the developed capitalist countries had not grown sufficiently due to the recession which commenced during 1971, and the recycling of the OPEC surplus. (2) This was concomitant with a phase of rapid expansion of transnational banking led by US banks, and joined by European, Canadian and Japanese banks. Lending to developing countries, was spurred by the fierce competition between banks and their drive for profits and asset growth. The intense competition caused banks to abandon their conservative tenets of banking in 1973-74, and they assumed an aggressive attitude, offering loans to countries at attractive terms. The lending was supply led as export earnings of oil exporting countries leapt from US\$39.0 billion in 1973, to US\$117.9 billion in 1974, which, even after increased imports, increased their current account surplus from US\$6.7 billion to US\$68.3 billion.

Transnational bank lending to developing countries was profitable, absolutely and relative to national operations. Loans to developing countries, were made at rates of interest above those to industrial countries, e.g., the average yield on syndicated loans to developing countries averaged about one percentage point higher than the U.S. prime rate during 1973-78. The fees charged, varied from 0.25% up to 2.5%. Foreign operations of U.S. transnational banks became very profitable in the 1970's and accounted for an increased share of total profits. A study of 13 large U.S. bank holding companies, revealed that between 1970 and 1976, their foreign earnings increased by about US\$700 million, while domestic earnings rose by less than US\$40 million. Therefore, 95% of the increase in total earnings originated from international operations. By 1975, foreign earnings averaged 52% of total earnings. The profitability of foreign operations declined between 1976 and 1979, reducing their shares of total earnings to 43% in 1979.

On the demand side, the principal factors were (1) the ever increasing balance of payments deficit of developing countries after 1973. A combination of deteriorating terms of trade, fluctuating primary product prices, inflation in import prices especially oil prices, stagnating capital

flows and slow growth in export demand led to a sharp increase in balance of payments deficits. Current account deficits of the non-oil developing countries grew from US\$11.6 billion in 1973 to US\$46.5 billion in 1976 to US\$99.0 billion in 1981. This represents an increase of eight times in an 8-year period. (2) At the same time, the IMF did not have enough funds to provide adequate financing for the deficits of developing countries as total Fund quotas fell from about 12 per cent of world imports in the early 1960's, to around 4 per cent at the end of 1980 — despite the increase of the Fund's Capital under the Seventh General Review of Quotas in November, 1980. Total outstanding use of IMF credit by non-oil developing countries amounted to only US\$14.9 billion in 1981. The conditionality stipulated by the IMF for use of its higher credit tranches discouraged borrowing. Deficit countries refused to make use of their quotas or made use of them too late, preferring the private banks instead.

The non-oil developing countries faced the choice of draconian reductions in economic growth and standards of living, with the probability of serious social and political upheaval or financing balance of payments deficits by borrowing from transnational banks, through the Eurodollar market. During the period 1971 to 1980, syndicated bank credits to developing countries amounted to US\$184.4 billion or 48.2% of all credits. These Eurodollar loans were used both for financing balance of payments deficits and fiscal deficits on the assumption that the recession in the world economy was temporary.

There was also considerable borrowing from commercial banks by oil exporting countries, e.g., Mexico, Venezuela, Nigeria and by the so-called « newly industrialized countries », e.g., Korea and Brazil. Paradoxically, the increase in the price of oil encouraged debt accumulation in both oil exporting and oil importing countries. The former countries were favoured by transnational banks and they borrowed on the assumption that despite the world recession, their export prospects were good and that they would be able to roll over their debts with new borrowings.

