DEPARTMENT OF THE SENATE
PAPER No. 4405
DATE
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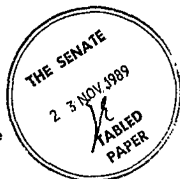
THE PARLIAMENT OF THE
COMMONWEALTH OF AUSTRALIA



Joint Committee on
Foreign Affairs, Defence and Trade

THIRD WORLD DEBT: AN AUSTRALIAN VIEW

November 1989

Australian Government Publishing Service
Canberra

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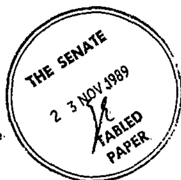

Joint Committee on
Foreign Affairs, Defence and Trade

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November 1989

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Canberra

TERMS OF REFERENCE

Appropriate Australian policy responses to the present international trade and financial situation, including debt, and, in particular, measures Australia could take to improve its own balance of trade in goods and services.

MEMBERSHIP OF THE COMMITTEE

35th Parliament
Main Committee

Chairman: Mr G.N. Bilney, MP
Deputy Chairman: Hon. M.J.R. MacKellar, MP

Senator N. Bolkus (to March 88)
Senator B.K. Childs (from March 88)
Senator N.A. Crichton-Browne
Senator R. Hill
Senator G.N. Jones
Senator D.J. MacGibbon
Senator P. McLean (from March 89)
Senator M.J. Macklin (to March 89)
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Mr D.F. Jull, MP
Hon. R.C. Katter, MP
Mr L. Kent, MP
Dr R.E. Klugman, MP
Mr J.V. Langmore, MP
Mr E.J. Lindsay, RFD, MP
Mr G.B. Nehl, MP
Mr P.M. Ruddock, MP
Mr J.L. Scott, MP
Mr R.F. Shipton, MP
Dr A.C. Theophanous, MP

Secretary to the Committee:
Mr P.N. Gibson, MC

Trade Sub-Committee

Chairman: Mr L. Kent, MP
Deputy Chairman: Senator N.A. Crichton-Browne

Senator B.K. Childs
Senator R. Hill
Senator M.J. Macklin (to April 88)
Mr P.J. Baldwin, MP
Mr G.N. Bilney, MP (ex officio)
Mr G. Campbell, MP
Mr N.J. Hicks, MP
Dr R.E. Klugman, MP
Mr J.V. Langmore, MP
Mr E.J. Lindsay, RFD, MP
Dr A.C. Theophanous, MP
Hon. M.J.R. MacKellar, MP (ex officio)

Inquiry Staff

Mr A.J. Pulley
Mrs L. Cowan

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DISSENT

Senator N.A. Crichton-Browne, Senator R. Hill, Senator D.J. MacGibbon, Senator G.E.J. Tambling, Mr R.G. Halverson, OBE, MP, Mr N.J. Hicks, MP, Mr D.F. Jull, MP, Hon. R.C. Katter, MP, Hon. M.J.R. MacKellar, MP, Mr G.B. Nehl, MP, Mr P.M. Ruddock, MP, Mr R.F. Shipton, MP 115

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GLOSSARY

ACFOA	Australian Council For Overseas Aid
ADB	Asian Development Bank
AIDAB	Australian International Development Assistance Bureau
BIS	Bank for International Settlements
DAC	Development Assistance Committee
DMA	Debt Management Authority
ECA	Export Credit Agency
EFIC	Export Finance and Insurance Corporation
ESAF	Enhanced Structural Adjustment Facility
GDP	Gross Domestic Product
GNP	Gross National Product
HIMIC	Highly Indebted Middle Income Country
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
LDC	Less Developed Country
LIBOR	London Interbank Offer Rate
MIGA	Multilateral Investment Guarantee Agency
MYRA	Multi Year Rescheduling Agreements
NGO	Non Government Organisation
NIE	Newly Industrialised Economies
ODA	Overseas Development Assistance
ODF	Overseas Development Finance
OECD	Organisation for Economic Co-operation and Development
OPEC	Organisation of Petroleum Exporting Countries
SAF	Structural Adjustment Facility
SDR	Special Drawing Right
SSA	Sub-Saharan Africa
UNICEF	United Nations Childrens Fund

CURRENCY

All dollar values are in Australian dollars unless otherwise specified.

A$1 = SDR0.6119 in April 1989.

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FOREWORD

Source of the Reference

1. On 1 December 1987, the then Minister for Foreign Affairs and Trade, the Hon. Bill Hayden, MP, formally referred the following topic to the Joint Committee on Foreign Affairs, Defence and Trade for inquiry and report:

> Appropriate Australian policy responses to the present international trade and financial situation, including debt, and, in particular, measures Australia could take to improve its own balance of trade in goods and services.

2. The Committee resolved to form a Sub-Committee to conduct the Inquiry. Mr L. Kent, MP, was elected as Chairman of the Sub-Committee and Senator N.A. Crichton-Browne was elected Deputy Chairman. Other members of the Sub-Committee were Senator B.K. Childs, Senator R. Hill, Senator M.J. Macklin (until 18 April 1988), Mr P.J. Baldwin, MP, Mr G. Campbell, MP, Mr N.J. Hicks, MP, Dr R.E. Klugman, MP, Mr J.V. Langmore, MP, Mr E.J. Lindsay, RFD, MP, and Dr A.C. Theophanous, MP. The Chairman and Deputy Chairman of the Main Committee, Mr G.N. Bilney, MP and the Hon. M.J.R. MacKellar, MP, respectively, were ex officio members.

Scope of this report

3. The concepts and problems embraced by the terms of reference are of fundamental importance to the world's economic and social fabric. Growing public and especially media interest has increasingly focused on the world debt problem in the last few years. Manifestations of the problem include mounting world indebtedness, payment defaults by some countries, significant decline in the standards of living in some debtor countries and

growing unease, within the banking system of creditor countries, at ever increasing risk attached to loans totalling hundreds of billions of dollars.

4. The Committee noted the broad nature of the terms of reference and consequently decided to present its report in two parts. This volume of the report (Part I) covers world debt, particularly with regard to developing countries, and the international financial situation. Part II of the report will cover trade matters, in particular, measures Australia could take to improve its balance of trade in goods and services. Quite obviously national and international trade, financial and debt matters are closely interwoven, but in order to present a timely report, the Committee considered it to be more appropriate to divide the report broadly into international and national parts.

Conduct of the Inquiry

5. The Inquiry was advertised nationally on 19 December 1987. Submissions were invited from the public by 30 March 1988 although submissions were accepted for this part of the report until April 1989. In addition, the Sub-Committee invited a number of organisations and individuals with an interest in trade, financial and debt issues to forward a submission. A list of submissions received is at Appendix 3.

6. Public hearings were held in Canberra on 10 April 1988, 21 October 1988, 2 December 1988 and 6 March 1989. Witnesses at the public hearings included representatives from Treasury, banks, public institutions, industry bodies, an aid umbrella organisation and academics. A list of witnesses is at Appendix 4.

7. In addition to the public hearings of the Committee, members also met informally and had helpful discussions with a number of Ministers and officials of foreign governments and with

officials of Australian Government departments. Discussions were held with, inter alia, the Netherlands Minister for Trade, the Mexican Foreign Minister, the Indonesian Foreign Minister, the French Minister for Trade, the President of the World Bank and several Ethiopian Ministers.

8. The Committee's approach to this report is that primarily it should promote public awareness of and provoke public discussion on the question of world debt, which the Committee sees as of fundamental and pressing international importance. As a consequence of this approach, a number of relevant issues in this report are canvassed by presenting various differing views on these issues.

EXECUTIVE SUMMARY

1. This report focuses largely on the foreign debt problems of the third world. Debt problems have been severe and chronic since the beginning of this decade for many developing countries, particularly those in Latin America and in Sub-Saharan Africa. Foreign debt levels in many countries have been such that the debt under contracted conditions could not be serviced, and as a result, since 1980 over $US500 billion of debt has been restructured, most of it being rescheduled many years into the future. For a number of countries, scheduled debt servicing on existing foreign debt exceeded the value of exports. Some other countries have found it necessary unilaterally to suspend debt service payments. Argentina, currently saddled with massive foreign debt and internal economic problems has experienced recent rioting arising from those problems, and has suspended all payments on foreign debt.

2. These problems are serious, and the ramifications extend far beyond creditor banks and debtor central banks. Commentators have noted the lost decade of the '80s, and have described the problems arising from debt as existing in many areas; health, education, economic, social and political. Infant mortality and malnutrition is rising in poor countries, and in poor areas of middle income countries; schooling is contracting in countries where governments must cut back in social welfare budgets; and capital stock is deteriorating for want of domestic investment and savings (or indeed for want of foreign capital).

3. A number of causes of the world's debt problem have been described but perception is required in determining whether certain factors are causes or effects, chicken or egg, or whether or not so called causative factors are independent of the debt problem. The two oil price shocks of the 1970s have had a significant effect on the world's financial system. The

propensity of many countries to have continuing current account deficits is cited as a cause of debt, but this is like saying debt is caused by a high rate of getting into debt. High interest rates and low commodity prices are also cited as causes, but these are themselves caused by other underlying economic factors. The Committee notes the social and economic decline in many developing countries and views critically the policies of some international financial bodies, particularly the International Monetary Fund, in imposing rigid conditions on some debtor countries which in the short term at least have led to economic decline.

4. Foreign debt levels in developing countries had been growing rapidly in the late 1970s and early 1980s, but the bubble was burst in August 1982 when Mexico announced that it could no longer service its debts. A number of other countries followed suit. The spectre of a total collapse of the world's banking system has so far been avoided by co-operation by creditors and debtors, with the most important palliative mechanism being rescheduling of debts, ie, by postponing certain debt payments, in some cases for up to 20 years. The Committee notes that rescheduling is a palliative mechanism. In rescheduling, creditors and debtors acknowledge the reality that in the short to medium term some countries cannot now service current debt levels. During this decade, repeated reschedulings demonstrate that some countries may never be able to service current debt levels. New initiatives will have to be taken to write off debt.

5. At the Group of Seven (G7) summit meeting in Paris in mid-July 1989, major industrial countries expressed concern at the world debt problem. They stated that the International Monetary Fund and the World Bank will support significant debt reduction by setting aside a portion of policy based loans, and they urged banks to take realistic and constructive approaches in their negotiations with debtor countries.

6. Debtors, creditors and international bodies alike realise that prudent economic policies are essential for a country to grow out of its problems and to restore creditworthiness to ensure future essential capital flows.

7. The chronic world debt problem seems to have stabilised from its earlier acute phase in the early 1980s, however concerted action is needed now by governments of both debtor and creditor countries alike. Debtor countries must apply sound long term growth oriented economic policies. Creditor countries must ensure that their policies are not protectionist and must allow other countries to grow. In the end the bullet must be bitten and mechanisms must be found to lower debt levels, eg, by write-offs, and to lower interest rates.

For one sixth of mankind, the march of human progress has become a retreat. At least half a million children have died in the last twelve months as a result of the debt crisis and recession.

The State of the World's Children 1989, UNICEF

SUMMARY OF RECOMMENDATIONS AND CONCLUSIONS

Chapter One

1. The Committee recognises the desperate plight of many poor people in developing countries, and notes the association between increasing debt levels and increasing poverty.

Chapter Two

2. The origins of the debt problem in the developing countries are three-pronged:

- internationally induced, from interest rate rises, commodity price falls and world recession;
- domestically generated, from excessive borrowing, and inappropriate policies leading to capital flight and unproductive investment projects which failed to generate returns necessary to service the loans; and
- generated by irresponsible lending policies of banks.

Chapter Three

3. The Committee notes the short and medium term relief provided by debt rescheduling, both to debtor countries and to banks. *However, the Committee considers that as the net effect of* rescheduling on commercial terms is to change current burdens into future burdens at compound interest rates, rescheduling alone is not a real solution to the debt crisis, and is only helpful in buying time for debtors to, hopefully, grow out of debt and for creditors to provision for losses.

4. The Committee notes that negative effects associated with IMF programs are readily perceived within debtor countries and are serious in nature. Riots during 1989 led to a number of deaths in Jordan, Venezuela and Argentina, and these occurred during economic austerity linked with IMF adjustment programs.

5. The Committee recommends that

R1. the Government, through its IMF Governor and through requests to the Executive Director representing Australia in the IMF, strongly urge the IMF to prepare social impact statements in respect of country adjustment programs that it initiates. (para 3.5.31)

6. The Committee sees no difference in principle between Bank and Fund directions (as a condition for assistance) to recipient Governments concerning monetary or fiscal policy, and directions concerning land reform, a sensitive approach to population control issues, and military expenditure.

7. The Committee is alarmed by the fact that despite conditions attaching to IMF and World Bank assistance, and despite the large scale lending by the First World to the Third World countries, (in the order of US$1.3 trillion), the gap between rich and poor countries, and between the rich and poor in the debtor countries, is getting even wider.

8. With regard to conditionality of external assistance to debtor countries, the Committee is of the view that it is obvious that an external assisting agency must be able to influence policy within an assisted country so that economic imbalances, and shortcomings in policy and administration can be addressed through mutual consultations. The conditionality should be sensibly applied with a view to attaining long term stability and minimising short term disadvantages. The Committee welcomes moves by the World Bank to introduce environment protection policies.

These moves demonstrate a new measure of environmental sensitivity by the Bank.

9. The Committee adopts as a recommendation

R2. the UNICEF strategy of 'adjustment with a human face' which aims at appropriately changing productive structures while also emphasising:

- **more expansionary macro-economic policies;**
- **concentrating sectoral policy on employment and income earning areas including small farming and informal activities;**
- **a greater equity as well as cost effectiveness incomes policies and social programs;**
- **compensatory programs to protect health and nutrition of the poor during restructuring;**
- **closer monitoring of major aspects of living standards, so as to respond more quickly to deprivation;**
- **ecological responsibility; and**
- **democratic control of economic policy-making. (para 3.5.38)**

10. The Committee recommends that

R3. the Government examine in detail international financial institutions with respect to the effects of conditionality on democratic policy making. As long as international economic and monetary issues are seen as

only technical and abstract subjects which should be left to officials and bankers, some of the most important economic issues which affect the lives of all people are removed from the area of public debate. Greater political involvement of parliamentarians as well as international co-ordination of parliamentary action is a high priority in this respect. (para 3.5.39)

Chapter Six

11. The social and human consequences of the economic decline in many developing countries following the debt crisis can be summarised as

- increasing unemployment
- increasing malnutrition and starvation
- increasing food prices
- decline in living standards
- decline in health, education and transport services
- deterioration in infrastructure.

What is happening to hundreds of millions of people in developing countries at the present time in this world of high technology and knowhow and multi-billion dollar investment flows is an avoidable tragedy. The Committee considers that solutions to this tragedy are the responsibility of Governments of both debtor and creditor countries. The existence of poverty affecting so many people and to such a harsh extent is a telling indictment on the governments of affected countries and on the whole international system, and is based on inequity and exploitation.

12. *A solution to the debt crisis will need to address the* large negative transfers in the commercial financing sector. Commercial banks are having their debt paid back and are receiving large interest payments paid for by official transfers. The Committee recommends that

R4. in return for this indirect official support, the commercial banks should be required to participate in the debt and debt service reduction proposals, such as the Brady proposal, which are currently being promoted. (para 6.4.14)

Chapter Seven

13. The collapse of international bank lending is devastating to developing countries. Measures to encourage private lending should therefore be an integral part of overall plans to alleviate the debt problem.

14. The Committee recommends

R5. a significant reduction in the amount of world debt stock, with appropriate variation country-by-country depending on ability to pay as measured by export earnings and volume of debt. (para 7.2.7)

Bearing in mind the comments on debt stock reduction, the Committee is also of the view that an equally prime tool to alleviate the world's debt problem is to reduce interest rates on existing debt.

15. The cost of servicing the remaining debt should be further reduced. The Committee therefore recommends that

R6. with regard to remaining debt, measures should include, where appropriate:

. rescheduling principal repayments;

. reduction of interest rates to concessional levels; and

. recycling repayments by allowing local currency repayment into reinvestment funds with repatriation constraints (in order to provide investment resources for developing countries as well as limiting outflows). (para 7.2.9)

These steps are appropriate to complement the Brady initiative and should be supported by the necessary regulatory and tax treatment to permit and induce banks to participate and to give priority to participating banks over non-participating ones.

16. Policies to reduce capital flight should be part of the economic reforms which accompany debt reduction schemes. When such changes are being implemented by debtor countries the Committee recommends that

R7. the industrialised countries assist the process by co-operative steps including:

. disclosure by tax authorities in the countries concerned;

. disincentives to capital flight such as taxation in the country of inflow; and

. recycling of at least a share of the funds to developing countries. (para 7.2.10)

17. The Committee recommends that

R8. the Australian Government in co-operation with other supporting countries such as France should formally recommend to the World Bank that a proposal for a DMA be prepared for consideration by member countries. (para 7.3.13)

18. The Committee in an earlier report of February 1989 recommended that

R9. the Government implement a policy of rapid growth in Australia's ODA as a proportion of GNP: by 1992 Australian aid should once again stand at 0.5 per cent of GNP. This Committee reiterates this earlier recommendation. (para 7.4.1)

In addition the Committee recommends that

R10. the Government vigorously press in international forums for a general increase in ODA from donor countries. (para 7.4.2)

19. The Committee considers that the existing practice of current aid levels being directed to lower income countries is sound. The Committee also considers that current low income aid recipient countries should not be disadvantaged by any debt relief programs which extend to middle income countries.

20. For low income debtor countries the Committee recommends

R11. . a write down of a significant portion of the Paris Club debt;

. a moratorium of ten years on all official interest payment obligations;

. the use of International Development Association terms for these rescheduled payments;

. that the budgetary costs of these debt reductions be added to aid donor commitments and not be taken from existing aid allocations;

- that aid donors who have not already done so plan now a program of cancellation of their aid-related debts;
- significant expansion of concessional resource flows;
- the development of improved means of encouraging the restoration of eligibility for those countries in arrears to the IMF; and
- that the IMF consider the sale of a portion of its gold holdings to finance additional multilateral concessional lending to low-income debt-distressed countries. (para 7.4.6)

21. The discussion in Chapter Seven flags the need for reform of the international financial system, and that Australia should be more supportive of such reform. Increased Australian activity in this area would raise Australia's international standing. In addition, Australia's exports would be encouraged if the current financial restraints were reformed, and Australia would enjoy the systemic benefits from a reformed financial system. As a vehicle for this reform the Committee recommends that

R12. the Australian Government support calls from other countries for a global conference on international financial reform. (para 7.5.1)

22. Immediate international actions that Australia should support would include an increase in allocation of SDRs and the restoring of access to IMF and World Bank credits for excluded countries.

Chapter Eight

23. Considering the continuing world wide criticism of the IMF and the World Bank to deal adequately with the debt situation on advice from Treasury officials and bankers, the Committee recommends that

R13. the task of Australian representation on World Bank bodies should be transferred to the Minister for Foreign Affairs and Trade and his Department. The Committee also considers that Foreign Affairs and Trade representatives will be more sensitive than financial experts or bankers to social, trade and foreign affairs implications of decisions that threaten social stability and have grave environmental and ecological implications. (para 8.3.3)

24. The Committee recommends that

R14. other domestic actions which Australia should take should include:

- reviewing our banking regulations with a view to encouraging private banks to reduce debts;
- regular reporting by the Treasurer to Parliament on Australia's policy stance in the IMF, World Bank and other international debt forums;
- establishing a mechanism for consultations between Government and NGOs on Third World debt and other international financial issues; and
- providing access to policy and background papers by the IMF, World Bank and other international organisations. (para 8.3.4)

25. These specific recommendations should not neglect wider issues of development strategy which must be addressed by the international community. The Committee recommends

R15. increased concessional aid flows, support for future general capital increases of the World Bank to increase development lending, doubling of IMF quotas, and similar expansions in the capital base of the regional development banks and of the International Fund for Agricultural Development. (para 8.4.1)

26. The Committee recommends that

R16. the Government give strong support to international financial institutions in any actions taken concerning proposals outlined in this report. In particular, the Committee recommends that the Australian Government, in order significantly to influence decisions made in international financial institutions and in foreign capitals, should apply vigorous diplomatic pressure on other participants at the start of any decision making process. (para 8.4.2)

CHAPTER ONE

INTRODUCTION

1.1 Seriousness of the problem

1.1.1 Increasing public attention has been focused on the debt problem in recent years. The debt crisis has been crippling national economies and adversely affecting social fabric particularly among the poor. Developing debtor countries have suffered sharp declines in standard of living, large increases in unemployment, nutritional problems and rising infant mortality rates. Increasing risk spawned the spectre of loan repayment default, and a number of major banks were highly exposed. Although the risk of bank collapse has receded recently, nervousness about high risk over-exposure has led the commercial banking sector virtually to turn off the tap for new funds to developing countries. The debt crisis is a real crisis, will not go away quickly, and requires reforms by the world's governments, international bodies and the private business sector.

1.1.2 The seriousness of the world debt problem can be clinically and statistically presented by financial tables, statistics and figures. However, the real nature of the problem and its serious human manifestation is divorced from numbers and diagrams, and has been described graphically in some publications, a selection of which is presented below. Over the past seven years the people of the developing countries have experienced 'growing poverty ... increasing malnutrition, increasing infant mortality, lower literacy rates, falling real wages and increasing unemployment.' (Life After Debt, Australian Council for Overseas Aid, 1987, p.1)

1.1.3 The World Bank, in its World Development Report 1988 in discussing the continuing need to alleviate poverty commented:

> Poverty in the developing countries is on the rise. Between 1970 and 1980 the number of people with inadequate diets in developing countries (excluding China) increased from 650 million to 730 million. Since 1980 matters have turned from bad to worse: economic growth rates have slowed, real wages have dropped, and growth in employment has faltered in most developing countries. Precipitous declines in commodity prices have cut rural incomes, and governments have reduced their real spending on social services.
>
> In the aftermath of the second oil price shock, the subsequent world-wide recession, and the debt crisis, it is not surprising that governments have focused their attention on stabilisation and adjustment and that fiscal austerity has reduced spending on the relief of poverty. However, increases in the incidence of poverty make it essential for the issue to move again into the forefront of policy design - and especially the design of public spending programs. (op cit., p.4)

1.1.4 The United Nations Childrens Fund (UNICEF) takes a grave view of the debt crisis. As an illustration of the seriousness of its views, UNICEF has placed on the front of a folder containing its report The State of the World's Children 1989 a coloured sticker with the prominent statement:

> For one sixth of mankind, the march of human progress has become a retreat. At least half a million children have died in the last twelve months as a result of the debt crisis and recession.

1.1.5 In the recent Report and Recommendations of the Advisory Group on Financial Flows for Africa, the Chairman, Sir Douglas Wass, reported:

> The African continent presents some of the most intractable development problems in the world. The great majority of its countries are heavily dependent on imported manufactures, imported oil and even imported food. To earn foreign currency for these essential imports, they rely on a narrow range of commodity exports, whose prices fluctuate erratically. The physical infrastructure - roads, housing, schools, hospitals, etc - is grossly inadequate by the standards of most of the world.