While there was some unregulated and reckless lending and some optimistic borrowing, associated with postponing adjustment and fiscal expansion, the fact is that the international banking system fulfilled a necessary function. The banks recycled the surplus of oil exporting countries to finance the deficit of oil importing developing countries. The banks played the role which an adequately funded IMF and multilateral development agencies should have but did not undertake. Bank lending allowed « debt led growth » in the developing countries, who were able to grow at 5.1% per annum, during 1973-1981, compared to 5.8% in 1967-1972. By contrast, economic growth in industrialized countries fell from 4.4% in 1967-72 to 2.8% in 1973-81. The changing circumstances after 1981 have terminated the role of bank lending and the collapse of oil prices and the associated surpluses, yet the IMF and multilateral

development agencies have not yet assumed their obvious responsibilities. The failure is the direct consequence of the self-centredness and myopia of governments in the developed countries. While monetarism and petty nationalism in the developed countries are partly to blame, the seeds of the crisis lie in the defects and inadequacies of the institutions charged with monitoring and regulating the world economy, namely, the IMF, the World Bank and the G.A.T.T. These institutions are yet to address the fundamental issue of how to co-ordinate national economic policies to immunize the world economy from implosion when there are structural payments deficits and surplus countries which refuse to adjust and deficit countries which pursue «beggar the neighbour» policies such as protectionism and competitive devaluation. This is what happened in the 1930's: let us hope we are not doomed to repeat it in the 1980's.

#### DEVELOPMENT OF THE DEBT CRISIS.

Since 1981, the debt problem has become a debt crisis. By 1984, there were 34 rescheduling arrangements and now several developing countries are in default. Almost 50% of developing countries' debt to transnational banks was rescheduled in 1981-83. During 1975-1980, the value of official debt rescheduled at the Paris Club was US\$9.6 billion and that of bank rescheduling was US\$7.2 billion. During 1982 - mid-1985, these amounted to US\$17.2 billion and over US\$150 billion, respectively. The arrears owed to the IMF, were SDR 5-6 billion in 1977-1981, but had risen to SDR 26 billion by the end of 1983. Several countries have had to restructure their debt almost annually including Brazil (1983, 1984, 1986, 1987) and Mexico (1983, 1985, 1986, 1987), two of the largest debtors, each owing over US\$100 billion.

The debt crisis has been brought about, primarily, by two factors, an unfavourable international economic environment and policies in developed countries. The current account position of developing countries changed from a surplus of US\$22.6 billion in 1980, to a deficit of - US\$56.4 billion in 1981 and deteriorated even further in 1982, to reach - US\$99.4 billion. The deficit was - US\$68.2 billion, - US\$45.7 billion and - US\$47.7 billion in 1983, 1984 and 1985 respectively. The value of exports of developing countries increased up to 1980, but declined in 1981, 1982 and 1983 by 1.0%, 12.4% and 5.1%. It increased by 7.0% in 1984, but fell by 3.3% in 1985, so that exports in that year were US\$90 billion less than in 1980. The terms of trade have deteriorated during the period despite improvements of 1.2% in 1981 and 1984. There were declines of 1.2%, 3.9% and 2.2% in 1982, 1983 and 1985. Non-oil commodity prices declined by 15.2% in 1981, by 12.3% in 1982 and by 12.2% in 1985. The sudden decline in commodity prices have inflicted major losses, e.g., *The Economist* has estimated that developing countries lost US\$65 billion in

1985. The reduction was even more dramatic for some commodities, e.g., the price of sugar fell from 28.7 US-cents in 1980 to 8.4 US-cents in 1982. The recession in the industrialized countries has reduced developing countries' exports, e.g., the value of exports of agricultural commodities by developing countries decreased by 3% to 5% in 1981, and by a further 11% in 1982. The value of mineral exports fell by 11.5% in 1981 and by another 10.5% in 1982.

The policies pursued by developed countries have aggravated an already bad situation. High interest rates, protectionism and reduced aid, have all had a debilitating impact on developing countries. Aid levels have declined in real terms and have even, in some instances, been reduced in nominal terms. In 1980, roughly 48% of world trade was affected by protectionism compared to 40% in 1970. Protectionism on manufactured goods has risen from 13% to 24% in the same period. The proportion of imports subject to non-tariff barriers more than doubled in the United States between 1980 and 1983 and increased by 38% in the E.E.C. By 1983, about 29% of agricultural exports of developing countries to developed countries was affected by non-tariff barriers. The figure for manufactured goods was 18%. For developing countries protectionist barriers in industrialized countries caused a loss of US\$7.4 billion for sugar exports in 1983, and US\$45.1 billion per annum for beef/veal exports during 1979-81. In the last few years, developing countries have had to face high and fluctuating interest rates on their commercial debts, i.e., 12% in 1978, 17.5% in 1981 and 13% in 1983. This had a profoundly destabilizing effect, e.g., interest payments as a percentage of exports in 1985 were 46% in Chile, 38% in Bolivia and 52% in Argentina and about 40% in Mexico and Brazil.

The IMF estimates that direct investment in these years dropped by 52%. Bilateral aid to developing countries was reduced from US\$29.7 billion in 1980 to US\$26 billion in 1984, by the developed countries. Borrowing from private institutions, the greater part of which was from banks, collapsed from US\$78 billion in 1981 to a mere US\$10 billion in 1985. Following Mexico's default in August, 1982, transnational commercial banks considerably reduced lending to developing countries, most of which was «involuntary lending». The IMF has made their lending conditional on the bank's rescheduling and providing new loans, e.g., in the case of Mexico, banks had to provide new loans amounting to the equivalent of 7% of loans outstanding. Even this target was difficult to attain because of the 1,400 banks which lent money to Mexico before 1982, only 562 banks extended new loans in 1982 and 1983. Of the US\$30 billion of new loans from banks in 1983-84, only US\$7 billion was outside of rescheduling agreements. Reduced lending combined with higher interest payments resulted in a net transfer of US\$83.6 billion from the 15 developing countries included in the Baker Plan to banks between the end of 1981 and June, 1985. The capital accounts of many

countries, especially in Latin America, was aggravated by massive capital flights. In the case of Venezuela, between 1979 and 1982, capital flight as a percentage of gross capital inflows was 137%. During 1980-1981, Latin America and the Caribbean received a net transfer of financial resources totalling US\$11 billion, but between 1982-1985, there was a net loss of financial resources of US\$106 billion.

The worsening in the recession in the world economy, higher interest rates, reduced export demand and deteriorating terms of trade were the principal causes of the adverse balance of payments development in developing countries. In fact, the impact of external shocks in the period 1981-82, was larger than the years 1974-75, following the first period of increased oil prices and in 1977-80, following the second round of increases in oil prices. An example is Jamaica where the impact of external shocks on the balance of payments as a percent of GNP was 9.6% in 1974-75, 13.3% in 1979-80 and 29.4% in 1981-82. For Chile, the figures were 4.7%, 1.2% and 13.3% and for Korea, they were 9.5%, 8.1% and 21.7% respectively.

## PART II

Repayment on the existing schedules is beyond the capacity of developing countries and almost all the rescheduling agreements concluded since 1982 have collapsed. Enders and Mattione have calculated that in terms of national income the largest Latin American debtors would be better off in 1987, if they had defaulted in 1982, rather than serviced their debt. The authors assumed two scenarios (a) default causes a 5% loss in exports and 5% increase in the price of imports; and (b) a 10% fall in exports and a 10% increase in the cost of imports. In either scenario, Argentina, Brazil and Venezuela would have had higher national income throughout the period 1983-87. Mexico gains in the 5% scenario but loses in the 10% scenario. The deflation and export expansion necessary to produce current account surpluses required to service the debt are not possible especially in an environment of protectionism, reduced capital inflows and capital flight. It is estimated that the negative net transfer of financial resources from Latin America averaged US\$25 billion per annum during 1982-85 - the equivalent of 25% of exports.

If the debt crisis is not resolved, then the simultaneous and cumulative default of developing countries would plunge the world economy into another Great Depression. Default on developing country debt would immediately shake the foundations of the international banking system. Banks would have to cut lending and call in loans by a multiple of the amount of the defaulted loans in order to re-establish the legally required capital to loans ration. Cline has estimated that the nine (9) largest U.S. banks would have to cut outstanding loans by US\$160 billion as a result of a loss of US\$8 billion of their capital which would occur if Argentina,