> Management and administrative skills are scarce. Population growth is high and per capita incomes are generally very low indeed.
>
> The international community has recognised Africa's need for external help if it is to develop its potential and raise incomes above subsistence levels. Official development assistance has for more than two decades been given on a substantial scale by the multilateral aid institutions and by individual donor countries. But the development experience has been disappointing. Per capita incomes remain low and in many cases are no higher, or even lower, than they were 20 years ago. Investment has not taken off. Domestic savings have not increased much. Dependence on outside help is as great as ever.
>
> In addition to these chronic problems, the 1980s have seen the emergence of a new set of problems, which have turned a disappointing picture into a critical one. The region's export earnings have fallen disastrously as the prices of its staple products, notably coffee and cocoa, have weakened and remained weak. To finance their shortfall in export income and other resources, African countries have resorted to increased borrowing, much of it on commercial terms, and have created debt-service burdens they are palpably unable to bear. External capital flows, which used to cover foreign exchange shortages, have, apart from ODA, shrunk to negligible proportions. Almost all of sub-Saharan Africa is now suffering from import strangulation. Machinery is breaking down for want of spare parts; development programmes are under threat. Social services, including health and educational facilities, are in disrepair. A spirit of despair pervades the continent. (Financing Africa's Recovery', Report & Recommendations of the Advisory Group on Financial Flows for Africa, UN, 1988, pp. v, vi)

1.1.6 These statements all outline the seriousness on the human side of the world's poverty problem. The Committee **recognises the desperate plight of many poor people in developing countries, and notes the association between increasing debt levels and increasing poverty.**

1.2 Context

1.2.1 Although the debt problem of the 1980s is undoubtedly serious, it should be seen in the wider context of a general slowdown in world economic growth in the 1980s. The vigorous postwar reconstruction and growth in the 1950s and the subsequent buoyant conditions in the 1960s and 1970s came to a close in the 1980s.

1.2.2 High debt levels do not necessarily afflict all developing countries. For example, the dynamic economy of the Republic of Korea is such that it can now support massive financial outflows: within the space of a decade, it has gone from a position of being a major debtor to being a net creditor. Of the 111 indebted developing countries listed in the World Bank's World Debt Tables 1988, 62 had not rescheduled debts in the period from 1980. The debt of these 62 countries without a debt rescheduling problem represents 35 per cent of third world debt.

1.2.3 Industrialised countries are not immune from massive debt. USA is now the world's largest debtor with a net indebtedness of over $US500 billion, and Australia is also a massive debtor whose debt, in excess of $100 billion, is comparable with that of Mexico and Brazil in magnitude. This comparison could, however, be seen as misleading. Australia has the capacity to service its foreign debt while Mexico and Brazil are caught in a debt trap of repeated debt rescheduling and repayment difficulties. Table 1.1 gives an international comparison of debt levels.

1.2.4 A yardstick may be helpful. The relative significance of Australian involvement as a creditor to problem debtor countries, as a provider of foreign aid and as a participant in international financial institutions can be summed up as follows:

TABLE 1.1: INTERNATIONAL COMPARISONS OF FOREIGN DEBT AND DEBT SERVICE RATIOS

As at end of 1986	Gross Foreign Debt $US billion	Gross Foreign Debt as a percentage of GDP	Interest on Gross Foreign Debt as a percentage of exports of goods and services	Interest on Gross Foreign Debt and repayments as a percentage of exports of goods and services
O.E.C.D.				
Australia	70.1	42.2	16.5	72.8
Austria	11.5	12.2	11.7	38.5
Belgium	45.6	39.9	25.0	48.1
Canada	150.9	42.9	12.4	56.6
Denmark	64.5	80.3	13.5	100.4
Finland	32.3	45.9	12.6	91.9
France	65.0	9.0	4.4	22.6
Germany	180.0	20.1	4.2	30.3
Greece	20.3	51.4	14.8	81.4
Iceland	2.1	57.9	9.4	52.1
Ireland	22.1	90.4	9.5	82.1
Italy	98.1	16.4	8.1	35.9
Japan	145.0	7.4	7.1	20.2
Netherlands	18.3	10.7	8.2	14.5
New Zealand	18.3	70.9	12.7	55.9
Norway	38.0	55.4	8.0	64.3
Portugal	22.7	78.6	10.3	72.1
Spain	32.0	14.2	6.0	30.1
Sweden	58.0	44.2	9.9	57.3
Switzerland	27.5	20.5	4.7	21.3
Turkey	32.2	55.4	17.0	90.9
United Kingdom	145.4	26.6	19.5	60.9
U.S.A.	525.0	12.4	16.5	74.1
OTHER				
Argentina	51.6	67.7	46.7	102.0
Brazil	110.3	40.8	39.6	130.5
Chile	21.5	127.6	36.6	90.0
Indonesia	42.0	57.2	16.9	73.2
Israel	31.5	114.2	20.3	131.9
Malaysia	24.4	87.8	7.9	37.2
Mexico	100.3	78.6	35.0	120.1
Philippines	28.3	95.3	23.1	132.1
Singapore	4.2	23.3	4.7	18.2
South Africa	22.6	36.8	9.5	86.8
South Korea	52.0	54.7	9.0	53.6
Taiwan	12.5	17.3	1.5	12.9
Thailand	20.4	48.1	12.3	53.1

Source: Australia's Foreign Debt, Legislative Research Service, Australian Parliament

- Australian banks hold less than $2 billion of rescheduling country debt, which is about 0.5 per cent of the debts of these problem debtors;

- the Australian Government, through the Export Finance and Insurance Corporation (EFIC), holds or insures about $1 billion of debt to rescheduling countries, about 0.25 per cent of the debts of these problem debtors;

- Australian developing country debt rescheduled in the Paris Club represents about 0.5 per cent of total Paris Club reschedulings;

- Australia provides about $1 billion of official development assistance (ODA) which is about 1.5 per cent of total world ODA; and

- Australia has a voting power of about 1.8 per cent in the World Bank, 1.6 per cent in the IMF and 1.5 per cent in the World Bank's International Development Association (IDA).

1.3 Definition of the problem

1.3.1 The essence of the problem is not the absolute level of the debt, but a country's ability to service and repay that debt. The problems are:

- that the effort required to service debt may generate social and political problems in the debtor country;
- the extent of the misery of both debtor and creditor if the debt is not serviced;
- the social and political implications for a country if vital capital is not sufficiently available; and
- that the pressure of the debt servicing is preventing LDCs from developing.

1.3.2 Countries which have either defaulted on loan payments or which have obviously no hope of servicing current debt commitments have experienced virtual cessation of trade credits (short term finance) and of commercial longer term finance. (Which bank would want to lend to a country that has no hope of servicing even its current level of commitments?) Currently, the bulk of the external finance of some countries is from concessional, ie, subsidised, finance through official channels.

1.3.3 The supply of vital components for the efficient running of an economy, such as spare parts, essential fuels, food and pharmaceuticals, is drastically cut as a result of lack of trade credits and finance, and what follows is increased unemployment, idle machinery and capital equipment, malnutrition and lessened capacity for fighting disease.

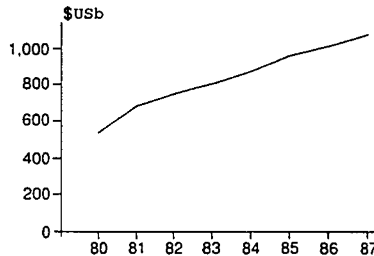
1.3.4 Such problems as these in some debtor countries already exist, however the spectre of bad debts also haunts affluent creditor countries. There is continuing real risk of collapse of some banks and several prominent US banks have suffered a significant decline in their financial position particularly since the start of the Latin American debt crisis in 1982. Since 1982, banks have managed to avoid (or postpone) trouble by rescheduling debt. The basis of this approach is that the debt remains on the books for longer, with the Micawber-like hope that something will turn up to alleviate the problem.

1.3.5 The banks that have declined in financial position have made significant loan loss provisions which in effect divert funds (presumably from notional profit) into various provisions for write-off or write down of doubtful loans.

1.4 Levels and Trends of Debt

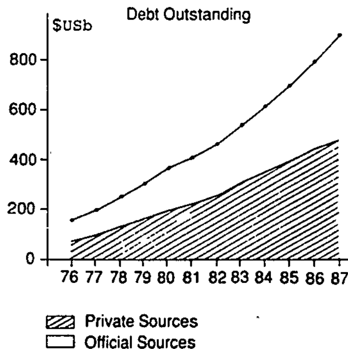
1.4.1 Figure 1.1 shows the extent of the secular rise in total external debt for developing countries since 1980. Debt levels

FIGURE 1.1: TOTAL EXTERNAL DEBT - DEVELOPING COUNTRIES



Source: **World Debt Tables 1988,** World Bank

FIGURE 1.2: PUBLIC DEBT OUTSTANDING - DEVELOPING COUNTRIES



Source: **World Debt Tables 1988,** World Bank

almost doubled, from $US579 billion to $US1,021 billion in the period 1980-86.

1.4.2 Figure 1.2 shows a breakdown (of a slightly differently defined category) of debt of developing countries from 1976 to 1986 into debt to private creditors and official creditors. During the 1980s, private creditors have held between 55 and 58 per cent of total debt, but because the flow of commercial funds to developing countries has contracted sharply in recent years, the private creditor proportion of total debt has been slipping.

1.4.3 Statistical information released by the World Bank (World Debt Tables, Vols I & II, 1988) shows that the world's problem debtor countries can be divided into two major categories, as listed in para 5.1.1:

- highly indebted middle income countries (HIMICs) (mostly Latin American) whose debt is largely to commercial creditors, eg, banks and private consortia; and
- low income African countries, mostly with more modest debt (in absolute terms) but largely consisting of debt to official creditors.

1.4.4 Compared with the two problem debtor categories above, the East Asia and the Pacific group, listed in 5.1.2, experienced the fastest growing debt burden during the 1980s. This does not necessarily imply that circumstances in countries of East Asia and the Pacific are generally as bad as those in Sub-Saharan Africa or the HIMICs. However, the financing gap in East Asia and the Pacific has grown and several countries are experiencing critical debt servicing problems.

1.4.5 External debt of countries has been categorised into debt to commercial and official creditors. Debt to commercial creditors reflects capital raised, by private and official bodies

within the debtor country, on the international commercial market through banks and other institutions. Debt to official creditors reflects loans from international organisations and foreign governments.

1.5 **Debt and Equity**

1.5.1 The World Bank, in presenting data on world debt, defines total external debt as public and publicly guaranteed long term debt, private non-guaranteed long term debt, short term debt (ie, of one year or less) and the use of IMF credit. Not included is debt repayable in local currency or direct investment (World Bank, World Debt Tables, p.xliv).

1.5.2 It is worth noting that in the past, direct, or equity investment from external sources has formed a significant part of capital flows and investment in debtor countries. Such equity investment, by its nature, involves repayment of a portion of profit as the price of the capital, and, generally speaking, if there is no profit, there are no dividend payments. Thus equity investment requires a dividend when times are good, and nothing when times are bad. There are, of course refinements to this simplistic picture, eg, repatriation of dividends may be blocked when times are good for a company if foreign exchange is in short supply.

1.5.3 Debt from loans, however, generally requires service, ie, interest and capital repayment, whether or not times are good or regardless of whether the project using the loan is profitable.

CHAPTER TWO

BACKGROUND AND CAUSES OF WORLD DEBT

2.1 Bank lending to LDCs from the 1960s to the Debt Crisis

Lending before the 1973 oil shock

2.1.1 Until the 1970s, banks' involvement with LDCs was limited to the provision of short term trade finance facilities, a few term loans to governments extended mainly in conjunction with IMF stabilisation programs and often with gold as collateral, and a few project-related loans. Most of the finance raised by LDCs was acquired from governments (official development assistance), the World Bank (for economic development projects) and, as necessary, from the IMF (for balance of payments adjustment purposes). As from 1971, about one-third of LDC debt was owed to banks. Before that time, banks financed little more than 7 per cent (on average) of the LDCs' net external borrowings. (The analysis in this section 2.1 is extracted from B. Kettell & G. Magnus, The International Debt Game 1986, pp43-54).

2.1.2 In the immediate years before the first oil price shock in 1973-74, it can be seen from Table 2.1 that the role of banks in lending to LDCs was still rather small though beginning to become more important. Some of the reasons why banks and LDCs were beginning to form closer relationships are:

- during and after the second half of the 1960s, a number of LDCs began to open up their economies to foreign investment and trade and generate rapid economic growth and investment opportunities. To support the dynamism in these economies, governments and the multinational companies to which they played host now began to require increasing amounts of foreign aid;

TABLE 2.1: FINANCING THE NON-OPEC LDCs 1968-1973 (US$ billion)

	1968	1969	1970	1971	1972	1973
Current account deficit	6.8	5.9	8.7	11.4	9.2	9.9
Net external borrowing	5.0	3.8	7.1	8.2	10.5	10.2
of which, banks	0.3	0.4	0.4	1.2	2.1	3.7
suppliers credits	0.7	0.8	0.7	0.2	0.3	0.3
other private sources	-	-0.1	0.8	1.2	2.0	0.5
official sources	2.6	2.8	3.1	3.3	3.6	5.1
IMF	0.2	-	-0.4	-	0.4	0.2
short term	1.2	-0.1	2.5	2.3	2.1	0.4

Source: IMF, Annual Reports.

TABLE 2.2: CURRENT ACCOUNT BALANCES 1973-1981 (US$ billion)

	1973	1974	1975	1976	1977	1978	1979	1980	1981
Industrial countries	20	-11	3-	1	-2	33	-6	-40	1
Oil exporting countries	7	68	35	40	30	2	69	114	65
Non-oil LDCs	-11	-37	-46	-33	-29	-41	-61	-89	-108
Centrally planned economies	-2	-2	-9	-7	-3	-5	-3	-4	-4

Source: BIS, OECD, IMF

- the growth of aid from official sources had begun to slow down and had, in any case, been redirected towards those LDCs with the lowest per capita income and the least flexible economies. As a result, the 'better-off' LDCs turned to private commercial banks for more trade - and project-related financing. The fact that the gap between commercial and official interest rates was narrowing made commercial borrowing more attractive and the fact that banks, unlike the IMF, could not impose conditions and could arrange loans rather more quickly made commercial borrowing more appealing;

- the rapid growth in international banking and the eurocurrency market in particular allowed the supply of loanable funds to rise substantially. More and more banks were becoming active in international lending - around sixty new banks a year started to participate including, it should be noted, many that had little or no experience in lending to LDCs or managing country risk;

- the development and expansion of the syndicated loan market allowed more and more banks to become involved in lending to LDCs, to spread their risks geographically and to share in the perceived rewards resulting from the strong economic performance of the borrowers.

Lending from 1973 to 1981

2.1.3 The first watershed in international lending to LDCs arrived with the first oil price shock in 1973-74, which created a massive imbalance in the international balance of payments. The current account balance of oil exporting countries jumped from a surplus of $7 billion in 1973 to $68 billion in 1974 and remained

between $30 and $40 billion until 1977, while the current account balance of the non-oil LDCs deteriorated from a deficit of $22 billion in 1973 to $37 billion in 1974 and $46 billion in 1975 (see Table 2.2).

2.1.4 At the time of the 1973 oil shock, there were dire predictions that the world would never be able to live with such large payments imbalances and that a major economic depression was likely since the oil price increases were seen as a sort of tax on the rest of the world that would not be offset by additional spending from the OPEC countries. The IMF and World Bank did not have the resources to lend to the rest of the world and the governments of the industrial countries had neither the willingness nor the ability to take the steps necessary to help the world economy to adjust. With the encouragement of major Western governments, almost by default, international banks took on the job of recycling the surpluses of the OPEC countries to the rest of the world, notably the non-oil producing LDCs.

2.1.5 As it happened, OPEC nations did spend rather more than had been expected and, being for the most part conservative investors, they deposited substantial funds at relatively short maturities in the eurocurrency market. Private financial institutions now found themselves awash with liquidity at a time when there was a large-scale demand for credit on the part of LDCs and when mechanisms existed to intermediate those surplus funds to LDCs.

2.1.6 In recent years there have been frequent criticisms that after 1973-74 banks 'overlent' and/or that LDCs 'over borrowed'. There is little question that the banks lacked proper tools and mechanisms for evaluating sovereign government risk and that LDCs borrowed partly, but not exclusively, for the purpose of sustaining consumption. However, had the banks not intermediated the so-called petrodollars in the way they did, LDCs would have been forced to curtail their development programs sharply and

economic activity in industrial countries would have fallen more dramatically and for much longer. Thus the lending was just as much in the interest of the developed world than the LDCs.

2.1.7 The most important development to be noted in and immediately after the 1973-74 period was the major change in LDC financing between private and official sources (see Table 2.3). Banks were now the most important players in the game, encouraged in part by the governments of industrial countries which, at the very least, did nothing to interfere. Multilateral official institutions, notably the IMF, became in effect the lender of last resort to LDCs if private markets were unwilling to lend or accept the risks involved.

2.1.8 In 1979-80, the second oil shock generated new upheavals in the international economic system. The OPEC surplus rose from $2 billion in 1978 to $114 billion in 1980 and remained over $60 billion in 1981, while the non-oil LDCs increased their deficit from $41 billion in 1978 to $198 billion in 1981. This created a renewed major demand for recycling, which banks duly fulfilled but this time the warnings of more serious problems were gathering. In 1979 Turkey was obliged to renegotiate its foreign debt and the Iranian crisis sent shock waves through the banking system. In both cases, however, the conventional wisdom was that these were isolated incidents and the result of specific domestic political upheavals. In the few years before the debt crisis finally 'broke', bank lending continued at a rapid pace (see Table 2.4).

2.1.9 There are two important aspects of banks' lending activities in this period which need to be highlighted. The first is the concentration of banks' exposure among a small group of countries. The second is the steady growth in the proportion of short term debt, ie, debt that falls due for repayment within twelve months.

TABLE 2.3: FINANCING THE LDCs[1] IN THE 1970s

	1971	1976	1978	1980
Total external debt ($ billion)[2]	90	220	345	465
- financed by (%)				
Bank loans	12.2	29.1	30.4	33.3
Other private lending	10.0	7.3	8.4	7.6
Total private	22.2	36.4	38.8	40.9
Official sources	26.7	16.8	14.2	12.3
Multilateral sources	11.1	11.8	11.6	12.0
Export credits	30.0	23.2	24.6	24.5
Other[3]	10.0	11.8	10.7	10.3

1. Including OPEC
2. External term debt
3. Includes lending by OPEC countries

Source: OECD, Development Co-operation 1982 Review

TABLE 2.4: BANK LENDING TO NON-OIL LDCs, 1976-1981

	1976	1977	1978	1979	1980	1981
Lending to all non-oil LDCs ($ billion)	21	15	25	40	49	50
- as % of current account deficit	64	52	61	66	55	46
Increase in bank claims (%)	28.7	14.9	19.3	26.6	26.2	22.2
Share of non-oil LDCs in total net bank lending (%)	30	21	28	32	31	30

Source: BIS, IMF

2.1.10 From the first oil price shock to just after the second one, the outstanding bank loans to the major LDC borrowers grew at an average annual rate of 30 per cent, compared with just over 22 per cent for all LDCs. By 1982, the major LDC borrowers accounted for 84 per cent of all debt owed by LDCs to Bank of International Settlements (BIS) banks. For US banks alone, the group accounted for 88 per cent of LDC bank debt owed to the nine largest US banks and 90 per cent of the debt owed to all US banks. An increasing proportion of the debt contracted in the last few years was of a short term character. This was deemed to be less risky than longer term commitments to which lenders would be 'locked-in', but the rapid growth in short term debt increased the vulnerability of borrowers to a sudden drop in the willingness of lenders to roll over that debt and it also made it more difficult for banks to extricate themselves from particular debt situations on the grounds that if all lenders withdrew credit lines, they would precipitate the very liquidity crisis they sought to avoid. Mid-1984 data, however, confirm that the proportion of short term debt started to decline.

Lending from 1982

2.1.11 The second watershed for the market in lending to LDCs can be dated to early 1982, around six months before Mexico announced that it could not repay its loans. A decline in new bank lending to LDCs had started in the Spring of 1982 and it gathered pace as banks reacted quickly and sharply to a growing loss of confidence in LDC lending. Banks actually reduced their exposure to Eastern Europe in the first half of the year and the slowdown in the growth of assets to other countries followed quickly as more countries experienced debt service difficulties or as one country's problems became regional problems in the eyes of the banks. For example, the Polish debt crisis after 1981 cast a long shadow over the whole of Eastern Europe as a credit risk and the Mexico debt crisis had a similar effect on both Latin America in particular and oil-producing nations in general.

2.2 Recent Historical Perspective

2.2.1 For the purposes of analysis in this Chapter, short factual sections on oil prices, interest rates, and commodity prices precede general discussion on background and causes of the debt crisis.

Oil Crisis

2.2.2 A major factor setting the scene for the 1980s debt crisis was the 1973 Middle East war which triggered a rapid rise in the price of oil. In 1974 the price of oil had risen to five times the price it was in the previous year. In 1978 the oil price again skyrocketed by a factor of 2-1/2 within two years. So sharp were these price rises that in the eight years from 1973 to 1981 the unit oil price had risen by 1400 per cent. In inflation adjusted real terms the price rise was close to 600 per cent. This massive price rise in an essential and high volume commodity destabilised the world's economic balance. Oil producing countries, particularly in the Middle East, suddenly, from 1973, had massive inflows of income of which only a small proportion could be spent domestically. In placing their surplus funds these countries largely chose to use the international banking system so that the banks were indebted to the oil producing countries for the invested oil revenue, and developing countries became indebted to the banks for the loans. Banks thus in general assumed the primary risk attached to LDC loans.

Commodity Prices

2.2.3 While prices for developing country commodities (ie, their exports) were generally falling during the 1980s, consumer price indexes (CPIs) in those countries were rapidly outstripping world consumer price indexes, and as a corollary, industrial country CPIs have been significantly below the average world CPI. To the extent that consumer goods form a significant part of

developing countries' imports, import prices for these countries have escalated much more rapidly than for industrial countries. Tables 2.5 and 2.6 show:

- general commodity price indexes for developing country commodities; and

- world consumer price indexes compared with developing country consumer price indexes.

2.2.4 The developing country commodity price indexes were calculated by IMF and are based on selected imported commodities from developing countries, such as food (eg. bananas, cocoa, sugar), beverages (eg. coffee, tea), agricultural raw materials, (eg. rubber, copra, palm oil) and metals, (eg. copper, bauxite, tin). In the last decade, general commodity prices have suffered a marked fall, such that by 1986, prices for developing country commodities were 25 per cent below their 1980 level. Prices for some commodities relevant to this report have firmed in the last year or so and the general IMF index of commodity prices for developing countries' exports increased by about 18 per cent in 1989. This recent arrest in the general decline in developing country commodity prices during the 1980s is a welcome respite for these countries. This benefit, however, is offset by the recent rise in interest rates, as discussed in the following paragraph. In discussion and analysis of the world debt problem by commentators, emphasis is placed on such falling third world commodity prices, so price indexes for a number of relevant commodities are presented in Table 2.7.