Brazil and Mexico missed one year's debt repayment. This would necessitate calling in loans, thus contracting output, employment and demand including imports. The Federal Reserve would have to inject capital into these banks. In the case of European and Japanese banks, their U.S. \$ deposits far exceed the U.S. \$ reserves of their central banks. The effect of all this would be to reduce imports from and loans to debtor countries. This in turn would result in reduced imports by debtors from creditors. The impact can be gleaned from recent US-Latin American trade. When Latin America debtors cut imports, there was a 48% decline in U.S. exports to the five major debtors in 1981-83. This was an important factor in the growth of the U.S. trade deficit in those years. If the U.S. had retaliated, it would have reduced the main export market for Latin America. In 1982-84, Latin America's exports rose by US\$11 billion, of which 87% went to the U.S.A.

Repayment on presently existing terms is not a realistic possibility and default is widespread and will probably become more attractive to debtors. Since this outcome will disrupt the world economy, the debt crisis must be resolved.

#### PROPOSALS.

Numerous proposals have been put forward to handle the debt crisis of developing countries. These proposals fall into three categories: (a) unilateral; (b) bilateral; and (c) multilateral.

#### I. UNILATERAL.

##### (1) *Default/Repudiation.*

Default or repudiation may be undertaken by an individual country or it may be collective. There are ten retaliatory measures which lenders may resort to in the event of a deliberate default or a debt repudiation. Most of these sanctions can be applied directly by the lending institution, while those requiring governmental action or authorization can be engineered by political pressure. e.g., transnational commercial banks are influential in the foreign economic policy of the United States. Punitive measures include the following: (a) Termination of Lending, (b) Acceleration, (c) Default Interest, (d) Legal Action, (e) Withdrawal of Export Insurance, (f) Termination of Aid, (g) Import Ban, (h) Termination of Trade Credit, (i) Seizure of Foreign Assets, and (j) Economic Embargo.

There is an increasing fear that default or repudiation could have a domino effect which would cause panic among the shareholders and depositors of the transnational banks. The banks are therefore likely to resort to strong retaliatory measures.

(2) *Limiting Debt Service.*

Debtor countries who are unable to secure new balance of payments financing, rescheduling or find the terms of either unreasonable, may actually be better off by limiting debt payments. The basis for arriving at a limit, would be an assessment of ability to pay. In July, 1985, President Alan Garcia of Peru limited service payments on the US\$14 billion debt to 10% of the forthcoming year's export earnings. Since then, Peru has been unable to reach an accommodation with the IMF and recently, expelled the Fund representative. Payments to the World Bank and other aid agencies have been paid as well as some of the arrears to the IMF, but no payments on medium and long term commercial bank debt. Even so, this has in fact required, it is estimated, at least 30% of export earnings. Where a country has been able to hold out, it has secured better rescheduling terms, e.g., Nicaragua got the best terms of rescheduling of any country up to that time and without having an IMF agreement.

(3) *Cancellation.*

The cancellation of inter-governmental debt of the poorest countries has frequently been advocated but has been implemented by few creditor countries including Britain, the Netherlands, Sweden, Switzerland, Canada and the Federal Republic of Germany. These developed countries have converted loans into grants by « retroactive terms adjustment » but there is no consensus on standardized procedures and the eligibility to be classified as « least developed ». The cancellation of loans is not unprecedented, e.g., 11.2 million pounds owed to the British Treasury by the colonies was written-off in 1940.

Proposals to write-off the « Bad Debt » of commercial banks are unlikely to be accepted by the creditors since they correctly refuse to accept the analogy of bankrupt firms and bankrupt countries. Firms do go bankrupt and therefore their debt cannot be recovered but countries cannot go bankrupt, so that their debts can be recovered however long it may take.

## II. BILATERAL.

(1) *Rescheduling.*

Until 1982, rescheduling arrangements have averted a major crisis in the international banking system. However, nearly all the countries which rescheduled since 1982, have been forced to default. The reasons have been the stagnation of the world economy and the terms have not realistically reflected the development needs and servicing capabilities of

debtors but the financial objectives of the banks. To be successful, these arrangements would have to include a « Bisque clause » which allows the debtor to adjust repayment according to changing ability to pay and cash flow position.