Interest rates

2.2.5 Interest rates were historically low in the mid-1970s, and indeed real interest rates were negative, as for some years inflation rates exceeded interest rates. However, in 1980 and 1981 there was a general rise, and commercial interest rates in

TABLE 2.5 COMMODITY PRICE INDEXES - LDCs

	1980	1981	1982	1983	1984	1985	1986	1987	1988
All Commodities	100.0	86.1	77.4	83.3	86.7	75.6	74.7	77.2	91.3

Source: International Financial Statistics, IMF

TABLE 2.6: CONSUMER PRICE INDEXES - WORLD AND LDCs

	1980	1981	1982	1983	1984	1985	1986	1987	1988
World	100	114	138	144	166	188	205	228	258
LDC	100	128	164	229	338	499	653	919	1451

Source: International Financial Statistics, IMF

TABLE 2.7 SELECTED LDC COMMODITY PRICE INDEXES

	1980	1981	1982	1983	1984	1985	1986	1987	1988
Cocoa Beans (Ghana)									
Index	100	80	67	80	92	85	78	74	61
Palm Oil (Malaysia)									
Index	100	93	79	83	125	86	44	59	75
Sugar (Brazil)									
Index	100	78	43	43	42	31	32	31	31
Coffee (Uganda)									
Index	100	70	76	84	94	82	101	69	64
Rubber (Malaysia)									
Index	100	78	59	73	71	56	59	69	90
Copper (UK)									
Index	100	79	68	73	63	65	63	81	119
Tin (Bolivia)									
Index	100	83	76	77	73	71	34	41	40

Source: International Financial Statistics, IMF

particular rose sharply to 14.1 per cent in 1981 compared with 8.6 per cent six years earlier. Rates generally declined in the six years from 1981 but there was a significant rise during 1988. From the beginning of 1988 to May 1989, London Interbank Offer Rates (LIBOR) on one year US dollar deposits rose from 7.47 per cent to 9.82 per cent.

2.2.6 Commentators on the international debt situation have rightly homed in on high interest rates as a catalyst for the debt crisis. However, some more detailed examination of interest rate trends and levels, particularly concerning countries and country groups should be useful for informed debate.

2.2.7 Tables 2.8, 2.9 and 2.10 set out average terms of new loan commitments of developing countries. While this may give a good guide to interest rate trends, it does not necessarily give an accurate guide to interest rates payable in any one year, as interest rates from earlier loans may be at fixed or floating rates which may differ from the average for new loans for any particular year. The Tables show selected average terms of new commitments for all developing countries, for highly indebted countries and low income African countries.

2.2.8 The following points can be observed from these Tables:

- for new loan commitments, interest rates and maturity periods show a marked difference between private and official creditors. Maturity periods for official debt are more than twice those of private debt, and private interest rates are significantly higher, in some years being more than twice as high as for debt to official creditors; and

- low income countries are very heavily favoured regarding terms of loan commitments. In 1986, their average interest rate for new loans was 2.8 per cent,

TABLE 2.8: AVERAGE TERMS OF NEW LOANS - ALL DEVELOPING COUNTRIES

	1975	1980	1981	1982	1983	1984	1985	1986	1987
All Creditors									
Interest %	6.9	9.4	11.1	10.4	9.1	9.0	7.8	6.8	6.4
Official Creditors									
Interest %	5.1	5.6	6.6	7.5	7.4	7.0	6.4	6.4	5.5
Maturity (Yrs)	25.1	23.5	21.5	22.1	21.7	22.6	22.6	21.3	23.1
Private Creditors									
Interest %	8.5	12.4	13.8	12.2	10.4	10.6	8.9	7.4	7.4
Maturity (Yrs)	8.4	9.3	9.5	9.4	8.8	9.8	10.5	10.0	10.3
Percentage of Public Debt Outstanding									
Concessional	42.0	27.8	26.3	24.9	22.7	21.4	20.9	20.7	21.6
Variable Rate	19.5	34.6	37.6	38.9	43.8	46.6	44.9	45.1	43.6

Source: World Debt Tables 1989, World Bank

TABLE 2.9: AVERAGE TERMS OF NEW LOANS - HIGHLY INDEBTED COUNTRIES

	1975	1980	1981	1982	1983	1984	1985	1986	1987
All Creditors									
Interest %	8.3	11.7	13.2	12.6	10.6	11.1	9.3	8.3	7.7
Official Creditors									
Interest %	7.1	7.8	8.5	9.8	9.4	9.1	8.6	8.1	7.4
Maturity (Yrs)	19.4	16.5	15.4	15.4	15.7	15.8	15.8	16.7	16.8
Private Creditors									
Interest %	8.8	13.2	14.8	13.6	11.4	12.3	9.9	9.1	7.9
Maturity (Yrs)	6.9	8.6	8.6	8.2	7.5	9.1	9.5	8.4	12.8
Percentage of Public Debt Outstanding									
Concessional	19.6	10.3	9.4	8.3	6.8	6.1	6.1	5.9	6.0
Variable Rate	34.3	55.4	59.3	60.1	66.9	70.0	67.7	67.7	66.0

Source: World Debt Tables 1989, World Bank

TABLE 2.10: AVERAGE TERMS OF NEW LOANS - LOW INCOME AFRICAN COUNTRIES

	1975	1980	1981	1982	1983	1984	1985	1986	1987
All Creditors									
Interest %	4.8	4.9	5.3	4.8	3.4	4.0	3.2	2.9	2.1
Official Creditors									
Interest %	3.4	3.2	3.8	3.9	2.9	3.3	2.5	2.3	1.8
Maturity (Yrs)	27.5	26.8	27.5	29.7	30.7	32.0	34.9	34.0	35.1
Private Creditors									
Interest %	8.2	9.1	11.0	10.1	8.6	8.5	8.2	7.3	7.6
Maturity (Yrs)	8.7	8.6	7.7	8.7	9.6	11.2	9.9	8.8	9.4
Percentage of Public Debt Outstanding									
Concessional	54.7	50.2	51.1	53.1	53.9	55.0	55.2	55.5	57.2
Variable Rate	10.0	6.5	8.5	8.1	7.7	8.1	4.8	5.1	4.7

Source: World Debt Tables 1989, World Bank

with over 90 per cent of loans being at fixed interest rates (compared with average interest rate 8 per cent and only 31 per cent of loans at fixed interest rates for highly indebted middle income countries). In addition, more than half of all new loans to low income countries are concessional (compared with around 6 per cent for highly indebted middle income countries) and the average maturity period for new loans to low income countries is in the order of three times as long as for highly indebted middle income countries.

2.2.9 Another trend worth noting is that as general debt levels rose, and while commercial money was still flowing freely, private creditors insisted more and more on floating interest rates and short-term debt became more common. In the period 1973-74, 32 per cent of the total debt of the 15 heavily indebted countries was at floating interest rates. By 1981-82 this figure had risen to 71 per cent. Equivalent figures for the share of short term debt in total debt are 7 per cent and 25 per cent. Thus debtor countries were subjected to greater unpredictability. At the time of taking out these loans, the possibility of higher interest rates was offset of course by the possibility of lower interest rates, but with impeccable hindsight we now know that average commercial interest rates almost doubled from 1975 to 1981, from 8.6 per cent to 14.1 per cent. Average official debt interest rates have been significantly below commercial rates, but this would reflect the concessional nature of some finance from official sources. Sizeable subsidies from donor countries support these lower official interest rates.

2.2.10 It is obvious from the trends in prices of oil and commodities and consumer goods, and interest rates, that in this decade, non oil exporting developing countries have been hit with a triple whammy. Many countries and organisations filled their coffers with cheap and plentiful foreign loans in the 1970s and

early 1980s and interest rates then climbed steeply. To compound their problems, the basis of their export income, commodity prices, fell dramatically and in addition to their higher recurrent costs for capital, import prices for manufactures, fuel and other essential items remained high, while consumer prices continued to climb.

2.3 The Current Situation - Worsening Problems

2.3.1 For the developing countries as a group, real GDP is estimated to have increased by almost 4.5 per cent in 1988, faster than previously expected. However, this strong growth performance was concentrated largely in Asian countries. In most countries with debt servicing problems, particularly in the Western Hemisphere and Sub-Saharan Africa, economic activity was even weaker than forecast early in 1988. This general pattern of uneven regional growth performance is unlikely to change much in the next few years.

2.3.2 In Argentina and Brazil GDP virtually stagnated in 1988 in spite of a substantial rise in exports. In both countries investment declined as the sharp acceleration of inflation over the past two years heightened uncertainty about economic policies. In Mexico growth slowed in 1988 as financial policies were tightened significantly to curb inflation and as the exchange rate appreciated in real effective terms. Growth was relatively well maintained in Chile, which has pursued relatively cautious financial policies in recent years and thus has been able to avoid the disruption of high inflation. The Committee draws particular attention to the success of Chile in fighting inflation and in rectifying some of its economic ills. These would need to be the subject of a separate study. In Bolivia, where inflation was brought down sharply in 1986, the recovery that began in 1987 strengthened further in 1988. Growth in this region is expected to remain weak in 1989 owing to the negative consequences of the rise in international interest rates and the

short-term implications of bringing down excessively high inflation rates in some countries.

2.3.3 In Sub-Saharan Africa, the pace of economic activity also slowed in 1988 and real per capita GDP continued to decline. Owing to a narrow export base, this region benefited far less than other developing countries from the strength of demand in the industrial countries. Export earnings were also severely affected by the weakness of oil markets and of prices of tropical beverages. A few countries, including Ghana, Kenya and Senegal, were able to sustain growth rates close to or above five per cent, owing largely to the positive effects of earlier adjustment programs and far-reaching structural reforms. In contrast, Cote d'Ivoire and Cameroon, where adjustment had been delayed, experienced a sharp contraction of output in 1988. Prospects have improved somewhat for a number of countries that have recently begun to tackle protracted structural problems. Output growth in Africa is projected to remain weak in 1989 before strengthening moderately in 1990. However, the projected rise in per capita GDP will only make a small dent in the erosion of living standards experienced almost continuously for nearly a decade.

2.3.4 The IMF comments in its World Economic Outlook 1989, that the strength of activity in the industrial countries has been accompanied by a rapid expansion of world trade, and the large movements in exchange rates over the past three years have led to a significant redistribution of export market shares. World trade expanded by 4.4 per cent in 1986, 6.1 per cent in 1987, and by an estimated 9.25 per cent in 1988 - the strongest performance in this decade and over three percentage points above the average for the 1970s. With the anticipated slowdown in activity in 1989-90, the rise in world trade is expected to moderate to an annual rate of about six per cent in 1989-90 (IMF: World Economic Outlook 1989, p.16). It is a matter of regret that such buoyant world trade activity does not appear to be appreciably benefiting much of Latin America or Sub-Saharan Africa.

2.3.5 To date, in 1989, adverse economic conditions have led to serious riots in Jordan, Venezuela and Argentina. In Argentina 14 people were killed in riots following rampant inflation, and the country is reported to have stopped servicing most of its $US52 billion foreign debt in April 1988. In Venezuela almost 300 people were killed during austerity protests in February and March 1989.

2.4 **Origins of the Problem**

2.4.1 In its submission to the Inquiry, the Treasury provided a concise summary of the current debt problems. This is covered in the following paragraphs.

2.4.2 At the end of 1975, the estimated total medium and long-term external debt of 17 highly-indebted middle-income countries was $US77 billion. By the end of 1982, when serious debt-servicing problems first became apparent, this figure had risen to $US278 billion. The proportion of such debt owed or guaranteed by the public sector in debtor countries increased from 65 to 72 per cent over this period, while the proportion of public and publicly-guaranteed medium and long-term debt owed to private creditors rose from 60 to 76 per cent. Total external debt of all developing countries grew at an annual rate of 21 per cent during the 1970s, from $US85 billion in 1970 to $US580 billion in 1980.

2.4.3 The background for this rapid growth in the stock of debt includes the following factors:

- the deterioration in the current account positions of (non-oil) developing countries following the oil price shocks in 1973-74 and 1979-80.

- the rapid growth of commercial bank lending to developing countries - part of a general expansion of bank lending beginning in the 1960s but fuelled also by the supply of petrodollars available for 're-cycling' (a process generally encouraged by creditor governments and international financial institutions). Such lending was seen by the banks as very low risk because sovereign governments were involved. It was often undertaken without adequate assessment of the borrower's capacity to incur further debt or of the uses to which funds were to be put. Banks had incomplete knowledge of the scale of lending by their competitors and therefore of the cumulative nature of the problems being built up.

- more generally, institutional changes in international financial markets, including a general shift from investment to debt financing and refinement of the floating rate syndicated loan market as a major source of such financing.

- excessive borrowing by debtor governments, encouraged by low or negative real interest rates (reflecting high inflation rates and the ready availability of funds).

- negligent lending policies of banks and inappropriate policies in borrowing countries, many of which borrowed to sustain consumption or to finance marginal or unproductive investment projects which failed to generate the returns necessary to service the loan. The IMF estimates that the median fiscal deficit as a proportion of GDP of non-oil developing countries reached nearly 6 per cent by 1985, compared with 3.5 per cent in the late 1970s. For the major Latin American countries these ratios ranged from 14 to 18 per cent in 1982. Large budget deficits were typically financed by rapid monetary expansion and accompanied

by severe inflationary pressures, the erosion of international competitiveness and the further deterioration of balance of payments positions. Over-valued exchange rates and subsidised domestic interest rates distorted resource allocation (often by discouraging the growth of exports), reduced incentives for saving and the productive use of investment resources, and encouraged large-scale capital flight. (The IMF has estimated that outflows of resident capital almost doubled the external financing requirement of Western Hemisphere developing countries during 1977-80.)

2.4.4 The severity of the underlying problem was revealed by the 1980-82 world recession. For much of the 1970s inflation in the OECD countries was generally increasing. Many governments were pursuing loose fiscal and monetary policies in an attempt to maintain economic growth and reduce rising unemployment levels following the quadrupling of oil prices in 1973-74. At the same time, the microeconomic performance of many industrial countries was adversely affected by structural rigidities in product and labour markets. The depressing impact of the second oil price rise on OECD activity was reinforced by widely adopted policies directed against endemic inflation - itself partly a consequence of the rise in the price of oil. In 1980 the average OECD inflation rate had risen to nearly 13 per cent and reasonable price stability was seen by most OECD countries as a necessary prerequisite for the return to satisfactory and sustainable world growth.

2.4.5 A disproportionate share of the anti-inflationary task was borne by monetary policy, ie, by Government influence on interest rates. Interest rates rose to historically high levels in 1981, reinforcing the slow-down in demand and activity.

2.4.6 Debtor countries were hard-hit by the weakness in demand in the industrial countries from 1980-1982, as the slump in international trade and fall in non-oil commodity prices after 1979 cut their export receipts. Reflecting their increased reliance on bank lending, a substantial proportion of their external debt was at variable interest rates (or was short term). They were therefore particularly vulnerable to sharply higher interest rates, a drying up of external finance and the downturn in the world economy. The strong real appreciation of the US dollar over the period 1981-84 also contributed to a significant increase in debt ratios.

2.4.7 In the second half of 1982 new bank lending to debtor countries contracted sharply, largely in reaction to debtors' emerging difficulties, initially those of Mexico. This contraction, the continued rise in debt-service payments,and declining export earnings combined to produce, in 1982 and 1983, a rapid increase in the number of countries experiencing external payments difficulties, seeking rescheduling agreements, or falling into arrears (The Treasury, Submission, pp.S862-865).

2.4.8 The origins of the debt problem in the developing countries are thus three-pronged:

- internationally induced, from interest rate rises, commodity price falls and world recession, caused by contractionary monetarist policies adopted by many of the developed western countries;

- domestically generated, from excessive borrowing, and inappropriate policies leading to capital flight and unproductive investment projects which failed to generate returns necessary to service the loans; and

- generated by irresponsible lending policies of banks.

CHAPTER THREE

INITIAL REACTIONS TO THE CRISIS

3.1 Introduction

Precipitation: Mexico

3.1.1 Given the background, within the LDCs, of continuing and increasing current account deficits, massive foreign borrowings, commodity price collapse and interest rate hikes, it was inevitable that developing countries would be unable to meet all their commitments. Mexico was the first to succumb.

> When in August 1982 the Mexican Finance Minister announced that Mexico could not meet its debt-service payments, the impact on confidence was dramatic. Mexico was a large borrower but she was an oil exporter and she had been regarded as the most creditworthy of the borrowers. The whole situation was now reappraised in a more depressing light. Loans to several countries needed rescheduling; to others, loans would have to be made in order that debt-service could be met. The dreadful word 'default' was being used, albeit covertly, and a disaster model - that major debtors would combine in a 'cartel of default' - was being mentioned. 1982 and 1983 were dark years for many international bankers. Major defaults (*a fortiori* a cartel-imposed moratorium) would have threatened some of the greatest international banks, particularly in the USA. Last-resort facilities - the IMF, governments acting in consortia, etc. - were being canvassed.
>
> The crisis eased. The IMF dealt firmly (some would say cruelly) with the Mexican problem. Brazil was next on the list. Slowly and painfully these countries under IMF duress changed their domestic policies in order to give priority to adjusting their external deficits. The threat of collective action among the debtors passed. (W.M. Scammell, *The Stability of the International Monetary System*, p.123).

3.1.2 Foreign bankers had appeared to lose confidence in a number of developing countries before the Mexican default, but very quickly the flow of money for new loans contracted sharply. Any foreign commercial loans that were coming through to developing countries in trouble were generally 'involuntary' in that they were a rollover of maturing loans which could not be paid out or were for capitalisation of interest. Thus, time for seeking a solution was bought.

3.1.3 In contrast to the diminished flow of commercial loan funds, official money flows continued, but there has been an increasing tendency for international financial bodies to attach economic policy and performance conditions to loans. This is duscussed in detail later in the report.

3.2 Rescheduling

3.2.1 The main initial reaction to the crisis was that both commercial and official debts were increasingly rescheduled. This rescheduling was through necessity, not through philanthropic volunteering on the part of the banks. The state of de facto default had to be regularised to prevent bank collapse, and possibly system collapse. Rescheduling bought time for readjustment at a price of continuing interest accrual.

3.2.2 Rescheduling is a technique by which a problem debtor country and its creditors can meet and agree on a new schedule of debt service payments which, while not (usually) relieving the debtor of any absolute payment obligations, spreads scheduled repayments over a longer timeframe, often with extensive grace periods. Thus, an intolerable repayment burden in the short to medium term can be ameliorated by creating a longer term burden. It is worth noting that most rescheduling is done at no cost to the creditor, ie, interest continues to accrue but its payment can be delayed. It is also interesting to note that it is much in the bankers' interests that a loan continue to be serviced by

the debtor rather than repaid in full. The continuous indebtedness of the debtor is of no consequence to the lenders so long as interest keeps flowing in. Debts rescheduled can be to official creditors or to commercial creditors as defined in para 6.1.1. The ways by which this rescheduling is done are similar, but the negotiating venues are different.

3.2.3 The rescheduling of official debt is normally carried out by what is called the 'Paris Club', a multilateral forum of major creditor countries which, in recent years, has involved between 5 and 20 creditors. The rescheduling of bank debt, and private debt generally, is a more complicated affair, often involving hundreds of creditors (eg, over 500 banks in the case of Poland, over 1,000 in the case of Mexico). In recent years the incidence of rescheduling both types of debt has increased dramatically as have the amounts of debt involved. During 1974-78 an average of four countries rescheduled about $1.25 billion per year. By 1978-82, these figures had risen to some nine countries and about $4.5 billion per year. In 1983, no less than 30 countries rescheduled their debts for a total in the region of $60 billion: these included five of the ten largest bank debtors and 11 out of the largest 25. While most restructurings prior to 1982 involved official debt, since that time they have mainly involved private debt (J. Loxley, Debt and Disorder, p.78).

3.2.4 Between January 1980 and September 1988, fifty developing countries have renegotiated their foreign debts through multilateral negotiations. Debts to foreign governments and insured export credits were rescheduled in meetings with official creditor groups (mainly the Paris Club); debts to commercial banks not covered by export credit insurance were restructured in meetings with representatives of commercial banking consortia. In all, $US497 billion of maturities have been renegotiated since 1980, $US415 billion with commercial banks and $US82 billion with official creditors. Of the $US415 billion restructured with commercial banks, over one third is previously

rescheduled debt, for which the terms of repayment were subsequently improved. In addition, commercial banks have assembled $US47 billion of new long-term loans under reorganisation packages and have arranged special short-term credit lines of $US37 billion (see Table 3.1).

3.2.5 In the first nine months of 1988, fourteen debt restructuring agreements were signed restructuring a total of $US84 billion of debt. Since 1987 the major feature of debt renegotiated with official creditors was that the Paris Club introduced significantly longer terms of repayment for selected low-income countries. Commercial bank consortia also restructured debt for longer repayment periods and for lower spreads than formerly. However, there was less use of new money packages in connection with commercial bank debt restructuring since 1987. Another significant feature of the year was the need to renegotiate a number of previously negotiated multiyear debt relief agreements.

3.2.6 Short and medium term relief is provided by debt rescheduling, both to debtor countries and to banks. However, as **the net effect of rescheduling on commercial terms is to change current burdens into future burdens at compound interest rates, rescheduling alone is not a real solution to the debt crisis, and is only helpful in buying time for debtors to, hopefully, grow out of debt and for creditors to provision for losses.**

3.3 International Monetary Flows

3.3.1 Total net resource flows (consisting of official development finance, export credits and private flows) to developing countries peaked in 1981, both in constant prices terms and in book value terms. Perhaps the sharpest initial reaction to the 1982 debt crisis was the drying up of export credits. Export credits to developing countries fell from $US13.7 billion in 1982 to $US4.6 billion in 1983 and by 1986 was

TABLE 3.1: AMOUNT OF DEBT RELIEF, JANUARY 1980-SEPTEMBER 1988 (US$ billions)

Debt Relief	Jan 80 Sept 88	1983	1984	1985	1986	1987	1988 to September
Debt Restructuring							
Bank	414.9	47.6	91.3	23.2	72.2	92.4	76.8
Official Creditors	82.0	8.4	4.3	16.4	11.3	28.2	7.0
TOTAL	496.9	56.0	95.6	39.6	83.5	120.6	83.8
New Long-Term Money Disbursed	47.1	13.0	10.4	5.3	3.5	4.9	1.5
Concerted Short-Term Credit Facilities	36.5	29.4	34.9	32.0	31.8	31.4	32.2

Source: World Bank, World Debt Tables 1989, Vol.1.

negative in net terms. Private international bank lending to developing countries fell from $US52 billion in 1981 to a mere $US5 billion in 1986. Total private flows more than halved between 1981 and 1983 and have remained at roughly the same level since.

3.3.2 In contrast to the contracting levels of export credits and private flows to developing countries, levels of official development finance were generally stable from 1980 to 1984 and have risen significantly since then. Accordingly, for many developing countries, any financial stability they have is largely due to official development finance. As discussed elsewhere in this report, Official Development Assistance (ODA), which forms the bulk of Official Development Finance (ODF), is mostly directed to low income countries and so the economies of highly indebted middle income countries, as listed in para 5.1.1, of which Latin America forms the major part, have been more severely affected by the contraction in resource flows since 1981. Table 6.2 gives details of monetary flows to developing countries.

3.4 Responses of the IMF

3.4.1 In March 1986, the IMF established the Structural Adjustment Facility (SAF) from repayments of Trust Fund loans, totalling about SDR2.7 billion. The purpose of this facility is to provide concessional balance of payments assistance to low-income developing countries facing protracted balance of payments problems. Loans under the facility are made available at an interest rate of half of one per cent per annum and are repayable in ten equal semiannual instalments over 5-1/2 to 10 years. Sixty-two members have qualified as low-income countries for this purpose and are eligible for assistance under the facility.

3.4.2 Arrangements under this facility require the adoption of a comprehensive policy framework that sets out explicitly the macroeconomic and structural policy measures to be undertaken to strengthen the country's balance of payments position. The Fund and the World Bank collaborate closely in assisting members with the formulation of policy framework papers. These papers are reviewed by the Executive Board of the Fund and by a Committee of the Whole of the World Bank's Executive Board.

3.4.3 As of April 1988, 25 members had three-year arrangements under the facility for a total amount of SDR 1.36 billion, of which SDR 0.58 billion has been disbursed. Of the 15 new arrangements in 1987/88, 13 are with African countries.

3.4.4 On 18 December 1987, the Executive Board approved the establishment of the Enhanced Structural Adjustment Facility (ESAF), whose objectives, basic procedures, and financial conditions parallel those of the SAF. The ESAF will have a resource base of about SDR 6 billion in addition to the resources of the SAF. It is the Fund's intention to extend ESAF loans at the same highly concessional interest rate of half of one per cent as for the SAF, subject to the availability of subsidy contributions for this purpose.

3.5 Conditionality - IMF and World Bank

3.5.1 Much controversy has recently occurred over the conditions which the IMF and the World Bank attach to their assistance and loans. Such controversy was manifested in West Berlin in September 1988 during meetings of the IMF and World Bank when public demonstrations against policies of the Fund and the Bank caught the eye of the media. Opposition to the conditionality stems from the perceived effects of this conditionality on the economies of some developing countries. The IMF has thus been ironically labelled in some quarters as the 'Instant Misery Fund'.

3.5.2 The IMF's financing arrangements are complicated and a brief outline from ACFOA's book Life After Debt follows. If a member is suffering a balance of payments deficit over an extended period this implies that, as foreign currency reserves of the member are run down, there will be a shortage of foreign exchange to pay for the excess of imports over exports or to make repayments on foreign debt. The Fund does not strictly make loans but provides balance of payments support by selling foreign currency to member countries in return for their own currencies up to a certain percentage of their membership quota. This is called 'making a drawing from the Fund'. That is, they have to pay back the foreign currencies purchased from the Fund.

3.5.3 Drawings from the IMF are undertaken in tranches. No conditions are attached to drawings under the first tranche, representing 25 per cent of a member's quota. However, if a member wishes to draw under subsequent tranches it must agree to conditions proposed by the Fund to ensure that action is taken to reduce the balance of payments deficit. The conditions are embodied in a Letter of Intent which is usually drafted by the Fund but signed by the member's Minister of Finance. The IMF makes **Standby Arrangements** under which it is agreed that the member can make drawings from the fund up to the stated amount and subject to the agreed conditions. Standby Arrangements originally operated for a year. However, throughout the 1970s, it was accepted that the chronic balance of payments deficits of many developing countries were the result of problems which could not be solved in a year. In 1979 the Fund extended their operation to up to three years. In 1974 the Fund established the **Extended Fund Facility** to provide additional assistance to countries implementing its program of balance of payments adjustment. Members could draw up to 140 per cent of their quotas under the ordinary credit tranche facility and up to 165 per cent under the Extended Fund Facility.

3.5.4 The Fund has also created further finance assistance instruments. These include the **Compensatory Financing Facility**, designed to provide financial assistance for primary product exporters whose balance of payments difficulties are at least partly attributable to falls in export earnings beyond the countries' control. Other forms of financing include the Oil **Facility**, funded by OPEC, which was designed to ameliorate the balance of payments difficulties of countries especially affected by the oil price rises of the mid-1970s. Additionally the Buffer **Stock Financing Facility** is used to assist members who have difficulties in financing their contributions to international buffer stock schemes for primary products. The Oil Facility lapsed and was not replenished when the price of oil increased in 1979 and the Buffer Stock Financing Facility remains relatively insignificant. The Fund also borrows from countries with surplus on their balance of payments to finance the **Supplementary Finance Facility** and the **Policy of Enlarged Access**, which were established in the late 1970s to enable a member with a standby arrangement to obtain further assistance from the Fund.

3.5.5 As mentioned previously, there are limits to the amount of foreign currency a member can draw from the Fund without conditions being attached. A developing country with a small quota but a large balance of payments deficit can quickly reach the limit of drawing without conditionality and be subject to the full impact of Fund surveillance and conditionality.

3.5.6 **Conditionality** refers to the policies that members are expected to follow when they use the Fund's resources to assist with their balance of payment difficulties. The purpose of conditionality derives from Article V of the Fund.

3.5.7 It is useful to differentiate the Fund's conditionality into three elements - performance criteria, preconditions and policy understanding. The main elements in the **performance criteria** concern the variables on which economic policy must act

in order to reorient the adjustment process in reducing the deficit. They are also used as indicators for monitoring progress towards achievement of macroeconomic targets. These criteria usually consist of limits for the volume of domestic credit, with restrictions for the state sector and restrictions on the money supply and government foreign debt. When the performance criteria are achieved they also serve as a 'seal of approval' which can be used to advantage in commercial international financial markets. Failure to meet performance criteria can limit or close a country's access to international finance.

3.5.8 **Preconditions** refer to measures which must be taken before an adjustment agreement begins and assistance is provided by the Fund. Preconditions usually consist of discrete changes to such economic variables as the exchange rate. The greater the Fund's doubts about whether the measures it considers necessary will be implemented after the agreement is concluded, the more exhaustive the list of preconditions. **Policy understandings** relate to measures considered useful to achieve the performance criteria set out in the adjustment program. These can include necessary restrictions on government expenditure required to bring down the fiscal deficit (ACFOA, Life After Debt, pp.46-49).

3.5.9 The World Bank was established to complement the role of the IMF. While the Fund is responsible for short-term balance of payment equilibrium the World Bank promotes long-term development. It does so by promoting a flow of international capital into productive investment at the global level.

3.5.10 Membership of the World Bank is conditional on membership of the IMF. This ensures members' willingness to submit themselves to supervision by the Fund. The World Bank undertakes loans for specific projects such as major infrastructure and agriculture developments. The World Bank now also includes two other financial bodies - the International Development Association (IDA), a concessional lending affiliate,

and the International Finance Corporation (IFC) which promotes the development of private capital markets and private enterprise in developing countries.

3.5.11 Adjustment loans were established by the World Bank in response to the hostile international financial environment faced by developing countries. The World Bank was concerned by the continuing deterioration of the prospects for developing countries and commenced a program of lending in support of adjustment and policy reform.

3.5.12 Sector adjustment loans are provided to support policy changes in a particular sector. Structural adjustment loans are provided to support programs of specific policy changes and institutional and sectoral reform across a number of sectors in developing countries designed to achieve a more efficient use of resources and thereby

a. contribute to a more sustainable balance of payments in the medium and long-term and to the maintenance of growth in the face of severe constraints; and

b. lay the basis for regaining momentum for future growth.

3.5.13 Both types of loans are designed to provide funds which are disbursed quickly, making an immediate contribution to a country's foreign exchange needs. Although the granting of these adjustment loans is not formally dependent upon a previous agreement with the Fund, there is a de facto requirement as they have only been provided in close connection with a Fund loan. They are disbursed over 2-6 years and, as with the IMF loans, they are paid out in several instalments. The last instalment is paid only when the agreed measures have been implemented.

3.5.14 An interesting aspect of the loans is their resemblance to conditional drawings from the Fund. However, unlike the Fund, the World Bank does not judge compliance with its terms on the basis of strictly quantified performance criteria such as changes in the money supply. Compliance is judged on the implementation of specific economic measures such as tax reform or deregulation of the market for certain goods. This method of assessing economic goals is an improvement over the Fund's method in that criteria can be established that take a fuller account of the particular situation of a developing country. While adjustment loans have increased rapidly during the 1980s they still only accounted for $US3 billion or less than 20 per cent of total World Bank lending during 1986. This represents a very small proportion of the resources required by developing countries to undertake programs to reduce their current account deficits.

3.5.15 The prospects of success for the supply side oriented policies of the World Bank are restricted by the Fund's deflationary adjustment packages. In other words, the World Bank's capacity to lend is limited by the deflation philosophy of the IMF. World Bank measures aimed at long-term growth have only the degree of latitude allowed by the Fund's policies aimed at balance of payments adjustment in the short run (ACFOA, op.cit., pp.49-50).

3.5.16 The Committee is aware of strong and reasoned criticism of some IMF and World Bank policies particularly those concerning conditionality. Critics suggest that recession and other adverse human impacts are a direct result of stringent conditions attending to financial assistance and loans. Critics also point out that the conditionality is almost uniform and fails to take into account the particularities of the individual countries and that it is invariably based on monetarist theories, supporting measures to strengthen the private sector against the public sector. It is also worthwhile to note that while public

expenditure is always recommended to be cut, this rarely extends to military expenditure.

Criticism - Conditionality

3.5.17 ACFOA has been quite critical of IMF and World Bank conditionality and adjustment programs. While the Fund's recommendation to devalue may result in some expansion of exports on the part of a single country, the Fund has in the past recommended devaluation to a number of countries whose products compete on international markets. This situation is aggravated when the consumers in industrial countries are not responsive to the lower prices of export products. Considering that the fears of a return to the 'beggar-thy-neighbour' policies of the 1930s stimulated the establishment of the Bretton Woods system, it is ironic that the Fund has recommended that countries engage in a series of self defeating competitive devaluations. This is especially relevant where a number of countries compete with a narrow range of exports. For example, during the period 1980-82 exports of coffee accounted for over 60 per cent of total exports from Uganda, Burundi, Rwanda, Ethiopia, Ghana and Columbia and exports of copper accounted for over 40 per cent of export revenue for Zambia, Papua New Guinea, Chile and Zaire.

3.5.18 In this situation the effect of a series of devaluations in several countries can lead to an over-supply on world markets as producers in those countries expand production in response to the increased domestic price for their product as a result of the devaluation. This can lead to a slump in international prices. The experience of the copper market in the mid-1970s is a good example of this problem. In 1975 the price of copper slumped, pushing the major copper exporting countries, Chile, Zambia, Peru and Zaire, into balance of payments difficulties. They asked the IMF for assistance. All four countries were required by the Fund to devalue, leading to an oversupply of copper even in the face of economic expansion in the industrial countries. Consequently copper prices again slumped below their 1975 levels.

3.5.19 The effect of these characteristics is to reduce the efficiency of the adjustment programs recommended by the Fund. In the absence of policy measures designed to speed up the reallocation of capital and labour there is a reliance on demand management to benefit the balance of payments in the short to medium-term. This occurs principally through the decline in imports as a result of the IMF engineered recession. The cost in terms of lost domestic output and employment can be heavy. The World Bank has recognised that 'in many instances, these countries had pursued adjustment policies that led to a compression of imports rather than increases in exports and savings; budget deficits were being pared not through increases in output, but by reducing expenditures on health, education and other social services, thus endangering both long-term economic growth and social harmony (World Bank Annual Report 1986, p.15). Structural and Sectoral Adjustment Loans were an attempt by the World Bank to assist countries with the adjustment process (ACFOA, op.cit., pp.55-56).

The human impact of adjustment programs

3.5.20 The IMF adjustment programs have been portrayed as a cause of domestic recession, as the growth in the export sector does not create enough employment to compensate for the cut-back in domestic demand. While devaluation should lead to better sales for exports, protectionism and slow growth in industrial countries restricts the expansion of developing country exports.

3.5.21 The Fund's adjustment programs aim to reduce the rate of inflation and restore international competitiveness to the economy through restricting the volume of domestic credit and money supply. However, the rate of inflation is sometimes initially accelerated following the adoption of the Fund's recommendations. The objective of the devaluations is to change price and wage relationships to bring about a cut in real wages in order to reduce consumption of imports and increase the

profitability of exports. A devaluation will therefore affect *income distribution and may set off a chain reaction of wage* demands and price changes leading to spiralling inflation.

3.5.22 The price effects of devaluation, the reduction in subsidies and the increases in indirect taxes which follow the IMF's recommendations to cut back fiscal deficits often lead to higher price increases on basic necessities than for other consumer goods such as cars, refrigerators and so on. This penalises the more vulnerable poorer elements of society (ACFOA, op.cit., p.57). **Therefore, while loans in many instances may not have been used for the benefit of the people, the burden of servicing these loans lies on the shoulders of the poor.**

3.5.23 On the other hand, the Treasury takes a more sanguine and supportive view of IMF and World Bank conditionality and adjustment programs. Under its Articles of Agreement the IMF is required to support policies that will assist members to solve their balance of payments problems in a manner that is consistent with the provisions of the Articles and that will assure the revolving character of Fund resources. Decisions of the Fund require it to pay due regard to the domestic social and political objectives of its members, to their economic priorities, and to their circumstances, including the causes of their payments difficulties.

3.5.24 One difficulty has been the readiness of some governments to use the Fund as a scapegoat for politically unpopular measures by portraying these measures as externally imposed. In fact, economic adjustment is an inevitable response to unsustainable imbalances. However Governments may legitimately object to the particular form of adjustment being prescribed by external agencies. The sharpness of the correction will be reduced if adjustment occurs at an early stage of a country's difficulties, and if there is an appropriate blend of adjustment and financing. The choice confronting many countries is not

whether adjustment occurs but how it occurs, whether in the framework of a coherent, comprehensive economic policy strategy or more haphazardly.

3.5.25 The Treasury has pointed out that a review by the IMF of empirical studies on the impact of Fund-supported adjustment programs on growth indicates that the deflationary impact of demand-management policies under these programs is usually more than offset by the expansionary effects of supply-side and exchange rate policies. Any net negative growth effects associated with Fund programs tend to be short-lived.

3.5.26 **The Committee notes that these 'net negative growth effects associated with Fund programs' are readily perceived within debtor countries and are serious in nature. Riots during 1989 led to many deaths in Jordan, Venezuela and Argentina, and these occurred during economic austerity linked with IMF adjustment programs. There is also a real risk that a severe adjustment program may hinder or undermine the development of democratic institutions in the countries affected.**

3.5.27 The IMF Executive Board completed its latest comprehensive examination of conditionality in April 1988. This included issues in the design of IMF-supported adjustment programs such as the means of ensuring that programs foster growth, how programs affect poverty, the monitoring of structural adjustment, and technical issues in program monitoring.

3.5.28 There has been an increasing emphasis on structural adjustment measures in IMF-supported adjustment programs (and in World Bank lending) as the adjustment process has moved from initial stabilisation to the direct promotion of growth.

3.5.29 At the same time, there has been greater recognition of the need for measures to reduce the poverty impact of adjustment programs. Appropriately balanced and sustained economic growth is

the most important means of improving the living conditions of the poor and growth-oriented adjustment policies will bring substantial net benefits to low-income groups. Growth alone is not, however, sufficient to alleviate poverty. Growth-oriented policies need to be supplemented by clearly defined poverty alleviation objectives and programs.

3.5.30 The World Bank is now giving a more explicit anti-poverty focus to its country assistance strategies and sectoral lending and a greater emphasis to protection of the poor during adjustment operations. The Bank is helping debtor countries address poverty problems by: designing adjustment programs so that they take greater account of the effects of specific policies on the poor; maintaining, whenever possible, social expenditures that disproportionately benefit the poor, and improving targeting of other expenditures such as food subsidies; and designing short-term compensatory programs that benefit identifiable poor groups affected by adjustment.

3.5.31 Recently, the IMF has attached considerable importance to collaboration with member governments in improving the design of programs to protect the poorest segments of the population, including, where possible and necessary, through the efficient use of compensatory measures for groups of poor people. The Committee **recommends** that

> **R1. the Government, through its IMF Governor and through requests to the Executive Director representing Australia in the IMF, strongly urge the IMF to prepare social impact statements in respect of country adjustment programs that it initiates.**

3.5.32 It is important to recognise that the primary responsibility for action lies with recipient country governments whose commitment is essential to effective poverty reduction strategies and programs. Loans to support poverty alleviation

programs are made to governments rather than the poor and their impact on poverty depends on recipient government policies. Progress in such key areas as land reform, population control, and the allocation of government expenditures and taxation burdens is essential to poverty alleviation. The Treasury considers that these are all sensitive matters of national policy in which the Bank and Fund can only operate as a source of advice and assistance, not as policy decision-makers. The Committee, **however, sees no difference in principle between Bank and Fund directions (as a condition for assistance) to recipient Governments concerning monetary or fiscal policy, and directions concerning land reform, a sensitive approach to population control issues, and military expenditure.**

3.5.33 The Bank and Fund can, however, encourage recipient governments to increase the priority accorded to poverty reduction by increasing the focus on poverty reduction in country assistance strategies for all borrowing member countries, not just interested governments.

3.5.34 Co-operation between the World Bank and NGOs has increased significantly in recent years, including through meetings of the Bank-NGO Committee. As noted in the Bank's 1988 Annual Report, a primary goal of operational collaboration between the Bank and NGOs is to increase the participation of poor people in the planning and implementation of Bank-supported people in the planning and implementation of Bank-supported projects. NGOs have also contributed substantively to the Bank's policies on the social costs of adjustment and the environment. The Bank has participated in meetings and exchanges with a wide variety of religious and other NGOs on the effect of adjustment on poverty, and with environmental and development NGOs on how environmental and poverty issues are related. It is also relevant that some countries in their bilateral aid programs make particular use of NGOs.

3.5.35 A discussion of the World Bank's support for projects designed to protect the poor in adjustment programs in Bolivia and Ghana was included in the Bank's 1988 Annual Report and is reproduced at Appendix 1 (The Treasury, Submission, pp.S890-895).

3.5.36 The Committee is however alarmed by the fact that despite all the above measures of conditionality, and despite the large-scale lending by the First World to the Third World countries (in the order of US$1.3 trillion), the gap between rich and poor countries, and between the rich and poor in the debtor countries, is getting even wider.

3.5.37 With regard to conditionality of external assistance to debtor countries, the Committee is of the view that it is obvious that an external assisting agency must be able to influence policy within an assisted country so that economic imbalances, and shortcomings in policy and administration can be addressed through mutual consultations. The conditionality should be sensibly applied with a view to attaining long term stability and minimising short term disadvantages. The Committee welcomes moves by the World Bank to introduce environment protection policies. These moves demonstrate a new measure of environmental sensitivity by the Bank.

3.5.38 The proposals for debt relief outlined in this report require sharply increased resources. As with all financial flows creditor nations and international institutions must continue to exercise appropriate management to assure that the funds will contribute to equitable and sustainable growth. Such financial management should form part of an international development contract in which the partnership between the industrialised and developing countries is clearly recognised. This must include a more balanced approach to conditionality in which the partners have shared responsibility in both national and international policies. The **Committee adopts as a recommendation**

R2. the UNICEF strategy of 'adjustment with a human face' which aims at appropriately changing productive structures while also emphasising:

- **more expansionary macro-economic policies;**
- **concentrating sectoral policy on employment and income earning areas including small farming and informal activities;**
- **a greater equity as well as cost effectiveness incomes policies and social programs;**
- **compensatory programs to protect health and nutrition of the poor during restructuring;**
- **closer monitoring of major aspects of living standards, so as to respond more quickly to deprivation;**
- **ecological responsibility; and**
- **democratic control of economic policy-making.**

3.5.39 **The Committee recommends that**

R3. the Government examine in detail international financial institutions with respect to the effects of conditionality on democratic policy making. As long as international economic and monetary issues are seen as only technical and abstract subjects which should be left to officials and bankers, some of the most important economic issues which affect the lives of all people are removed from the area of public debate. Greater political involvement of parliamentarians as well as international co-ordination of parliamentary action is a high priority in this respect.

CHAPTER FOUR

DEBT POLICIES 1985-1988

4.1 Introduction

4.1.1 This Chapter discusses a number of approaches to third world debt management in recent years.

4.2 The Baker Plan

4.2.1 At the 1985 IMF/World Bank Annual Meetings, then US Treasury Secretary Baker launched an initiative which became known as the 'Baker plan'. It comprised three main elements:

- adoption by principal debtor countries of comprehensive macro-economic and structural policies to promote growth and balance of payments adjustment and to reduce inflation;
- a continued central role for the IMF in conjunction with increased and more effective structural adjustment lending by the World Bank and regional development banks, both in support of the adoption by principal debtors of market-oriented policies for growth; and
- increased lending by the commercial banks to those countries implementing comprehensive economic adjustment programs.

4.2.2 The proposal emphasised that sound policies and sustained, low-inflation growth in the industrial countries must provide the essential foundation for a successful debt strategy, and are a prerequisite for stronger growth in the debtor countries. It also referred to the importance of resisting protectionist pressures.

4.2.3 Secretary Baker said that there were two motivations for the proposal:

- concern about increasing reluctance among banks to participate in new money and debt rescheduling packages (introducing serious uncertainties for borrowers and in some cases making it more difficult for them to pursue economic reforms); and
- the need to build upon the then current debt strategy to strengthen its ability to foster growth, including through institutional and structural policies involving increased reliance on the private sector; supply-side actions to mobilise domestic savings and facilitate efficient investment, both domestic and foreign; and market-opening measures to encourage foreign direct investment and capital inflows, as well as to liberalise trade.

4.2.4 Specifically, the plan envisaged:

- an increase in World Bank and Inter-American Bank disbursements to principal debtors of roughly 50 per cent from the then current annual level of nearly $US6 billion; and
- net new lending by the commercial banks to heavily-indebted middle-income developing countries in the range of $US20 billion for the next 3 years.

4.2.5 The Baker plan therefore signalled an enhanced role for the World Bank in the debt strategy through an increase in

fast-disbursing, policy-based structural adjustment lending. It also confirmed a greater emphasis by the IMF on structural elements in its program design.

4.2.6 While the World Bank's commitments under the plan are being broadly met, the commercial banks have not provided net new lending on the scale envisaged. The Treasury suggest in their submission that this appears to be attributable partly to banks' reluctance to increase their exposure per se, but also to an assessment that a number of heavily-indebted middle-income countries have shown little willingness to undertake the strengthened, growth-oriented adjustment required as their contribution to the plan (The Treasury, Submission, pp.S881-883).