### III. MULTILATERAL.

#### (1) *Rolling Over the Debt.*

At the 1985 Fund-Bank annual meeting in Seoul, the U.S. Treasury Secretary Baker, proposed a global rolling-over of developing countries' debts. More specifically it would involve, first, an additional US\$20 billion to be provided by the commercial banks over three (3) years to the biggest debtors. Second, an increase of US\$3 billion in lending by the World Bank and the Inter-American Development Bank. Third, the IMF is to disburse US\$2.7 billion from its Trust Fund to countries with a per capita income of less than US\$550. This is to be supplemented by funds from the World Bank, and the industrialized countries to create a pool of US\$5-6 billion. This involves the capitalization of debt repayments by co-financing between IMF and World Bank and the commercial banks. The proposal is too little, too late and for too few. The sum proposed is insignificant compared to the IMF's estimate of debt servicing of at least US\$139 billion in 1986. It only provides relief for the 15 largest debtors, which are not necessarily the 15 neediest debtors. What about the other 130 developing countries? The programme aims to help the commercial banks by lending to the largest debtors, i.e., those whose default would pose a serious problem for the banks. While the banks have vociferously proclaimed their support they show no indications of coming up with their share of the package.

#### (2) *Pegging Debt Service to Export Earnings.*

There are three alternatives, (a) Debt service should be restricted to a maximum percentage of export earnings. Variations specify whether principal, interest or both should be included and the figures range from 15% to 30% of exports. This is a feasible proposal which would provide relief and stability, but some questions have been raised about the difficulties of calculating the ability to pay but this could be resolved by negotiation. (b) Determine in absolute terms the minimum amount of foreign exchange earnings to be retained by the country to ensure growth, with balance being available for debt servicing. This would, in effect share the risks of export instability between lender and borrower. (c) Debt repayment may be linked to export prices by the issue of « commodity bonds » whose returns i.e., redemption value or interest or both, vary

with the price of a commodity or a basket of commodities. There have been a few issues, notably by Mexico and the Philippines, with returns linked to the prices of energy commodities, namely oil and coal, and precious metals, i.e., gold and silver. The floating of these bonds is limited by the absence of a secondary market and the volatility in commodity prices.

(3) *Capping Interest Rates.*

A maximum rate of interest would be determined and the difference between this ceiling and the market interest rate would be (a) converted into principal; or (b) capitalized as lower interest bonds; or (c) funded by a new IMF compensatory financing facility. Capping protects the borrower's cash flow from the escalation in interest rates but increases debt and therefore does not really provide much relief. Lowered interest rates would not induce new lending, furthermore, it would reduce profits, slowing the growth of bank capital and reducing the expansion of lending.

(4) *Interest Subsidy.*

Loans to subsidize interest payments above a certain level with funding from governments in the O.E.C.D. countries or through a new IMF facility or an expansion of the Compensatory Financing Facility funded by a new issue of SDR's. This approach is seen by the O.E.C.D. group as too expensive for them.

(5) *Debt into Equity.*

The suggestion that the governments in developing countries should exchange equity in nationally owned companies for debt, has been made in the O.E.C.D. countries. This is an anathema to some governments of developing countries who view it as replacing debt peonage with a denationalization of the economies. Furthermore, the potential is limited by the size of the debt in relation to investment opportunities, absorptive capacity and the amount of existing securities; this proposal might be viewed with favour by private companies with foreign debt, the problem remains whether the banks would accept or would be allowed to accept shares for loans and whether they would view equity as less risky than debt. Perhaps the banks would be more favourably disposed if there was some guarantee, e.g., from the World Bank's proposed Multilateral Investment Guarantee Agency. Since 1980, Turkey, Mexico, Argentina, the Philippines, Brazil and Chile have instituted schemes which permit both direct conversion of debt into equity and sale of foreign debt for local currency which can then be used for investment.

(6) *Insurance.*

This proposal exists in a variety of forms. The IMF, World Bank or a new multilateral institution would:

(a) Insure existing commercial bank loans hopefully restoring the confidence of the banks thus prompting new lending to developing countries and rescheduling on more lenient terms.