4.2.7 The fact that the envisaged level of commercial bank money has not been forthcoming under the Baker plan has led to media comments to the effect that the plan is a 'failure'. ACFOA has commented that the Baker proposal was initially seen as a major change in the Reagan Administration's policy on the debt crisis. Criticism was focused on the limiting of the proposal to countries with major US trade and finance links, the lack of any US government financial commitment, the continuation of the case-by-case approach and the absence of any plan for follow-up.

> The proposal can now be seen as principally a political ploy to counter the political pressures which were then brewing in Latin America. Cuba had called for debt repudiation, Peru's new President had unilaterally cut debt repayments, Brazil had returned to democracy and Mexico was calling for the rescheduling of all Latin American debt.
>
> In practice the proposal has done very little. The commercial banks have refused to give financial commitments, and new lending by them has virtually stopped (ACFOA, Life After Debt, p.80).

4.3 Menu of options

4.3.1 After 1982, a number of debt relief proposals have been made. A World Bank summary of seven of these proposals is

contained in Appendix 2. Inherent in these proposals are a number of financial market instruments which have been loosely termed a 'market-based menu approach'.

4.3.2 The following options cover a range of financial market instruments which can be used in the debt workout process:

- new money instruments;
- onlending and relending facilities;
- multi-year rescheduling agreements with commercial bank creditors;
- interest and currency switching options; and
- securitisation and debt conversion techniques.

New money instruments

Bonds

4.3.3 Securitisation, or bond issues by debtor countries in exchange for existing debt, or as a prime instrument to raise new money, confers senior status on, and adds tradeability to, the new claims of creditors prepared to lend new money. Bonds have traditionally been serviced punctually by debtor countries because their total share has remained relatively low in LDCs' debt servicing obligations and also because of the bonds' bearer form which makes them more difficult to reschedule.

4.3.4 The de facto senior status of the new claims from bond financing would lead to a subordination of existing debt. If the proportion of bonds in a country's debt rises, the seniority of new bond investments would tend to erode. Banks holding large amounts of normal debt would be expected to view with jaundiced eye any tendency for growth in de facto new senior debt.

4.3.5 There has been a recent resurgence of interest in commodity-linked bonds. Essentially, the bonds relate the return

on the financing to the price of the underlying commodity. Proponents of these bonds argue that they benefit the issuing country by linking its debt service to its earnings on commodities and thus takes away at least some of the uncertainty of future debt services.

Trade credit facilities

4.3.6 In several debtor countries, specific purpose financing has been provided by new trade credit facilities. Some banks see debtor countries as giving a higher priority to serving trade-related debt, thus such lending could have reduced risk.

4.3.7 New money in the form of trade credit facilities has been extended to Argentina, which in 1985 and 1987 received a total of US$900 million in medium term trade credits. Costa Rica and Poland have also received revolving trade credit facilities. In a bilateral agreement in 1981 Australia extended to Poland a revolving trade credit facility for the sale of wool, hides and skins. This facility now supports these exports to Poland of up to $300 million annually.

Interest capitalisation

4.3.8 Voluntary interest capitalisation, from a debtor country's viewpoint, provides the same gap financing resources as new loans. From a creditor's point of view, an identical increase in exposure is achieved by refinancing, or capitalising, interest payments. The deferred interest instruments may bear the same interest and have the same maturity as the dominant 'new money' in the overall package. Formal interest capitalisation has been negotiated in only two cases, in Nicaragua and in Sudan.

4.3.9 Such a financing technique has been suggested by some banks, especially among continental European and US regional banks. Under current US regulation, if payment of interest is

delayed for a period of more than 90 days, the loans are designated 'nonperforming' and have to be provisioned against. In addition, accountants would possibly insist that capitalised interest be excluded from income. US tax authorities, however, might not permit exclusion of accrued interest from taxable income. European banking regulations (except in the UK and in France) permit deduction of capitalised interest from accrued income for tax purposes and hence this presents a tax benefit to the banks; moreover, regulation requires that new money lending to LDCs be provisioned against, which represents a loss of income to the banks.

4.3.10 In adopting interest capitalisation lenders would be clearly exposed to the risk of possible unilateral action on the part of the debtor countries, in the form of mandatory interest refinancing. The passive increase in bank exposure could weaken the negotiated approach to LDCs' gap financing and adjustment support. In addition, large-exposure banks may feel that selection of this option by smaller banks may undermine the public perception of the quality of their own loans to any given country, and hence may oppose this technique.

Other new money instruments

4.3.11 Other 'new money' instruments include conventional bank lending, interest retiming agreements and contingency and bridge financing facilities.

Onlending and relending

4.3.12 Onlending and relending are mechanisms that give creditor banks the right to reallocate credit within the debtor country. The concept of these facilities was created by the creditor banks in the context of the Brazilian Rescheduling in 1982-83. The main purpose of these facilities was to enable some foreign banks to avoid breaking their legal limits on single

borrower lending. Thereafter, they have been considered in several foreign debt negotiations; and provisions for at least one of these mechanisms were included in the restructuring or 'new money' packages of Argentina, Brazil, Chile, the Philippines and Venezuela.

4.3.13 Relending takes place within a rescheduling or restructuring agreement of existing debt. Formally, it is recorded as an operation in which when a domestic debtor repays a foreign debt, the funds are 'relent' by the foreign creditor to a second debtor within the same country. Hence, the date on which the foreign creditor is actually paid back in foreign currency is postponed. The second debtor may repay prior to the definitive repayment date, and the foreign creditor may relend again to a third debtor within the country. In theory there is a definitive repayment date at which the foreign creditor will receive and keep repayment in foreign currency from whoever is the debtor at the time. The basic idea of relending is that it defers the outflow of foreign currency from the borrowing country, while allowing the credit, and hence business risk, to be reallocated by the foreign creditor among different public and private sector entities. In practice, relending has occurred in situations in which the original borrower had the domestic currency to repay its debt (at the going exchange rate), but the Central Bank was not able or willing to provide the foreign currency.

4.3.14 Onlending is the equivalent to relending in connection to new money loans. Initially, the onlending funds are recorded as a deposit in the central bank; but the foreign bank and the contractual borrower (usually the Central Bank itself) agree that the loan proceeds will be made available to a third party within the country of the borrower. This third party may be a government agency, a public sector enterprise or a firm in the private sector. The foreign bank has to identify potential borrowers, negotiate the terms of the loan, and request the approval of the Central Bank. Once an onlending operation is approved, a separate

agreement has to be signed between the new borrower and the foreign lender. Then, the Central Bank 'repays' a corresponding portion of the loan and the creditor bank advances those funds to the new borrower. Although the new borrower is supposed to get a foreign currency loan, he actually received a loan in domestic currency that is linked to the exchange rate.

Multi-year rescheduling agreements with commercial bank creditors

4.3.15 The debt restructuring process for about 30 debtor countries which have faced debt servicing difficulties between 1978 and 1983 has relied on a fairly simple procedure of rescheduling principal falling due in the coming year as well as arrears on principal. For most of these countries the consolidation period (ie, the period during which specified debts fall due) was generally limited to one or two years of principal payments on debt contracted before a specific 'cut-off date'. The same cut-off date has been maintained for successful financial packages so as not to penalise subsequent voluntary lending. This short-term approach to rescheduling was somewhat mitigated by 'good will' clauses which provide the debtor with the insurance that a next round of negotiations would take place provided various conditions - usually under an IMF stand-by arrangement - were met. To a large extent the debt structuring process has made the foreign debt of LDCs more homogeneous by aggregating all the public sector debt of a large number of state-owned entities into one single category.

4.3.16 Following the emergence of widespread debt-servicing difficulties in 1982-83, a framework was developed to provide, on a case-by-case basis, more comprehensive **commercial bank debt relief** under the form of multi-year rescheduling agreements (MYRAs). Mexico became the first case for which a MYRA was agreed in principle in September 1984. These agreements were introduced in commercial bank debt negotiations with a view to smoothing debt amortisation profiles and reducing the burden imposed by

annual restructurings, such as administrative costs, devotion of the country managers' time and energy to debt negotiations, and lack of adequate economic and financial planning horizon. MYRAs have aimed at facilitating the return to normal market access for countries considered to have made substantial progress in their domestic and external adjustment efforts.

4.3.17 The adoption of this medium-term perspective for debt rescheduling has led bank creditors to negotiate monitoring procedures through the IMF's enhanced surveillance. Under such surveillance, the Fund's Article IV consultation reports review and appraise a country's economic policies for the period beyond the provision of Fund resources. The information about those policies is then transmitted to creditor banks by the country. In certain countries, the granting of extended consolidation periods of three or more years with generous repayment terms has been implemented through the succession of shorter serial reschedulings which come into effect automatically after certain conditions are satisfied. Altogether, commercial banks have negotiated MYRAs with ten developing countries for a total amount of more than $US100 billion as of late 1987.

4.3.18 MYRAs were intended to facilitate the transition toward the resumption of economic growth and of spontaneous private lending. On the other hand, in the context of untoward external developments and policy slippages, MYRAs have also introduced some element of rigidity in the debt workout process. Because MYRAs are intended to provide debt relief over a number of years. their existence has the potential for complicating relationships between debtors and creditors when adverse economic and financial developments occur for the debtor during the course of those years. Of the 11 MYRAs that were negotiated with bank consortia, one is not effective (Congo), three have been recast (Mexico, Venezuela and Ecuador) and one was being renegotiated (Cote d'Ivoire) at the end of 1987.

Interest and currency switching options

Currency redenomination options

4.3.19 Under several debt restructuring agreements, banks have been granted the option to redenominate existing loans in their domestic currencies or the ECU. Such options provide commercial banks with an asset management technique that can reduce funding risks, mitigate the effect of exchange rate volatility on capital asset ratios, and, for non-US$-based banks, lower funding costs. Banks may elect to redenominate their loans before the restructuring agreement is signed, or during a specified period thereafter. For debtor coutries, foreign debt obligations are therefore redenominated into a diversified portfolio of foreign currencies.

Interest rate switching operations

4.3.20 During the 1970s, a mounting share of commercial bank syndicated loans was provided on the basis of floating interest rates - typically the London Interbank Offer Rate (LIBOR) which reflects the market-determined funding cost of international banks. Thus, the share of variable debt in total debt outstanding rose to 2/3 from only 1/3 between 1975 and 1985. For several highly indebted countries such as Venezuela, Mexico, Chile and Brazil, the share of variable interest rate debt exceeded 3/4 at the end of 1986.

4.3.21 A number of new money packages and restructuring agreements have accompanied currency redenomination options with interest rate options. Such options provide creditor banks with alternative interest rate bases to which the margin is added for various eligible currencies. Banks may choose LIBOR, a domestic rate, the prime rate or a fixed rate. Interest based options are included in debt restructuring agreements with Argentina, Chile, Mexico, Nigeria, the Philipines, Uruguay and Venezuela.

4.3.22 By lending at floating rates, bank creditors in effect eliminate interest rate risk, but, because they pass that uncertainty to the borrower, this risk reduction is achieved at the expense of increasing their own credit risk. Sharp fluctuations in interst rates have significantly weakened the debtor countries' ability (and perhaps willingness) to continue servicing debt. The weight of floating rate debt in total liabilities is clearly one important destabilising factor in LDCs' external positions.

4.3.23 *Most recent new money and debt rescheduling agreements* have excluded the more expensive prime option as a US$ interest rate base. In addition, the combination of conversions into low-interest currencies and the switch from a variable to a fixed rate basis could preserve debtor countries' debt service capacity from interest rate shocks. Though the bulk of most highly-indebted countries' obligations are still based on variable rates, several of them gained a significant reduction in exposure to floating rates. Mexico's public long-term foating debt, thus, decreased five percentage points between 1984 and 1986.

Securitisation and debt conversion

4.3.24 A number of mechanisms are available to securitise debt (eg. through bonds) or to convert the debt into other forms. The debt may be converted into:

- equivalent debt - this enables banks to directly swap debts, largely for portfolio balancing reasons;

- cash - the creditor sells a debt, at a discount, either to another creditor or to the debtor. The debtor only benefits where he repurchases the debt, otherwise the face value of the debt would remain the same, regardless of who held the debt instrument;

- equity - foreign currency debt is swapped into local currency debt in a domestic firm;

- local currency - the debtors central bank issues a local currency debt obligation in exchange for a foreign debt claim;

- exports - a creditor bank can arrange to export a variety of debtor's domestic products to offset some debt;

- nature conservation - these swaps are arranged by private conservation groups to use the proceeds of debt conversions to finance conservation projects of valuable parklands or tropical forests; and

- bonds - at the initiative of the borrower, existing debt can be replaced by long term securities. Since debtor countries have traditionally serviced bonds on a preferred basis vis-a-vis syndicated bank loans, bonds have a de facto seniority status. Bonds also inherently possess greater tradeability in the secondary market than loans.

4.3.25 These mechanisms can benefit both creditor and debtor. The creditor can gain by increased tradeability of instruments and the debtor can gain by extinction of debt at a discount.

CHAPTER FIVE

SELECTED INTERNATIONAL DEBT ANALYSIS

5.1 Problem regions

5.1.1 Examination of relevant statistics for debtor developing countries shows several easily defined groups whose debt problems are more severe than those of other groups. The two most salient groups are highly indebted countries (largely Latin American), and low income African countries as listed below.

Highly Indebted Countries

- Argentina
- Bolivia
- Brazil
- Chile
- Colombia
- Costa Rica
- Cote d'Ivoire
- Ecuador
- Jamaica
- Mexico
- Morocco
- Nigeria
- Peru
- Philippines
- Uruguay
- Venezuela
- Yugoslavia

Low-Income African Countries

- Benin
- Burkina Faso
- Burundi
- Central African Republic
- Chad
- Comoros
- Equatorial Guinea
- Ethiopia
- Gambia, The
- Ghana
- Guinea
- Guinea-Bissau
- Kenya
- Lesotho
- Madagascar
- Malawi
- Mali
- Mauritania
- Niger
- Rwanda
- Sao Tome and Principe
- Senegal
- Sierra Leone
- Somalia
- Sudan
- Tanzania
- Togo
- Uganda
- Zaire
- Zambia

5.1.2 Other countries in Australia's region also have a rapidly growing debt. The relevant countries in South and East Asia, and the Pacific are listed below:

South and East Asia and Pacific Countries

- Bangladesh
- Burma
- China
- Fiji
- Indonesia
- Lao PDR
- Malaysia
- Papua New Guinea
- Philippines
- Solomon Islands
- Thailand
- Vanuatu
- Western Samoa

Note that the Newly Industrialised Economies of the region - the Republic of Korea, Taiwan, Singapore and Hong Kong - are excluded. The Philippines is also included as a highly indebted country in 5.1.1 above.

5.1.3 The highly indebted countries are characterised as being middle income and whose debt is predominantly to commercial creditors. These countries typically attract very little aid, or concessional finance, as aid is largely directed to more needy, or low income, countries. The debt, having a higher commercial component when compared with debt from multilateral or concessional flows, is generally of a shorter maturity period and at significantly higher interest rates than for lower income countries (see Tables 5.1 and 5.2). Gross national product for these countries peaked in 1981, fell rapidly for two years and has remained sluggish for the following four years. GNP for these countries for 1986 was almost 20 percent below its 1981 level. The debt ratio (public debt/GNP) of these countries has risen sharply since 1981. The debt service ratio (total debt service/exports of goods and services) has also risen, although because of debt rescheduling and moratoriums, actual debt service levels are now significantly below debt service which would have been due in the absence of repayment difficulties.

5.1.4 The debt of low income African countries is owed largely to official sources; in 1987 only 13 per cent of debt was to commercial creditors. Of the new loans to these countries, more than half of the amount is now classed as a grant element. Average interest rates for new loans had sunk to 2.1 per cent in 1987 (compared with 7.7 per cent for highly indebted countries). Similar to highly indebted countries, total debt, debt ratio and debt service ratios, in respect of low income African countries, have been climbing during the 1980s, while the 1987 GNP is only marginally above that for 1980. Given the rise in population in the period 1980-1987, there has been a significant decline in GNP per capita since 1980 in low income African countries.

TABLE 5.1: LDC DEBT ANALYSIS - HIGHLY INDEBTED LDCs

	1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)	289	351	391	422	438	454	482	527
Proportion of public debt outstanding (Official	26	25	24	22	22	25	28	32
Creditors/Private Creditors) as a percentage	74	75	76	78	78	75	72	68
Average Interest Rates of New Loans (per cent) – All creditors	11.7	13.2	12.6	10.6	11.1	9.3	8.3	7.7
Average Interest Rates of New Loans (per cent) – Official creditors	7.8	8.5	9.8	9.4	9.1	8.8	8.1	7.4
Average Interest Rates of New Loans (per cent) – Private creditors	13.2	14.8	13.6	11.4	12.3	9.9	9.1	7.9
Average Maturity period of new loans (years) – All creditors	10.7	10.3	10.1	10.5	11.7	12.4	14.9	14.9
Average Maturity period of new loans (years) – Official creditors	16.5	15.4	15.4	15.7	15.8	15.8	16.7	16.8
Average Maturity period of new loans (years) – Private creditors	8.6	8.6	8.2	7.5	9.1	9.5	8.4	12.8
Debt ratio (external debt/GNP) (per cent)	32.8	36.3	45.0	56.6	57.1	58.6	61.8	63.1
Debt service ratio (total debt service/exports) (per cent)	17.4	19.2	24.0	23.8	22.8	25.5	28.7	24.5
GNP (US$bn)	882	965	869	745	767	775	779	836
Export of goods and services (US$bn)	169	173	157	143	158	153	136	148
Imports of goods and services (US$bn)	197	223	203	158	158	155	150	158

Source: World Debt Tables 1989, World Bank

TABLE 5.2: LDC DEBT ANALYSIS - LOW INCOME AFRICAN COUNTRIES

	1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)	33	37	39	43	45	52	59	70
Proportion of public debt outstanding (Official	74	75	77	82	83	85	86	87
Creditors/Private Creditors) as a percentage	26	25	23	18	17	15	14	13
Average Interest Rates of New Loans (per cent) – All creditors	4.9	5.3	4.8	3.4	4.0	3.2	2.9	2.1
Average Interest Rates of New Loans (per cent) – Official creditors	3.2	3.8	3.9	2.9	3.3	2.5	2.3	1.8
Average Interest Rates of New Loans (per cent) – Private Creditors	9.1	11.0	10.1	8.6	8.5	8.2	7.3	7.6
Average Maturity period of new loans (years) – All creditors	21.6	23.4	26.7	28.8	29.2	32.0	31.0	33.7
Average Maturity period of new loans (years) – Official creditors	26.8	27.5	29.7	30.7	32.0	34.9	34.0	35.1
Average Maturity period of new loans (years) – Private creditors	8.6	7.7	8.7	9.6	11.2	9.9	8.8	9.4
Debt ratio (external debt/GNP) (per cent)	49.2	55.7	60.2	67.5	76.4	85.4	89.7	102.1
Debt service ratio (total debt service/exports) (per cent)	11.4	12.6	12.0	12.2	14.0	16.4	18.6	18.6
GNP (US$bn)	67	66	66	63	59	61	66	68
Export of goods and services (US$bn)	16.4	14.4	13.1	12.9	13.6	12.6	13.7	13.7
Imports of goods and services (US$bn)	24.1	23.1	21.7	19.2	19.1	10.0	21.0	22.4

Source: World Debt Tables 1989, World Bank

5.1.5 In addition to World concern over the highly indebted middle income countries (HIMICs) and the sub-Saharan African countries (SSAs), the Australian International Development Assistance Bureau (AIDAB) in its submission (p.S1047) has drawn attention to growing levels of debt in the East Asia and Pacific region. The Committee is also concerned with such problems in South Asia, particularly in Bangladesh and Burma. This South and East Asian and Pacific region experienced a faster growing debt burden in the 1980s than the HIMIC and SSA groups. The financing gap in these countries has grown, and several countries are experiencing critical debt servicing problems.

5.1.6 Tables 5.1 and 5.2 show, for the two groups of 17 identified highly indebted countries, and the 30 low income African countries:

- total debt levels, and the proportion of that debt due to private and official creditors;
- average interest rates 1980-1986, and average maturity period for new loans;
- debt ratio and debt service ratio; and
- GNP, and exports and imports of goods and services.

5.2 Selected Country analysis

5.2.1 Similar debt analysis to that in Table 5.2 above is presented in Tables 5.3 to 5.9 at the end of this Chapter for the following selection of countries:

Brazil
Mexico
Indonesia
Argentina
Bangladesh
Zaire
Zambia

In addition, Table 5.10 shows details of official and commercial debt rescheduling for Brazil, Mexico, Argentina, Zaire and Zambia. The various debt reschedulings have removed a significant debt service load from these countries, for the time being. Section 3.2 gives more background and detail on reschedulings. In essence, when rescheduling is done on a non-concessionary basis at market interest rates, time is bought for banks to reorganise their debt portfolios and hopefully for countries to 'grow' out of debt, but when commercial interest rates compound, on rescheduled debt, at a rate higher than a country's 'growth' rate the problem is pushed into the future and also compounds. It should be noted that Bangladesh and Indonesia have not rescheduled any debt in the 1980s.

5.3 Brazil and the Banks, 1987

5.3.1 In February 1987 Brazil announced a moratorium, suspending interest payments. This moratorium continued for over a year, yet its existence obtained relatively little coverage in the financial pages of the press, let alone much front-page coverage.

5.3.2 A major factor in the 'safe passage' through the debt crisis so far was Brazil's delay in declaring the moratorium. By February 1987, enough time had elapsed for the banks to prepare themselves for the worst. Banks had begun to strengthen their balance sheets by raising additional capital and using hidden reserves to write off bad debts.

5.3.3 Psychologically, banks were also better prepared to deal with what appeared at first to be the stronger bargaining position of heavily indebted countries. Under US law, bank loans are treated as non-performing 90 days after interest payments cease to be received from the clients. (Other countries have less stringent reporting requirements for their banks). Brazil possibly believed that major US banks could not afford to see

large portions of their loan portfolios classified as non-performing, and therefore would be likely to accede to Brazil's demands over renegotiation of the debt.

5.3.4 Instead, Citibank confounded everyone by declaring its loans as non-performing and expanding its total specific reserves against possible losses to 25 per cent of its portfolio of doubtful debts. This unexpected move cost Citibank US$3 billion in one 'hit' and led to Citibank reporting a US$1 billion loss in 1987. Citibank's William Rhodes chairs the Bank Advisory Committee for Brazil and it is assumed that Citibank's course of action was designed to strengthen the banks' relative bargaining position in ongoing negotiations with Brazil.

5.3.5 Citibank obviously believed that, since the investing public was widely aware of the debt crisis, the impact of recognising the problem in the bank's accounts would be minimal at home and would make Brazil's position more difficult. Once declared a non-performing client of the bank, it is very difficult to raise further credit. (Up to this point, Brazil had been receiving funds from international banks and returning them as interest payments, in order to maintain the facade that the loans were still 'performing').

5.3.6 Other major US banks quickly followed Citibank's example and, with their hands declared in this fashion, were able to refuse the injection of further funds into Brazil until Brazil resumed the observance of normal commercial standards. Two Finance Ministers later, Brazil eventually realised that the pain of capital starvation, combined with the high cost of obtaining day to day trade finance facilities, was not worth the savings on interest payments.