(b) Insure the asset portfolio of commercial banks. This may help the banks but does not ensure any debt relief or new loans.

(c) Insure new loans by banks to developing countries if they pass the scrutiny of some designated official institution, e.g., IMF, World Bank. Hopefully it would induce new bank lending.

(d) Former Managing Director of the IMF, Witteveen, has called for political risk insurance for bank loans, provided that debts comply with a Fund programme. This would have no impact on the level of indebtedness but would help the banks and may also be duplicating privately provided political risk insurance.

(e) Insurance of rescheduling agreements, for instance, one specific proposal is to make rescheduling arrangements for 13 years with the IMF and if, after 10 years, countries could still not pay despite adherence to IMF programmes, then payments in the final three (3) years would be guaranteed by the IMF. The problem is that it is extremely unlikely that developing countries who find it difficult to implement 1-3 year Fund programme could maintain a ten year programme.

(7) *Global Debt Restructuring.*

This proposal has a number of variations common to which are the establishment of a new international institution, long term rescheduling and changing commercial bank loans to loans or securities from a new multilateral institution. The variations include:

(a) A new international agency or facility, preferably under the aegis of the IMF and/or World Bank, to acquire the debt of developing countries in return for low interest bonds. Modelled on the operation of the Municipal Assistance Corporation in the New York City rescue, the objectives would be maturities of 20-30 years, interest rates of 6-8% and debt service ratio of 25% or less.

(b) The establishment of an International Debt Discount Corporation to purchase bank debts at a 10% discount in return for long term bonds, e.g., 10-15 years. The IDDC would reschedule developing countries' debts on generous terms and stand ready to discount its bonds.

(c) Exchange existing bank loans for non-interest bearing bonds or low interest bearing bonds with interest rate differential being financed by the IMF or World Bank or both. This proposal is patterned on the approach employed by banks to reschedule the debts of real estate investment trusts in 1974-75.

This seems the most constructive approach, however, it focuses on outstanding debt and does not induce new lending, especially if banks are forced to accept debt discounting. Restoring capital inflows to an adequate level, is essential if even the long term bonds are to be serviced. There is also the critical question of financing the discounting of the bonds and whether the O.E.C.D. countries would support this approach. It rests on the implicit assumption that banks would opt for security over profitability with higher risks. If the banks did not comply, could they be compelled by legislation?

(8) *Collective Default.*

A Collective default or repudiation by developing countries or by the 15 largest debtors could bring a collapse of the international banking system. It is even possible that a joint default by the two (2) largest debtors, Brazil and Mexico could be the epicentre of a banking crisis. In theory, the central banks of developed countries, if they act quickly and in unity, could provide capital and liquidity to overcome the insolvency of the international banking system, by pursuing Bagehot's adage - «lend, lend boldly and keep on lending». But history indicates that the necessary speed and co-operation is unprecedented. There is also the question of the confidence of depositors which may turn to panic, even with central bank intervention as illustrated by the demise of Continental Illinois Bank and Trust Company.

OVERVIEW.

The debt crisis is not going to solve itself nor do piecemeal measures such as case by case rescheduling, constitute a feasible solution. Several proposals have been made to resolve the debt crisis, none of which by themselves offer significant relief. Yet, a meaningful and lasting solution can no longer be postponed regardless of the difficulties involved. The debt crisis has had severe adverse effects in the real and financial aspects of developing countries and the world economy. In developing countries it prevents development and even growth, undermines the economic viability of these countries, places at times unbearable stress on social and political institution and jeopardizes democracy. At the level of the world economy, the debt crisis constrains world trade, inhibits capital flows or

induces perverse patterns, hampers growth in the developed countries and generates tremors of increasing severity in the international banking system. Indeed, the debt crisis threatens the functioning of the world economy.