5.3.7 In June 1988, Brazil announced that it had reached agreement with its 700 creditor banks to provide US$4 billion in new money immediately, with two further parcels of US$600 million

in 1988 and a final US$600 million in 1989, in exchange for bringing its interest payments up to date. Brazil thereby returned to the fold of orthodox debt management.

5.3.8 Other countries which, like Brazil, had declared a moratorium on debt may now adopt a more conciliatory view of their own debt payment obligations and the risk to the world's financial system appears to have decreased. In the long run, this reduction in risk is good for debtor countries as ultimately they will only extricate themselves from debt through the ongoing support of a strong financial system over many years to come (Louise Wilson, Submission, pp S809-811). However, the Committee notes that **unless the lending countries of the First World shoulder their responsibilities as well as the debtor countries (the Third World), the resolution of the debt crisis could stretch into the far distant future.**

TABLE 5.3: LDC DEBT ANALYSIS - BRAZIL

		1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)		70.6	80.4	91.9	97.5	104.9	106.5	112.8	123.9
Proportion of public debt outstanding (Official Creditors/Private Creditors) as a percentage		17/83	17/83	17/83	17/83	18/82	20/80	24/76	27/73
Average Interest Rates of New Loans (per cent)	All creditors	12.6	15.2	12.6	11.1	12.6	9.3	8.7	8.3
	Official creditors	9.1	10.8	10.9	10.6	10.0	9.2	8.4	8.4
	Private Creditors	13.5	16.2	13.0	11.3	13.2	9.5	8.6	8.1
Average Maturity period of new loans (years)	All creditors	9.1	9.7	10.8	10.3	9.1	12.5	13.0	13.7
	Official creditors	12.8	12.7	13.8	12.8	9.7	13.0	13.7	14.1
	Private creditors	8.8	8.9	10.1	8.9	9.0	9.9	9.2	10.3
Debt ratio (external debt/GNP) (per cent)		30.4	31.8	35.7	50.1	52.6	49.1	42.0	39.4
Debt service ratio (total debt service/exports) (per cent)		34.6	33.7	43.3	28.8	25.0	26.7	34.1	26.7
GNP (US$bn)		232	253	257	195	199	217	269	315
Export of goods and services (US$bn)		23.3	26.9	23.5	24.3	30.2	29.3	25.3	28.7
Imports of goods and services (US$bn)		36.3	38.9	39.8	31.3	30.3	29.7	29.9	30.0

Source: World Debt Tables 1989, World Bank

TABLE 5.4: LDC DEBT ANALYSIS - MEXICO

		1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)		57.5	78.3	86.1	93.1	94.9	96.9	101.0	107.9
Proportion of public debt outstanding (Official Creditors/Private Creditors) as a percentage		13/87	12/88	13/87	10/90	10/90	12/88	15/85	19/81
Average Interest Rates of New Loans (per cent)	All creditors	11.3	14.9	14.2	11.5	11.4	9.4	8.6	7.7
	Official creditors	8.0	8.2	11.2	10.0	9.6	8.7	8.4	7.6
	Private Creditors	12.6	16.1	15.1	11.9	11.9	10.3	9.6	7.7
Average Maturity period of new loans (years)	All creditors	9.7	8.2	7.4	7.6	10.7	11.4	13.1	14.1
	Official creditors	15.1	16.6	11.8	14.2	14.6	14.3	14.3	14.4
	Private creditors	7.6	6.6	6.0	6.1	9.7	7.9	7.5	14.1
Debt ratio (external debt/GNP) (per cent)		30.4	32.5	52.6	66.4	57.2	54.9	82.5	77.5
Debt service ratio (total debt service/exports) (per cent)		32.1	28.1	34.1	40.0	34.8	35.7	37.2	30.1
GNP (US$bn)		189	241	164	140	166	176	123	139
Export of goods and services (US$bn)		24.6	30.5	27.7	28.6	32.5	29.7	23.7	29.8
Imports of goods and services (US$bn)		33.1	44.6	34.2	23.5	28.6	29.5	25.8	26.5

Source: World Debt Tables 1989, World Bank

TABLE 5.5: LDC DEBT ANALYSIS - INDONESIA

	1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)	20.9	22.7	26.5	30.1	32.0	36.0	43.0	52.6
Proportion of public debt outstanding (Official	64	63	60	55	55	57	57	60
Creditors/Private Creditors) as a percentage	36	37	40	45	45	43	43	40
Average Interest Rates of New Loans (per cent) — All creditors	8.1	8.7	9.0	8.7	9.0	7.3	7.3	6.1
Official creditors	5.4	7.8	8.8	8.5	8.5	7.0	8.0	5.7
Private Creditors	12.4	9.4	9.1	8.8	9.7	7.5	6.5	7.6
Average Maturity period of new loans (years) — All creditors	18.8	15.3	15.2	15.3	16.3	17.7	15.6	19.9
Official creditors	24.4	20.5	20.9	22.5	21.7	22.8	20.5	21.9
Private creditors	9.9	10.7	11.8	10.3	9.2	10.7	10.7	10.0
Debt ratio (external debt/GNP) (per cent)	27.9	25.4	29.4	39.0	39.5	44.1	60.2	79.7
Debt service ratio (total debt service/exports) (per cent)	7.9	8.2	10.6	12.8	14.6	19.8	27.3	27.9
GNP (US$bn)	74.8	89.4	90.1	77.4	80.8	81.5	71.6	66.0
Export of goods and services (US$bn)	22.2	24.9	21.3	19.9	22.2	20.2	16.0	19.5
Imports of goods and services (US$bn)	19.4	25.7	26.7	26.3	24.2	22.2	20.1	21.6

Source: World Debt Tables 1989, World Bank

TABLE 5.6: LDC DEBT ANALYSIS - ARGENTINA

	1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)	27.2	35.7	43.6	45.9	48.9	49.3	49.7	56.8
Proportion of public debt outstanding (Official	19	18	12	11	10	12	13	15
Creditors/Private Creditors) as a percentage	81	82	88	89	90	88	87	85
Average Interest Rates of New Loans (per cent) — All creditors	13.8	11.9	11.1	11.9	10.6	9.8	8.9	8.2
Official creditors	5.8	9.1	9.2	9.7	10.6	9.0	8.6	8.2
Private Creditors	14.3	12.5	11.3	12.4	12.8	9.9	10.3	8.2
Average Maturity period of new loans (years) — All creditors	8.5	13.8	9.0	6.4	18.9	10.7	11.6	12.0
Official creditors	14.1	16.1	14.4	9.6	19.3	18.5	12.8	14.1
Private creditors	8.2	13.3	8.2	5.7	1.9	10.0	6.2	11.1
Debt ratio (external debt/GNP) (per cent)	48.4	63.8	83.8	77.3	67.5	81.5	66.8	73.9
Debt service ratio (total debt service/exports) (per cent)	16.6	17.3	23.1	24.5	24.9	40.6	51.8	45.3
GNP (US$bn)	56.1	55.9	52.0	59.4	72.4	60.5	74.4	76.8
Export of goods and services (US$bn)	12.0	12.4	10.0	10.0	10.3	10.5	9.1	8.6
Imports of goods and services (US$bn)	16.8	17.1	12.4	12.4	12.7	11.4	12.0	12.9

Source: World Debt Tables 1989, World Bank

TABLE 5.7: LDC DEBT ANALYSIS - BANGLADESH

	1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)	4.0	4.5	5.1	5.5	5.6	6.5	7.9	9.5
Proportion of public debt outstanding (Official Creditors/Private Creditors) as a percentage	98 / 2	98 / 2	98 / 2	97 / 3	97 / 3	98 / 2	97 / 3	98 / 2
Average Interest Rates of New Loans (per cent) — All creditors	1.6	2.1	1.7	1.5	1.4	1.1	1.1	1.1
Average Interest Rates of New Loans (per cent) — Official creditors	1.4	1.5	1.5	1.5	1.3	1.1	1.1	1.1
Average Interest Rates of New Loans (per cent) — Private Creditors	7.7	4.2	10.8	6.4	6.0	8.5	n.a.	n.a.
Average Maturity period of new loans (years) — All creditors	34.9	30.9	39.4	37.4	40.1	39.6	40.6	41.7
Average Maturity period of new loans (years) — Official creditors	35.6	35.1	39.9	37.6	40.8	39.7	40.6	41.7
Average Maturity period of new loans (years) — Private creditors	10.3	15.1	10.8	15.3	10.8	10.1	n.a.	n.a.
Debt ratio (external debt/GNP) (per cent)	31.5	31.3	38.5	45.5	40.2	41.0	51.2	54.4
Debt service ratio (total debt service/exports) (per cent)	6.6	7.7	9.8	9.0	10.6	14.1	17.1	16.5
GNP (US$bn)	12.8	14.2	13.1	12.0	14.0	15.9	15.3	17.5
Export of goods and services (US$bn)	1.2	1.3	1.2	1.5	1.6	1.6	1.6	2.0
Imports of goods and services (US$bn)	2.6	2.8	2.9	2.7	2.7	3.0	2.7	3.0

Source: World Debt Tables 1989, World Bank

TABLE 5.8: LDC DEBT ANALYSIS - ZAIRE

	1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)	4.8	4.9	4.8	5.1	5.1	5.9	6.9	8.6
Proportion of public debt outstanding (Official Creditors/Private Creditors) as a percentage	64 / 36	68 / 32	69 / 31	77 / 23	80 / 20	84 / 16	84 / 16	88 / 12
Average Interest Rates of New Loans (per cent) — All creditors	4.7	6.0	2.3	2.0	3.8	2.9	3.5	1.1
Average Interest Rates of New Loans (per cent) — Official creditors	2.6	5.7	1.9	1.8	3.8	2.4	3.1	1.1
Average Interest Rates of New Loans (per cent) — Private Creditors	10.1	7.9	9.0	7.0	n.a.	8.3	5.2	n.a.
Average Maturity period of new loans (years) — All creditors	21.7	24.8	38.7	38.5	36.2	37.3	26.3	38.2
Average Maturity period of new loans (years) — Official creditors	26.5	27.1	40.7	39.5	36.2	40.1	29.6	38.2
Average Maturity period of new loans (years) — Private creditors	9.3	12.2	9.7	14.6	n.a.	7.6	10.2	n.a.
Debt ratio (external debt/GNP) (per cent)	48.2	55.4	54.6	69.6	124.5	148.5	134.4	164.2
Debt service ratio (total debt service/exports) (per cent)	15.2	10.5	7.9	10.0	15.2	16.9	13.8	12.8
GNP (US$bn)	10.0	8.9	8.7	7.3	4.1	4.0	5.2	5.3
Export of goods and services (US$bn)	2.4	1.8	1.7	1.8	2.1	2.0	2.0	1.9
Imports of goods and services (US$bn)	2.9	2.7	2.4	2.3	2.5	2.4	2.5	2.7

Source: World Debt Tables 1989, World Bank

TABLE 5.9: LDC DEBT ANALYSIS - ZAMBIA

	1980	1981	1982	1983	1984	1985	1986	1987
Total external debt (US$bn)	3.3	3.6	3.7	3.8	3.7	4.6	5.6	6.4
Proportion of public debt outstanding (Official Creditors/Private Creditors) as a percentage	70/30	73/27	73/27	79/21	80/20	81/19	85/15	86/14
Average Interest Rates of New Loans (per cent): All creditors	6.5	8.1	6.9	4.6	8.2	2.2	5.3	3.0
Average Interest Rates of New Loans (per cent): Official creditors	3.6	4.6	4.7	4.2	7.1	1.4	4.8	2.8
Average Interest Rates of New Loans (per cent): Private Creditors	8.8	14.5	10.9	9.4	11.6	9.9	10.0	10.8
Average Maturity period of new loans (years): All creditors	17.3	18.1	22.0	25.0	20.9	41.0	31.0	27.6
Average Maturity period of new loans (years): Official creditors	27.4	24.3	29.0	26.6	23.5	42.8	33.1	28.2
Average Maturity period of new loans (years): Private creditors	9.1	6.7	9.1	5.3	12.2	23.3	6.7	5.5
Debt ratio (external debt/GNP) (per cent)	90.5	92.9	101.9	120.3	151.5	195.2	398.6	334.4
Debt service ratio (total debt service/exports) (per cent)	17.8	25.1	16.3	12.2	11.8	10.9	19.1	13.5
GNP (US$bn)	3.6	3.9	3.6	3.1	2.5	2.4	1.4	1.9
Export of goods and services (US$bn)	1.6	1.2	1.1	1.0	1.0	0.9	0.7	1.0
Imports of goods and services (US$bn)	2.0	1.8	1.6	1.3	1.1	1.0	1.2	1.0

Source: World Debt Tables 1989, World Bank.

TABLE 5.10: MULTILATERAL RESCHEDULING AND OTHER DEBT RELIEF SINCE 1980 - FIVE SELECTED COUNTRIES - $US millions

Year	Debt Rescheduled	New Money	Comments
		Argentina	
Commercial Banks			
1983	-	2,800	
1985	4,800	3,700	
1987	29,500	1,550	Includes rescheduling of earlier rescheduled debt
Official Creditors			
1985	2,123	-	
1987	1,600	-	
		Brazil	
Commercial Banks			
1983	4,800	4,400	
1984	5,900	6,500	
1986	16,271	-	
Official Creditors			
1983	2,338	-	
1987	4,455	-	
1988	4,992		
		Mexico	
Commercial Banks			
1983	23,199	5,000	(
1984	-	3,800	(Several reschedulings of
1985	48,100	-	(earlier rescheduled debt.
1987	53,400	7,700	(
Official Creditors			
1983	1,367	-	
1986	1,796	-	
		Zaire	
Commercial Banks			
1980	402	-	(
1983	58	-	(
1984	64	-	(Includes reschedulings of
1985	61	-	(earlier rescheduled debt.
1986	65	-	(
1987	61	-	(
Official Creditors			
1981	276	-	
1983	1,215	-	
1985	458	-	
1986	435	-	
1987	646	-	
		Zambia	
Commercial Banks			
1984	74	-	
Official Creditors			
1983	232	-	
1984	117	-	
1986	276	-	

Source: World Debt Tables 1989, World Bank

CHAPTER SIX

EFFECTS OF THE CRISIS

> For unto every one that hath shall be given, and he shall have abundance: but from him that hath not shall be taken away even that which he hath.
>
> Matthew 25:29

6.1 Causes or effects

6.1.1 In any rigorous and dispassionate analysis of the effects of the debt crisis, attention must be paid to any attribution of causation of adverse social effects. Indeed, one can be dispassionate about examining debt and also be compassionate about resolving the problems that are associated with it. The statement by UNICEF, mentioned in para 1.1.6 that 'half a million children have died in the last twelve months as a result of the debt crisis and recession' can be balanced by the statement in the Treasury submission 'debt is to an important extent a symptom rather than a cause of underlying economic difficulties in debtor countries.' That submission continues

> If debt burdens could be substantially lifted overnight debtor countries would clearly benefit, at least in a short-term financial sense, but many would continue to face large economic imbalances and structural weaknesses which, often for entrenched non-economic reasons, have not been addressed adequately over decades. The result in some cases has been endemic financial instability, inflation and poverty, which frequently remain the primary impediments to growth (The Treasury, Submission, p.S887).

6.2 Economic problems

6.2.1 General economic effects of the debt crisis stem from the initial stimulus of lack of foreign exchange within a country to pay external debts as they fall due, and the response incorporated in subsequent debtor governments' actions to correct the problems. Imports are curtailed, unemployment rises, inflation often runs at over 100 per cent per year and overall economic activity is depressed.

6.2.2 In Africa, imports on a per capita basis have been reduced to the levels of 20 years ago (UN, Financing Africa's Recovery, p.13). As imports provide a major proportion of developing countries' manufactured goods, one result of the constraint on imports is that there is now an urgent need for maintenance, restoration and upgrading of basic physical infrastructure, such as transportation and communication networks, food storage facilities, power stations and distribution systems. This curtailment of imports obviously restricts growth of exports from other countries.

6.2.3 Inflation in many developing countries is closely linked with financial stress arising from the debt crisis. After 1982 the highly indebted countries had to rely much more on internal financing of their public deficits. The fall in net external finance (that is, in their current account deficits) was greater than the reduction in their public deficits. That in turn meant greater reliance on monetary finance and internal debt accumulation. In some countries reduced foreign finance combined with devaluation led to domestic financial crises. Some governments assumed private foreign debt to preserve the country's international credit standing - sometimes under pressure from commercial banks - or to bail out private borrowers. Others made substantial public transfers to keep their financial systems afloat. Such operations further increased the public sector deficit and the need for additional internal

financing. Large exchange rate depreciations and growing reliance on monetary finance caused inflation to accelerate in many of the debtor countries during their stabilisation programs despite falling fiscal deficits.

6.2.4 Table 2.6 compares world and LDC consumer price indexes and illustrates that developing countries have been hit hard by inflation in the 1980s. Table 6.1 shows inflation levels in Argentina and Brazil from 1971 to 1987.

6.3 Social problems

6.3.1 ... and if he has no goods, he shall live on the charity of others, and if others will give him nothing let him die in the name of God ...

> Montague, C.J., 1551, quoted in Australian Bankruptcy Law, D.J. Rose, Law Book Coy Ltd, 1984, p.8.

Such was the attitude to debtors in England in 1551. Official attitudes to debtors may have changed in the intervening four centuries, but in 1989 the end result of economic destitution in poorer, less developed debtor countries has not changed much. UNICEF, in its report 'The State of the World's Children 1989' stresses that

> ... for almost nine hundred million people, approximately one sixth of mankind, the march of human progress has now become a retreat. In many nations, development is being thrown into reverse. And after decades of steady economic advance, large areas of the world are sliding backwards into poverty.
>
> Throughout most of Africa and much of Latin America, average incomes have fallen by 10 per cent to 25 per cent in the 1980s. The average weight-for-age of young children, a vital indicator of normal growth, is falling in many of the countries for which figures are available. In the 37 poorest nations, spending per head on health has been reduced by 50 per cent and on education by 25 per cent, over the last few years. And in almost

TABLE 6.1: INFLATION IN ARGENTINA AND BRAZIL, 1971-1987

(CPI percent December-over-December)

	Average, 1971-80	1981	1982	1983	1984	1985	1986	1987	1988
Argentina	121	131	210	434	688	385	82	175	388
Brazil	38	101	102	178	209	249	64	321	1,006

Source: 1971-1987 World Development Report 1988, World Bank, p.69; 1988 International Financial Statistics, IMF, 1989.

> half of the 103 developing countries from which recent information is available, the proportion of 6-11 year olds enrolled in primary school is now falling.
>
> In other words, it is children who are bearing the heaviest burden of debt and recession in the 1980s. And in tragic summary, it can be estimated that at least *half a million young children have died in* the last twelve months as a result of the slowing down or the reversal of progress in the developing world (op.cit., p.1).

6.3.2 In a discussion of recent public sector decline, the report 'Financing Africa's Recovery' states that

> Another result of the drastic decline in trade in recent years has been to curtail public revenues, heavily dependent as they are on customs receipts, and to thereby constrain public finance. As a consequence, health systems are collapsing for lack of medicines, schools have no books and universities suffer from a debilitating shortage of library and laboratory facilities. Restoring and maintaining essential public sector activities, including education and basic social services, call for foreign subventions directly to Governments' non-developmental budgets. This assistance is of a kind that many donors have hitherto not been inclined to provide. Nevertheless, all these diverse needs have to be weighed in the case-by-case consideration of specific situations by African Governments and their donors (op.cit., pp.16, 17).

6.3.3 In paragraph 1.1.3 above, the World Bank, in its 'World Development Report 1988' starkly describes poverty associated with the debt crisis.

6.3.4 The social and human consequences of the economic decline in many developing countries following the debt crisis can thus be summarised as

- increasing unemployment
- increasing malnutrition and starvation
- increasing food prices
- decline in living standards

- decline in health, education and transport services
- deterioration in infrastructure.

What is happening to hundreds of millions of people in developing countries at the present time in this world of high technology and knowhow and multi-billion dollar investment flows is an avoidable tragedy. The Committee considers that solutions to this **tragedy are the responsibility of Governments of both debtor and creditor countries. The existence of poverty affecting so many people and to such a harsh extent is a telling indictment on the governments of affected countries and on the whole international system, and is based on inequity and exploitation.**

6.4 Resource flow reversal

6.4.1 The developing countries require overseas capital to make the investments required to increase output and raise their standards of living. Being poor makes it very difficult to save enough to pay for the necessary investment. Therefore the governments and banks of the rich countries lend or grant resources to finance the investment and so help countries to grow out of their poverty.

6.4.2 The debt crisis of the 1980's has reversed this normal and economically rational transfer of resources from the capital rich to capital poor countries. Instead large repayments of capital and interest to the commercial banks has caused a massive outflow of funds from those who most need it, the poor countries to the industrial countries.

6.4.3 In 1982, but before the debt crisis began with Mexico's announcement that it was unable to meet its repayment commitments, the commercial banks had begun a rapid and deep cut in their lending to developing countries. This reduction in commercial bank lending is still continuing and is a major cause of the persistence of the debt crisis.

6.4.4 Commercial bank lending (net of principal repayments) to net debtor developing countries (footnote: The 126 countries listed in IMF's World Economic Outlook as net debtors) fell from $US87.8 billion in 1981 to $US59.7 billion in the following year). (See Table 6.2). This fall of $US 18.1 billion in a single year caused severe adjustment problems for countries also facing global recession, falling export prices and historically high interest rates. Twenty five countries quickly found themselves in the same position as Mexico, unable to obtain sufficient resources to meet their commitments and forced to reschedule their debt repayments. There were 85 such reschedulings in the period 1982 to 1987.

6.4.5 Commercial banking lending (net of principal repayments) continued its rapid downward slide and by 1988 this reached a negative flow of $US10.5 billion. In other words the net debtor developing countries repaid $US10.5 billion dollars more than they received from the commercial banks. Clearly this net transfer of resources to the commercial banks is both morally and economically inappropriate. It is a case of the less developed countries cutting their already meagre spending to support the commercial banks in developed countries. Economically it is an inefficient transfer of capital from capital poor countries with high rates of return to capital rich countries with low rates of return. This is the opposite of good economic theory and practice.