A solution to the debt crisis must proceed from a recognition that governments in developed countries, transnational commercial banks, multilateral institutions, e.g., IMF, World Bank and governments in the developing countries are all partly responsible for the impending debacle. Therefore, they must be part of the solution which implies full involvement in formulating the solution, nurturing the necessary consensus and implementing the stipulated policy measures. It must also be recognized, that the long run solution to the debt crisis is global recovery but in the short run recovery is only possible if the debt crisis is resolved.

### PART III

Traditional thinking on policies to stimulate global recovery has emphasized the need to initiate reflation in the North and then implement measures to ensure that it generates «spread effects» which promote growth in the South. Most frequently, the United States is assigned the role of leading sector, but it has also been suggested that joint European reflation, supported by appropriate policies in the U.S. could provide adequate stimulus. Even the call for simultaneous North-South growth through a new international economic order put the onus on the North. The following proposal argues that global recovery can be led by the South. Reflation in the South on a sufficient scale, can be achieved by an appropriate level of debt relief. By resolving the debt crisis in a particular way, sufficient resources will be set free to restore and/or increase the import capacity of the South. This would reflate these economies and provide growth and increased employment. Given the interdependence of the North and the South, much of the increase in imports by the South, would be supplied by the North, inducing increased growth and employment. Growth would lead to an increase in foreign investment and aid from the North and create an atmosphere in which a negotiated reversal of protectionism would be a real possibility.

A rough calculation can be made using IMF data for 1984-86 and assuming similar magnitudes in 1987-1988. The figures show that if developing countries were relieved of all debt servicing, they would have saved roughly US\$400 billion or US\$133 billion per annum. This would more than cover their current account deficit and represent an increase of 25% in import capacity. If 3/4 of this was spent on imports from industrial countries, it would cover their current account deficit and add 8% to exports. A Stimulus of this magnitude over a three-year period

with its multiplier effect, would certainly start the process of growth in the world economy.

To achieve this level of debt relief, the following programme of policy measures is required:

1. Cancellation of debts of the least developed countries.
2. Rescheduling of all principal payments of developing countries which fall due in the next three (3) years. The terms would be 15 years maturity with a grace period of three (3) years. No fees to be charged and no escalation in the rate of interest (above LIBOR) to be charged.
3. All interest payments on the commercial debt of developing countries falling due in the next three (3) years would be paid for by an issue of SDR's to the IMF. The SDR's would be provided to the governments of developing countries as a refund of payment on debt. These special SDR's could only be disbursed to the debtors for development imports, i.e., capital goods, raw materials, technology and energy.
4. A three-years moratorium on interest payments on debt owed by developing countries to multilateral and bilateral aid agencies. Interest payments to be converted into a new loan.
5. Banks holding SDR's could discount 20% of them per annum at the central banks of developed countries or keep them on deposit at the IMF or at the central banks of developed countries or the SDR's could be used like any other currency.
6. A strict limit would be placed on further external borrowing by developing countries during the three-year period. All new loans would have to meet three criteria (a) the efficiency criterion; (b) the transformation criterion; and (c) the liquidity criterion.

The efficiency criterion stipulates that the yield of the loan, that is, the increase in output resulting must exceed the cost of repayment. Obviously this implies that loans must be used for productive investment and not for consumption. The transformation criterion is met if the output resulting from the external debt financed investment generates sufficient foreign exchange earnings or savings to amortize the loan. The liquidity criterion addresses the problems of timing and cash flow. Even if the transformation criterion is met, the foreign exchange earnings might not coincide with the repayment schedule. This is highly probable where an investment project with a long gestation period is financed by short maturity loans.

This proposal has several advantages:

1. It stimulates growth in the world economy which is the only solution to the debt crisis.
2. It is cheap, i.e., the issue of SDR's is a fiduciary issue which does not cost member countries of the IMF.
3. All parties would be willing and interested in participating since there are clear advantages, e.g., the banks receive full interest payments on schedule while rescheduling principal on terms which are less generous than some already existing agreements. Developed countries are not asked to provide vast sums of money nor would they object to creating more international liquidity, i.e., SDR's since it would not be inflationary because it would be matched by increased output. Developing countries get « debt relief led growth » without the strictures of IMF conditionality.

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