6.4.6 Even if net official lending to developing countries (primarily aid loans, export credits and IMF drawings) is added to the net commercial lending there is still a dramatic drop in the net resources available to developing countries of 75 per cent from $US117.4 billion in 1981 down to only $US29.4 billion in 1988. This is because debt related aid flows have shown only a tenuously rising trend whilst commercial lending has dropped to a negative flow. The effect of this is that aid flows are being used to repay the principal owed to commercial banks because the

TABLE 6.2: NEGATIVE RESOURCE TRANSFERS TO THE NET DEBTOR DEVELOPING COUNTRIES

$US Billion

	1981	1982	1983	1984	1985	1986	1987	1988E
A. Net Borrowing from Commercial Banks(1)	87.8	59.7	30.4	16.1	7.5	-8.4	3.2	-10.5
B. Total Net External Borrowing(7)	117.4	102.2	76.6	58.6	43.6	39.7	31.1	29.4
C. Interest Payments(2)	-72.9	-82.5	-77.2	-87.9	-86.7	-85.0	-85.4	-92.2
D. Borrowing Net of Principal and Interest Payments(3)	44.5	19.7	-0.6	-31.3	-43.1	-45.3	-54.3	-62.8
E. Non-borrowed Resources (net)(6)	24.9	24.9	22.2	22.1	32.9	30.3	34.3	37.2
F. Net Resources(5)	69.4	44.6	21.6	-9.2	-10.2	-15.0	-20.0	-25.6

(1) Excludes six off shore banking centres (IMF Table A40)

(2) Includes dividends and other investment income not related to foreign direct investment (IMF Table A38)

(3) D = B - C

(4) F = D + E

(5) Includes official transfers, direct investment, SDR allocation, gold sales and valuation changes (IMF Table A40)

(6) IMF Table A40

Source: IMF, <u>World Economic Outlook</u>, April 1989, Washington DC, 1989.

banks have proved unwilling to support the developing countries. This is in stark contrast to the requirements in both the Baker and Brady Proposals for increased commercial lending.

6.4.7 Even simply focusing solely on capital flows (ie principal only) shows the strong negative influence of the international finance system on the debt crisis. However, this is only part of the debt flow question. Interest payments on the debt must also be considered.

6.4.8 Interest rates were at historically high levels at the beginning of the 1980s due to the tight monetary policies followed in the major industrial countries. Although they declined in the mid 1980s they are now still abnormally high and this has contributed to the very large interest payments (in the order of $85 billion per year) made by the debtor developing countries. These interest payments have rapidly consumed the stagnant level of aid related lending and have accelerated the negative flow of resources.

6.4.9 In 1981 borrowing (net of principal and interest payments) by debtor developing countries added $US44.5 billion dollars to the resources available for the development process. By 1983 borrowing (net of principal and interest payments) contributed nothing to the development process and thereafter this became a large and rapidly growing drain on the resources available for development. By 1988 the flow from poor to rich reached $US62.8 billion.

6.4.10 This huge negative flow consumed not only all the borrowed resources available to the debtor developing countries but also the non-borrowed resources such as direct investment and official transfers (primarily aid grants). Therefore by 1984 all aid flows (both debt and non-debt), all direct investment and all new commercial loans were effectively used up and found inadequate to meet the huge interest payments.

6.4.11 Therefore by 1984 the debtor developing countries were getting no net assistance from the rest of the world and instead were making massive transfers to the industrial countries. These grew from $US9.2 billion in 1984 to $US25.6 billion in 1988. In effect the poorest countries are going without desperately needed consumption and investment goods in order to export them and transfer the resulting income to the industrial countries. This transfer is as high as 6 per cent of GDP for many indebted countries and represents a massive drain on resources urgently required to overcome the poverty and backwardness of these countries.

6.4.12 There is some debate about the size of the negative resource transfers identified in Table 6.2. Major international institutions such as the World Bank have published figures which show large negative net transfers in the 1980s (World Bank Annual Report 1988, Figure 2-3, page 28) while the Development Assistance Committee of the OECD has estimated positive net financial transfers (Development Co-operation 1988 Report, Table III-4, page 53). The statistics used here in Table 6.2 are derived from the Statistical Appendix of the International Monetary Fund's "World Economic Outlook, April 1988".

6.4.13 The Committee recognises that the issue of financial or resource flows to developing countries is complex, and the task of illustrating the extent of the problem is made more complex by different definitions of 'financial flow' or 'resources flow' and by differing definitions of which countries constitute the LDCs. In addition, varying statistical coverage and accuracy of sources produce variations in the measurement of resource or financial flows. Indeed, the OECD Development Assistance Committee estimates that in global terms net financial transfers to all developing countries (including ODA grants and direct investment) remain significantly positive although considerably lower now than at the beginning of this decade. Tables 6.3 and 6.4 illustrate this point. Nevertheless it is also true that there is

TABLE 6.3: NET FINANCIAL TRANSFERS TO LDCs

	Current $US billion						
	1979	Average 1980-82	1983	1984	1985	1986	1987[3]
Sub-Saharan Africa	12	12	10	8	10	13	16
North Africa & Middle East	16	9	5	7	8	6	4
Asian LICs	10	12	12	14	17	17	22
Other Asia	5	6	9	1	-3	-2	-2
Western Hemisphere	28	30	-8	-8	-15	-10	-4
Other and adjustments[1]	7	8	-2	5	3	3	-2
Total LDCs[2]	78	77	27	27	20	27	34
For reference:							
Least developed countries	9	10	9	9	10	12	13

1. Europe, Oceania, unallocated and other adjustments.
2. Excluding Gulf countries and Taiwan.
3. Provisional.

Source: Development Co-operation OECD 1988

TABLE 6.4: TOTAL NET RESOURCE FLOWS TO DEVELOPING COUNTRIES

	Current $US Billion									Per cent of total		
	1980	1981	1982	1983	1984	1985	1986	1987	1988	1980	1985	1988
OFFICIAL DEVELOPMENT FINANCE (ODF)	45.6	45.6	44.3	42.4	47.7	49.0	56.1	62.0	67.0	35.5	58.5	65.1
1. Official development assistance (ODA)	37.8	36.9	34.0	33.9	35.0	37.4	44.3	48.4	51.0	29.5	44.6	49.6
of which: Bilateral disbursements	30.0	29.0	26.4	26.3	27.2	28.9	34.8	38.3	40.0	23.4	34.5	38.9
Multilateral disbursements	7.8	7.9	7.6	7.6	7.8	8.5	9.5	10.1	11.0	6.1	10.1	10.7
2. Other ODF	7.8	8.7	10.3	8.5	12.7	11.6	11.8	13.6	16.0	6.1	13.8	15.5
of which: Bilateral disbursements	3.0	3.0	3.7	1.3	4.5	3.7	4.0	6.6	8.0	2.3	4.4	7.8
Miltilateral disbursements	4.8	5.7	6.6	7.2	8.2	7.9	7.8	7.0	8.0	3.7	9.4	7.8
TOTAL EXPORT CREDITS	16.5	17.6	13.7	4.6	6.2	4.0	-0.6	-0.7	3.0	12.9	4.8	2.9
1. DAC countries	15.4	16.2	12.7	3.9	5.2	3.4	-0.8	-1.0	2.6	12.0	4.1	2.5
of which: Short-term	1.8	2.9	3.0	-3.5	0.3	3.2	3.0	4.1	3.6			
2. Other countries	1.1	1.4	1.0	0.7	1.0	0.6	0.2	0.3	0.4	0.9	0.7	0.4
PRIVATE FLOWS	66.2	74.5	58.3	48.1	31.7	30.8	28.2	35.6	32.9	51.6	36.8	32.0
1. Direct investment (OECD)	11.2	17.2	12.8	9.3	11.3	6.6	11.3	20.2	19.0	8.7	7.9	18.5
2. International bank lending	49.0	52.0	37.6	34.7	16.4	13.6	5.0	5.6	4.7	38.2	16.2	4.6
of which: Short-term	26.0	22.0	15.0	-25.0	-6.0	12.0	-4.0	5.0	-			
3. Total bond lending	1.6	1.5	5.0	1.2	0.3	4.8	3.3	1.0	1.6	1.2	5.7	1.6
4. Other private	2.0	1.8	0.6	0.6	1.1	2.9	5.3	5.5	4.0	1.6	3.5	3.9
5. Grants by non-government organisations	2.4	2.0	2.3	2.3	2.6	2.9	3.3	3.3	3.6	1.9	3.5	3.5
TOTAL NET RESOURCE FLOWS	128.3	137.7	116.3	95.1	85.6	83.8	83.7	96.9	102.9	100.0	100.0	100.0
Related data												
Use of IMF credit, net	2.6	6.1	6.3	12.5	5.4	0.8	-1.4	-4.7	-4.3			
Net capital outflows by LDCs	-10.9	-14.6	-10.5	-6.6	-10.8	-12.8	-6.8	-9.0	-9.5			
Flight capital (estimated)	-27.0	-36.0	-31.0	-24.0	-16.0	-14.0	-12.0	-11.0	-14.0			
Interest & dividends paid by LDCs, gross	-63.6	-86.4	-94.0	-80.6	-86.8	-88.7	-76.2	-74.7	-86.0			
	At 1987 Prices and Exchange Rates											
Total net resource flows	169.4	188.9	163.5	134.1	123.4	119.4	96.3	96.9	96.0			
Total Official Development Finance	60.2	62.4	62.3	59.8	68.8	69.8	64.5	62.0	62.5			
Total ODA receipts from all sources	49.9	50.6	47.8	47.8	50.4	53.3	51.0	48.4	47.6			
Total DAC ODA (bilateral & multilateral)	36.0	35.1	39.1	38.9	41.4	41.9	42.2	41.5	44.3			

Source: OECD, Financing and External Debt of Developing Countries, 1988 Survey

a net outflow of funds from the major debtor countries. Regardless of these variations in the measurement of the size of resource flows it is clear that on all measures the resources available to developing countries have fallen dramatically and aid resources have indirectly funded the repayment of commercial creditors.

6.4.14 A solution to the debt crisis will need to address the large negative transfers in the commercial financing sector. Commercial banks are having their debt paid back and are receiving large interest payments paid for by official transfers. The Committee **recommends that**

R4. in return for this indirect official support, the commercial banks should be required to participate in the debt and debt service reduction proposals, such as the Brady proposal, which are currently being promoted.

CHAPTER SEVEN

COMMERCIAL AND OFFICIAL DEBT

7.1 General

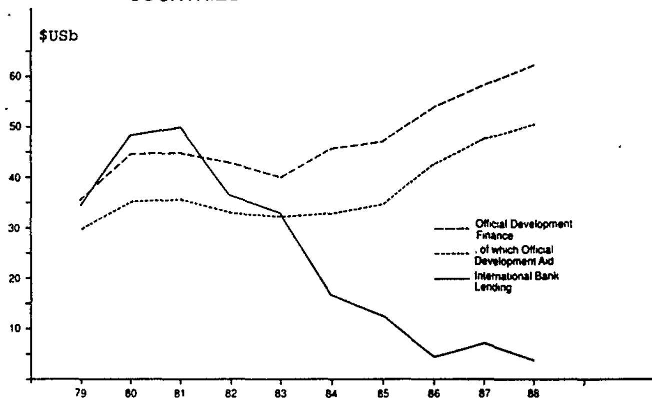
7.1.1 The initial contractionary response of the international banking sector to the 1982 debt crisis has continued. In 1988 international bank lending of $US4.7 billion to developing countries was less than one tenth of its historically high level in 1981 of over $US50 billion. Commercial lending has thus all but ceased in seven years. Similarly the flow of export credits to LDCs declined from a 1981 peak of over $US17 billion to effectively zero by 1986. By contrast, the rock on which many developing countries rely, particularly the less developed countries, has been the constant and generally gradually increasing levels of official fund flows in the form of official development finance (ODF) consisting of aid and other official flows. Figure 7.1 shows the stark reality of the drastic decline in flow of commercial bank funds to developing countries compared with the increasing official flow of funds.

7.2 *Commercial financial flows and debt*

7.2.1 Collapse of international bank lending has to some extent been offset by an increase in direct investment. This direct investment is a useful form of resources flow to developing countries, as by its nature it does not add to the stock of debt. Dividend payments on direct investment obviously lead to an outflow of funds when profits are made.

7.2.2 The collapse of international bank lending is devastating to developing countries. **Measures to encourage private lending should therefore be an integral part of overall plans to alleviate the debt problem.**

FIGURE 7.1: SELECTED RESOURCE FLOWS TO DEVELOPING COUNTRIES



Source OECD, Development Assistance Committee

7.2.3 Given that new private money flows would be based on commercial decisions, one of the key factors encouraging such flows would be increasing the creditworthiness of debtor countries. As banks (ie, their managements and ultimately their shareholders) have sustained massive losses from the market discounting of the face-value of some loan instruments, and face, in reality, more losses from such discounting in the future, they are understandably reluctant to increase loan funds into high risk and recent loss-making areas. In the light of this risk awareness and need for commercial confidence, in March 1989, Nicholas Brady, US Secretary of the Treasury outlined new suggestions for dealing with the international debt crisis, including debt reduction.

7.2.4 In his statement putting forward his suggestions Brady referred to the new debt strategy of 1985 (ie, the Baker plan) and commented that it 'still makes sense'. He reiterated the fundamental principles of the current debt strategy and claimed that they remain sound:

- growth is essential to the resolution of debt problems;
- debtor nations will not achieve sufficient levels of growth without reform;
- debtor nations have a continuing need for external resources; and
- solutions must be undertaken on a case by case basis.

7.2.5 The Brady plan incorporates the following proposals:

- that debtor nations must focus particular attention on the adoption of policies which can better encourage new investment flows, strengthen domestic savings and

promote the return of flight capital. He noted that total capital flight for most major debtors is roughly comparable to their total debt;

. that the creditor community - banks, IFIs, and governments should provide more effective and timely financial support:

- banks need to work with debtor nations to achieve both debt and debt service reduction and to provide new lending;

- debtor nations should maintain viable debt/equity swap programs and should encourage their own citizens to engage in such transactions;

- consideration should be given in some cases to ways of differentiating new from old debt;

- IFIs should promote sound policies in the debtor countries through advice and financial support. The IMF and World Bank could provide funding as part of their policy based lending programs for debt or debt service reduction purposes. A portion of their policy based loans could be used to finance or guarantee specific debt reduction plans. These measures could serve to strengthen prospects for greater creditworthiness and to restore voluntary private financing in the future;

- creditor governments should continue to reschedule through the Paris Club, and should consider how to reduce impediments to debt reduction.

. that there should be more timely and flexible financial support; and

. that sound policies and open growing markets within the industrial nations will continue to be an essential foundation for efforts to make progress on the debt problem (N. Brady: Speech to Brookings Institution and Bretton Woods Committee, USA, March 1989).

7.2.6 The significant difference between the Baker and Brady Plans is that the latter encourages debt and debt service reduction, involves the IMF and World Bank in funding and supporting such reduction programs, and subordination of existing debt.

7.2.7 The Brady initiative endorses the case for acceptance of debt reduction as the prime tool to end the negative resource transfer problem. The first success of the plan is an agreement between the commercial banks and Mexico which includes provision for a debt reduction of 35 per cent. But a major scale of debt reduction is essential for establishing conditions for renewed growth in most debtor countries. In this connection, the Committee draws attention to the fact that debt instruments for some developing countries are being sold at heavy discounts in the market, in some cases as low as 10 per cent of face value. The Committee is of the view that in the process of facing the world debt problem, it is inevitable that creditor countries will have to reduce debt stock; for some debtor countries by significant amounts. Such debt reduction is already proceeding in some countries which are unable to service existing debts and which have no prospect of ever being able to do so. To this end, the Committee **recommends**

R5. a significant reduction in the amount of world debt stock, with appropriate variation country-by-country depending on ability to pay as measured by export earnings and volume of debt.

7.2.8 Bearing in mind the above comments on debt stock reduction, the Committee is also of the view that an equally pressing priority is to alleviate the world's debt problem by reducing interest rates on existing debt.

7.2.9 The cost of servicing the remaining debt should be further reduced. The Committee therefore recommends that

R6. with regard to remaining debt, measures should include, where appropriate:

- rescheduling of principal repayments;
- reduction of interest rates to concessional levels; and
- recycling repayments by allowing local currency repayment into reinvestment funds with repatriation constraints (in order to provide investment resources for developing countries as well as limiting outflows).

The Committee is also of the opinion that these steps are appropriate to complement the Brady initiative and should be supported by the necessary regulatory and tax treatment to permit and induce banks to participate and to give priority to participating banks over non-participating ones.

7.2.10 The Brady initiative relies heavily on appropriate debtor country economic policies to reverse capital flight from debtor countries as a necessary condition for success of the approach. Reduction of capital flight is certainly a substantial potential source of additional investment. But this cannot be achieved until the investment environment in the debtor countries is attractive. Policies to achieve this goal should be part of the economic reforms which accompany debt reduction schemes. When

such changes are being implemented by debtor countries the Committee recommends that

R7. the industrialised countries assist the process by co-operative steps including:

- disclosure by tax authorities in the countries concerned;
- disincentives to capital flight such as taxation in the country of inflow; and
- recycling of at least a share of the funds to developing countries.

7.3 Debt Management Authority

7.3.1 Overall management of debt reduction and adjusting the debt service structure cannot be left to the private sector alone. Public sector resources will be required to support guarantees of claims remaining after adequate debt reduction. Co-ordination is required to ensure that the scale of debt reduction, reduction of resource transfers and accompanying debtor country policies are sufficient to make payments on these guarantees unlikely. Movement towards those goals would be greatly assisted by the French proposal to use an SDR facility through the IMF, Japanese support for an independent debt management authority or the US Congressional mandate to the Treasury to study and negotiate for such an authority. A facility of the World Bank would be an appropriate vehicle to perform these functions.

7.3.2 Debt reduction as a solution to the debt crisis is being actively promoted by the major industrial countries under the leadership of the United States. However the next step of agreeing on a practical mechanism for fostering debt reduction

has not yet been undertaken. Fortunately, there is a practical example of a functioning debt reduction mechanism which has attracted significant and growing support.

7.3.3 The best known precedent for governments establishing an institution to reduce debts comes from the US. In the 1970s New York City faced its own debt crisis. That debt crisis was solved by establishing the Municipal Assistance Corporation (MAC) to refinance and restructure New York City's debt.

7.3.4 The former head of the MAC, a prominent US investment banker, Felix Rohatyn, has proposed that a similar institution be established to refinance and restructure the debt of developing countries. This proposal has been widely supported in banking and political circles. Supporters include James Robinson, Chairman and Chief Executive of American Express, Syazawa Okita, former Japanese Foreign Minister, Kiichi Mi, former Japanese Finance Minister, President Mitterand of France, Paul Sarbanes, David Obey, John LaFalce, Bruce Morrison, Charles Schumer of the US Congress and President Carlow Perez of Venezuela. This proposal also has the support of many non-government aid agencies including the Australian Council for Overseas Aid.

7.3.5 A debt reduction institution, commonly called the Debt Management Authority (DMA), would operate through the secondary market for developing country debt. In this market the DMA could purchase the debt at a large discount on the face value of the loan (ie, the debt sells for less than the amount the debtor is ultimately expected to repay). These discounts are substantial, generally being over 50 per cent and even rise to 90 per cent for countries such as Bolivia.

7.3.6 Clearly this secondary market operates to provide debt reduction. All that is required is a suitable institution such as the DMA to pass this reduction on to the debtor countries rather than private purchasers. Generally debtor countries are excluded

from buying back their own debt by covenants on the original loans and by lack of finance.

7.3.7 Finance required by the DMA would be very modest compared to current funding of institutions like the IMF and World Bank. ACFOA (G. Barrett, Prospects for a Debt Management Authority, ACFOA 1988) has estimated that for an equity contribution of $US3 billion about $600 billion of debt could be purchased. This is practically all the third world debt held by commercial banks. The DMA would be able to reduce this debt by about half and save the debtor countries around $US30 billion in annual interest payments. This saving is double the current level of grant aid to developing countries and would wipe out their combined current account deficit. This is a major benefit for a very modest investment.

7.3.8 The key to this large benefit is the use of markets. The DMA would be a financial institution which would use its equity capital as a base to borrow in the international market for the purpose of buying heavily discounted debts. In this way liabilities would be covered by assets and the gearing and discounts would facilitate the purchase of a large amount of debt.

7.3.9 The $US3 billion of paid up equity could be raised by direct contributions from governments in the same way as the World Bank currently raises its capital. An alternative has been suggested by President Mitterand whereby the IMF would be authorised to issue an increase in its currency, the SDR, which would be used to fund the Debt Management Authority.

7.3.10 The DMA would require considerable expertise in financial management. Fortunately the World Bank is renowned for its innovative and successful financial management. The DMA could readily be established as a separate agency in the World Bank and so gain access to the Bank's expertise and staff. This would

achieve considerable cost economies. This approach has a number of precedents. Most recently the Multilateral Investment Guarantee Agency was set up as part of the World Bank Group. Membership is voluntary.

7.3.11 Together with the benefits to the debtor countries which would come from the transfer of resources from debt service to development purposes, the commercial banks, industrial country exporters and the international financial system would benefit from the DMA. The commercial banks would bear the cost of the discounts on the debts sold but in return they would receive a substantial cash injection and be able to draw down their substantial reserves held against those loans. The industrial country exporters would benefit from regaining markets in debtor countries which were forced to make very large cuts in imports in order to transfer funds to debt servicing. The stability and efficiency of the international financial system would benefit greatly from reducing developing countries' debt burdens down to their actual ability to pay rather than building up future debt as debt service is postponed.

7.3.12 While there is considerable support for the DMA approach there have also been substantial criticisms including from the Australian Treasury which opposes the DMA proposal. These criticisms are discussed below.

- It is argued that the DMA would involve the public sector taking over private risks at the taxpayers' expense. But an examination of the figures on lending to the debtor countries indicates that the official lenders have already taken over responsibility for the great bulk of new lending. In contrast the commercial banks have used the increased official involvement to obtain a repayment of their old loans. From 1985 to 1988, official creditors provided some 80 per cent of total financing flows to developing countries compared

to 35 per cent in 1980-82 (World Economic Outlook, IMF, April 1989). In 1988 total liabilities owed by developing countries to private sources (principally commercial banks) fell by 1.5 per cent (World Economic Outlook, IMF, April 1989). The commercial banks are already indirectly transferring their risks and loans to taxpayers. It could be argued that the DMA would minimise this transfer by borrowing private funds in the capital market and obtaining significant discounts from the banks.

- It has been suggested that the DMA would encourage countries to borrow commercially in the expectation that the DMA would take over these loans. This is arguable at best. The assaults on national sovereignty to which debtor countries are subject from bodies such as the IMF and World Bank would be far more than sufficient to discourage any country from voluntarily seeking problem debtor status.

- There is some concern that the DMA would attract funds away from existing aid expenditures. Naturally this is a potential problem with any new aid proposal. However the funds required by the DMA are modest compared with other international bodies and would be spread over several years as the debts are purchased. Given the international concern over the debt crisis and the recycling of surpluses from Japan and Germany, it is reasonable to hope that most of the DMA's funding would be additional to existing aid. Of course the SDR proposal of President Mitterand is additional funding and at no cost to taxpayers.

- Some point to a 'free-rider' problem if not all banks participate in the DMA. 'Free-riding' is already a major problem with many commercial banks refusing to

participate in debt rescheduling and new money programs for debtors. The DMA will provide a more comprehensive framework for providing incentives for participation and disincentives to 'free-riding' than are currently available.

- It has been argued that the DMA would allow the commercial banks to escape their responsibility to continue to provide adequate levels of new lending. Yet under the debt reduction strategy now adopted commercial banks are being asked to cancel debts and reduce debt service as an alternative to the debt expanding new lending strategy.

- Another criticism is that the DMA would undermine the enforceability of IMF and World Bank conditionality. Putting aside the need to reform conditionality which is discussed elsewhere, the DMA would be even better able to enforce conditionality because the debt reduction process is likely to take place over several years and could be cancelled at any stage.

- There is some concern that countries which are not experiencing the worst effects of debt rescheduling would not receive the same benefits as better performing countries. Firstly many of these better performing countries, such as Indonesia, have avoided debt rescheduling because they already receive preferential treatment in aid flows. Secondly, these countries could also benefit from debt reduction because even countries like Colombia, which has not rescheduled its debt, have very large discounts on their debt in the secondary market.

7.3.13 Taking account of these criticisms and the expected benefits of the DMA proposal the Committee recommends that

R8. the Australian Government in co-operation with other supporting countries such as France should formally recommend to the World Bank that a proposal for a DMA be prepared for consideration by member countries.

7.4 Official fund flows and debt

7.4.1 Following the 1982 Mexican debt crisis and the severe decline in international bank lending the official sector of the world's financial system has been instrumental in avoiding widespread chaos in the developing world. In the years following 1982, official development assistance (ODA or 'aid') and total official development finance have been increasing every year. The Committee in an earlier report of February 1989 recommended that

R9. the Government implement a policy of rapid growth in Australia's ODA as a proportion of GNP: by 1992 Australian aid should once again stand at 0.5 per cent of GNP. This Committee reiterates this earlier recommendation.

7.4.2 Such an increase in Australian aid would have an effect on total world ODA levels and on the international aid climate. But similar action is needed by other donor countries and therefore the Committee recommends that

R10. the Government vigorously press in international forums for a general increase in ODA from donor countries.

7.4.3 Official development assistance is generally distributed among low income countries, however the highly indebted middle income countries have critical debt problems, and a growing number of people living in poverty, but receive little in the form of aid. Even if there were a large increase in world aid to existing recipients, highly indebted countries such as Mexico, Brazil and Argentina would hardly benefit. The Committee however

considers that the existing practice of current aid levels being directed to lower income countries is sound.

7.4.4 When examining possible solutions for the world's debt problem which involve significant debt write-offs or concessional interest terms on existing debt, it is useful to consider to what extent donor countries would class such write-offs and interest concessions as aid. The Committee is aware that under certain circumstances debt relief measures can be classed as ODA. Because of the small official exposure of Australia to problem debtors, this question is not currently relevant for Australia, but the propensity of suggested debt relief schemes to distort current world aid distribution patterns away from low income countries towards highly indebted middle income countries should be examined. The Committee considers that current low income aid recipient countries should not be disadvantaged by any debt relief programs which extend to middle income countries.

Official Debt

7.4.5 Low income African countries face uniquely difficult economic development problems. Their human resources and their frequently fragile physical environments remain in peril. Their development in the near future depends more upon official than upon private external finance, and their external debts are primarily to governments. The Toronto summit set an important precedent by authorising debt reduction in connection with rescheduling in the Paris Club. The need of African and other low income countries for external resource flows and debt reduction has not yet, however, been adequately addressed. For most of these countries recovery has yet to begin.

7.4.6 For these countries the Committee therefore recommends:

R11. . a write down of a significant portion of the Paris Club debt;

- a moratorium of ten years on all official interest payment obligations;
- the use of International Development Association terms for these rescheduled payments;
- that the budgetary costs of these debt reductions be added to aid donor commitments and not be taken from existing aid allocations;
- that aid donors who have not already done so plan now a program of cancellation of their aid-related debts;
- significant expansion of concessional resource flows;
- the development of improved means of encouraging the restoration of eligibility for those countries in arrears to the IMF; and
- that the IMF consider the sale of a portion of its gold holdings to finance additional multilateral concessional lending to low-income debt-distressed countries.

7.5 International Financial Reform

7.5.1 The discussion in this Chapter flags the need for reform of the international financial system, and that Australia should be more supportive of such reform. Increased Australian activity in this area would raise Australia's international standing. In addition, Australia's exports would be encouraged if the current financial restraints were reformed, and Australia would enjoy the systemic benefits from a reformed financial system. As a vehicle for this reform the Committee recommends that

R12. the Australian Government support calls from other countries for a global conference on international financial reform.

7.5.2 Immediate international actions that Australia should support would include a renewal of the issue of SDRs and the restoring of access to IMF and World Bank credits for excluded countries.

CHAPTER EIGHT

AUSTRALIA'S ROLE IN SOLUTIONS TO THE DEBT CRISIS

8.1 Overview

8.1.1 It is useful to retain a perspective of the problem vis-a-vis the terms of reference of this Inquiry and the position of Australia. Australia is a small industrialised country possessing something in common with developed countries, eg, OECD membership and IMF developed country status; and with developing countries, eg, reliance on commodity exports and serious continuing current account deficits and mounting foreign debt. This inquiry is into **appropriate Australian policy responses** concerning, inter alia, foreign debt. Thus while it can be shown that there are many desirable policy prescriptions for both debtor and creditor countries, **Australian policy responses** will have to be directed through channels where they may at least be listened to, ie, in international forums such as the World Bank, the IMF, the Paris Club, the UN and the OECD.

8.2 Australia's role

8.2.1 Australia's financial involvement in the IMF includes:

- maintaining the value of Australia's obligations to the IMF (this involves payment to or from Australia depending on the movement of the $A vis-a-vis the SDR); and
- payment of SDR interest, charges and assessments.

In addition, under the provisions of Article IV of the Fund's Articles of Agreement the Fund conducts regular consultations

with all member countries, the purpose of which is to provide the Fund with detailed and accurate information about the economic situation of each member and about the conduct of its economic policies. In March 1988 an IMF Staff Mission visited Australia for an Article IV consultation. The Mission had discussions with the Treasury, other Commonwealth Departments and the Reserve Bank. In accordance with the Fund's practice, a staff report on the Australian economy was subsequently prepared and discussed in the Fund's Executive Board in June 1988. Board discussions of these reports on member countries are confidential and the reports are not publicly released.

8.2.2 Australia's financial involvement in the World Bank includes:

- payments associated with Special and General Capital Increases;
- replenishments of IDA;
- payments associated with the subscription on increase in the capital of the IFC; and
- payments (or reimbursements) maintaining the value of Australia's share of the Bank's capital.

In addition, with the consent of the Australian Government, the IBRD borrowed $A245 million in the Eurobond market during 1987-88 as part of its borrowing program on international capital markets. These Australian dollar raisings were swapped into other currencies. Australia co-financed a number of World Bank activities out of its overseas aid budget in 1987-88. Disbursements on these activities totalled approximately $A11.3 million. In 1987-88 the IBRD and IDA disbursed $US111.2 million in payments for Australian sourced goods and services, which represented 1.2 per cent of total disbursements.

8.3 Australia's policy involvement

8.3.1 Australia's inputs into formulation of IMF and World Bank policy are through the actions of the Governor for Australia (in the case of both the IMF and the World Bank, the Treasurer, Mr Keating) or the Executive Director for the constituency which includes Australia.

8.3.2 In September 1988 Mr Keating made a plenary statement at the IMF/IBRD meetings and a statement at the IMF interim committee. In this statement, the Treasurer said that:

- lower inflation, being a fundamental condition for growth, has increased confidence and stimulated consumption and investment in many countries;
- there is a need for, and has been progress on, structural reform;
- inflationary pressures, continuing large current account imbalances and persistent protectionist attitudes should be resisted;
- Japan, in deliberately increasing domestic demand has played a key role in the international economic arena, but the USA should move away from monetary policy towards fiscal policy;
- the freeing up of international trade is the single most effective means of promoting structural change and improving the medium term growth prospects for developed and developing countries alike;
- Australia supports the strengthening of the IMF's facilities and of its surveillance, in particular,

there should be a substantial increase in, and a realignment of, IMF quotas;

- Australia plans to make a substantial subscription to the World Bank's general capital increase in 1989;

- the World Bank's role in resolving debt problems must encourage effective adjustment and not replace private debt with public debt - this means the commercial banks must play their full part; and

- the World Bank has sharpened the focus of its attack on poverty - the lot of the poor can be improved through the fairer application of taxes and subsidies and more realistic exchange rates. Much of the Bank's investment lending has a direct impact on poverty, this impact should be maximised.

8.3.3 Considering the continuing world wide criticism of the IMF and the World Bank to deal adequately with the debt situation on advice from Treasury officials and bankers, in view of the difference between the IMF, purely a financial institution, and the World Bank, the latter being principally a development agency, the Committee **recommends that**

R13. the task of Australian representation on World Bank bodies should be transferred to the Minister for Foreign Affairs and Trade and his Department. The Committee also considers that Foreign Affairs and Trade representatives will be more sensitive than financial experts or bankers to social, trade and foreign affairs implications of decisions that threaten social stability and have grave environmental and ecological implications.

8.3.4 The Committee **recommends that**

R14. other domestic actions which Australia should take should include:

- **reviewing our banking regulations with a view to encouraging private banks to reduce debts;**

- **regular reporting by the Treasurer to Parliament on Australia's policy stance in the IMF, World Bank and other international debt forums;**

- **establishing a mechanism for consultations between Government and NGOs on Third World debt and other international financial issues; and**

- **providing access to policy and background papers by the IMF, World Bank and other international organisations.**

8.4 **Increased aid and resources for international bodies**

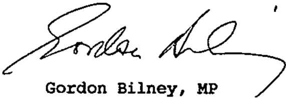
8.4.1 These specific recommendations should not neglect wider issues of development strategy which must be addressed by the international community. The Committee **recommends**

R15. increased concessional aid flows, support for future general capital increases of the World Bank to increase development lending, doubling of IMF quotas, and similar expansions in the capital base of the regional development banks and of the International Fund for Agricultural Development.

8.4.2 The Committee **recommends**

R16. that the Government give strong support to international financial institutions in any actions taken concerning

proposals outlined in this report. In particular, the Committee recommends that the Australian Government, in order significantly to influence decisions made in international financial institutions and in foreign capitals, should apply vigorous diplomatic pressure on other participants at the start of any decision making process.



Gordon Bilney, MP
Chairman

November 1989

DISSENT

Dissent by Senator N.A. Crichton-Browne, Senator R. Hill, Senator D.J. MacGibbon, Senator G.E.J. Tambling, Mr R.G. Halverson, OBE, MP, Mr N.J. Hicks, MP, Mr D.F. Jull, MP, Hon. R.C. Katter, MP, Hon. M.J.R. MacKellar, MP, Mr G.B. Nehl, MP, Mr P.M. Ruddock, MP, Mr R.F. Shipton, MP.

1 Overview

1.1 This report fails to recognise the underlying operation of the commercial banking system around the world in voluntarily mobilising capital funds to seek a profit. If conditions in a developing country do not offer sufficient incentive, needed capital will not be forthcoming. Trends indicate that an increasing proportion of capital flows to developing countries will come from official rather than commercial sources.

2 Underlying nature and causes of the debt problem

2.1 While increasing debt levels in the third world have led to severe economic and social difficulties in some developing countries, it is considered that the main focus of governments of creditor and debtor countries, and of responsible international bodies should be on the fundamental economic causes leading to unsustainable debt levels. Programs of short term palliatives such as rescheduling only postpone the debt problem, while debt forgiveness would obviously be useful to some developing countries. However, if the underlying economic malaise in those countries continues, either they will not attract the vital capital they need, or they could enter a morass of debt again, either option being equally undesirable.

2.2 In this context, it is essential that international financial bodies such as the IMF and the World Bank continue to impose sensible and appropriate economic policy conditions on

countries which use the services of those bodies. These economic policy conditions should include:

- maintenance of realistic exchange rates;
- cuts in subsidies;
- realistic food prices to producers to encourage domestic production of food; and
- expectation of appropriate return on capital for commercial project investment.

2.3 Figure 7.1 and Table 6.4 show the significant decline in capital flows to developing countries during the 1980s, and while living standards in some countries have declined during this time, it appears obvious that those living standards that were inflated inter alia by unsustainably high capital inflows in the late 1970s and early 1980s must necessarily decline along with the decline of capital inflow down to levels which are sustainable and which can reasonably be serviced. Indeed, the claim in para 6.4.3 that the reduction in commercial bank lending as a major cause of the persistence of the debt crisis is a weak argument in that if bank lending to LDCs had continued at the high 1981 levels as shown in Figure 7.1 and Table 6.4, the debt crisis would be orders of magnitude worse than it is now. Paragraphs 6.4.6 and 6.4.9 raise similar arguments about the heavy inflow of capital into the LDCs in the early 1980s. Quite obviously these inflows, if wisely spent, would have been beneficial in the short term to the recipient countries, but the longer term legacy was crippling debt.

3 Commercial incentives and concessional assistance

3.1 While developing countries want to continue to tap the commercial sector (including banks and the main stream of World Bank funds) for development funds the <u>incentive</u> for a return on capital <u>must</u> exist:

- the risk of default of repayment must be sufficiently low; and
- the interest rate must be sufficiently high;

otherwise, commercial funds will simply not be forthcoming.

3.2 Sections of the report imply that commercial banks have an obligation to support developing countries. This is simply unrealistic. The cold, hard fact is that in the commercial sphere, the obligation is in large measure to the shareholders.

3.3 Any need that developing countries have for foreign capital, but which has no commercial incentive, should be provided on concessional terms. In other words, the provision of these funds must be subsidised. It should be borne in mind that such subsidies are provided at taxpayers' expense, usually through aid votes. Although world-wide aid funds have been slowly increasing in recent years (see Figure 7.1), it should not be expected that aid funds will grow in the future as rapidly as commercial funds decreased in the mid 1980s. It is becoming increasingly clear that the role of the creditor countries in providing capital flows to the LDCs is being increasingly borne by the taxpayers in the creditor countries and that shareholder risk is rapidly being shed.

4 Resource flow reversal

4.1 The report, at section 6.4, discusses the 'resource flow reversal' and emphasises, in a number of places, the claimed negative nature of the resources flow, ie, that resources flowed from poor to rich in 1988 to the tune of $US62.8 billion. The argument and apparent facts behind these claims are less than rigorous.

4.2 Evidence received by the Committee (p. S907) points out the realistic situation that 'negative net financial transfers

(the difference between net capital inflow and interest payments) will result from any debt accumulation process.' When a loan is made and repaid, the creditor will receive a net income of interest, and this is a perfectly normal situation from which both parties benefit.

4.3 The internal inconsistency in the figures used in section 6.4 is obvious. The reference in para 6.4.12 to the World Bank publishing figures showing large negative net transfers in the 1980s should be read carefully along with the World Bank's definition in its 1988 Annual Report (p.26) of net transfer of financial resources as being the difference between gross disbursements and total debt service. When aid flows are taken into account, it can be seen quite clearly from Tables 6.3 and 6.4 that the 'resources flow' from North to South is continuing and is not reversed.

5 The proposal for a Debt Management Authority (DMA)

5.1 The report recommends (R8.) that a proposal for a DMA be prepared for consideration by member countries.

5.2 The report does not give due weight to arguments against a DMA. Some of these arguments on the DMA proposals are at pp.S915-S917 of Submissions and are as follows:

- Costs and risks would be shifted to taxpayers from the private sector (specifically from commercial bank shareholders). Quite apart from the inequity of such a transfer, there is the argument that the separation of commercial decisions from their consequences will lead to future sovereign lending decisions which anticipate official intervention in the event that this lending runs into difficulties.

- They would involve a substantial direct financial cost to taxpayers in industrial countries and the assumption by them of large contingent liabilities. Given widespread government budget constraints, it is unlikely these costs would be borne without at least some cuts in support for other forms of multilateral assistance, including aid to lower-income countries.

- There would be an incentive for individual banks not to join the scheme if they judged that other banks' participation would improve the debtor's capacity to service remaining debt at full face value (the so-called 'free-rider' problem). Banks' participation, and the amount of debt reduction achieved under the scheme, would depend heavily on the price at which debt was bought by the facility.

- it is likely that the facility would, at least initially, discourage rather than encourage new bank lending, enabling banks to shift a greater proportion of the new financing burden onto the official sector (directly or through official guarantees). Having realised significant losses on their developing country loan portfolios, with smaller claims to protect, and with the public sector assuming a major share of creditor responsibility under the debt strategy, banks would be unlikely to provide adequate levels of new lending until commercial creditworthiness was fully restored.

- There could be a reduced incentive for debtor countries to adjust their economies. While access to the facility could be made conditional on continued performance under an adjustment program, the scheme would signal to debtors that large-scale debt forgiveness was widely available and lead to political

pressures for access to the facility at relatively low conditionality - or for the alternative of unilateral suspension of debt service.

- There are also issues relating to equity as between debtor countries which have implemented strong adjustment measures and those whose adjustment efforts have lagged. Substantial debt relief would be provided to countries with a history of poor economic management, while those countries which avoided debt problems, or have achieved substantial adjustment, would receive little or no benefit.

5.3 The proposal for setting up another international bureaucracy (ie, a DMA) is fraught with difficulties. A DMA could pressure banks into non-commercial deals and in the long run, drive banks further away from assisting developing countries. The proposal is the thin end of the wedge of international bureaucratic dirigism.

6 Australia's aid effort

6.1 Recommendation 9 suggests that Australian aid should increase, in proportion, to stand at 0.5 per cent of GNP by 1992. At current prices this would require roughly $500 million more per annum by 1992 from the Government budget. Such a proposed extra drain on Government funds should be examined against Australia's then economic circumstances.

7 Long term view on solutions

7.1 Apart from increasing the emphasis on improving economic management in debtor countries, there is a bullet to bite. Some debtor countries can not and never will be able to service their current debt levels, and others may try to do so at great detriment to their people.

7.2 Commercial and official debt write-offs are already occurring and <u>there is a need for increasing levels of these write-offs</u>. These write-offs should however continue on a case by case needs basis as determined by commercial agreement or by agreement of the Paris Club for official debt.

APPENDIX 1

WORLD BANK SUPPORT FOR THE POOR

Protecting the Poor during Periods of Adjustment

The Bank's early support for economic adjustment focused on improving the efficiency of resource allocation and strengthening institutions with a view to restoring growth and improving the balance of payments in economies facing severe economic difficulties. This support reflected the judgment that quick restoration of growth was essential to help the poor.

More recently, building on experience with adjustment programs implemented in the early 1980s, the Bank has broadened its support for adjusting countries to include a more direct concern with the social effects of adjustment.

Today, the main way that the Bank's adjustment lending has a direct effect on the poor is through reviews and revisions of public expenditures. An adjustment program's rationalization of public expenditures and investment can help to eliminate uneconomic projects, reduce ineffective and wasteful programs, and redirect social spending more toward the poor. Where appropriate, the Bank follows up these reviews with lending operations.

The Bank is also increasing support for compensatory programs to ameliorate the social costs of adjustment. A growing body of experience in the Bank and elsewhere shows that properly targeted compensatory programs are feasible in widely different situations.

The Bank is also cooperating with other international and bilateral agencies, as well as with nongovernmental organizations (NGOs), that have experience in implementing such compensatory programs. In particular, the flexibility, local knowledge, and staff commitment of NGOs often allow them to administer social programs more efficiently than many official agencies. NGOs, working in conjunction with borrowing member countries, are already involved in more than 100 Bank projects covering urban upgrading, low-cost shelter, agricultural cooperatives, village water supply, and primary health care.

In fiscal 1988, the Bank helped to finance two projects—in Bolivia and in Ghana—that act directly to protect the poor during periods of adjustment.

• For more than two years, the Bolivian government has sustained an uphill effort to carry out a comprehensive economic-stabilization adjustment and reactivation program. It has achieved considerable success, seen against the economic turbulence and decline of the preceding era. Thus, whereas in October 1985, inflation had reached 24,000 percent, by late 1987, it had slowed to 10 percent. Gross domestic product, which had declined every year since 1980, grew by at least 1.5 percent in 1987.

Since 1986, the government has increasingly turned its attention to the short-term unemployment problems linked to its depression and stabilization measures, as well as to the longer-term need to improve social conditions. An emergency social fund (ESF) was set up, aimed at providing emergency relief and carrying out an employment-generating program over the three years 1987–89, as a bridge until recovery gains momentum.

In June 1987, some $10 million in IDA funds were approved in support of the ESF's first year of operations, with the intention of following this operation up with one that was larger.

March 1988 saw support given through a $27 million IDA credit for the ESF's second and third years of operation. The credit finances a range of small-scale subprojects sponsored by municipalities, community organizations, and NGOs. Subprojects fall into four broad categories: social assistance (food and nutrition, basic-health services, vocational training and support to education); social infrastructure (drinking water and sewerage facilities, repair of schools and health posts, low-cost housing, and cultural projects); economic infrastructure (maintenance of rural roads, street paving and other urban improvements, irrigation, erosion control, forestation, and other construction); and support to production (working-capital credit and other forms of support to cooperatives and small manufacturers).

The subprojects under the $59 million project will create an estimated 21,000 manyears of direct employment (the entire program may create between 35,000 and 50,000 manyears of employment). In addition, about 400,000 people will receive food, improved health care, and other services (from 600,000 to 950,000 people under the entire program), and the users of the new infrastructure and housing will enjoy not only better sanitation and lower transport costs, but also, will be subject to fewer effects of mountainside erosion.

Assistance to Bolivia's emergency social fund is also being provided by the Inter-American Development Bank, the United Nations Development Programme, Canada, the Federal Republic of Germany, Italy, the Netherlands, Switzerland, the United Kingdom, the United States, and the Save the Children Fund.

• During the 1970s and early 1980s, the economy of Ghana experienced severe decline. Real incomes plummeted, and the vast majority of Ghanaians, many of whom were already in difficult economic conditions, saw their living standards decline further. The country's social and economic infrastructure fell into disrepair, and a fixed nominal exchange rate contributed to declining exports and periodic foreign-exchange crises. The government's economic-recovery program (ERP), begun in 1983 and which has been supported by several IDA credits, has managed to reverse this downward trend and place the economy, once again, on the path toward growth. But, despite promising medium-term to long-term prospects for growth, the economy is still characterized by widespread poverty and economic hardship. Moreover, the ERP cannot alleviate the economic hardship of many of the poor and vulnerable groups in the short run. Indeed, some components of the ERP have exacerbated, and will exacerbate, their economic problems in the short run, thus threatening to impede the sustainability of the recovery program itself.

The government's response to this acute, short-term problem has been to develop a program of action to mitigate the social costs of adjustment—especially among the urban and rural poor who have suffered so during the past decade and who now face increased competition in the labor market as a result of measures to retrench 45,000 persons from the public service and 20,000 from the public-enterprise sector during the three-year period, 1987–89.

The projects within the program of action would include labor-intensive public-works projects that provide employment to the rural and urban unemployed and underemployed, while improving their economic and social infrastructure; a supplementary feeding and nutrition-education program to address the nutritional needs of mothers and children in poor households; projects to improve the access to education services and facilities; a scheme to provide essential drugs to address the health needs of the poor; and a strategy to help the newly unemployed find productive jobs.

In July 1987, the Bank participated in an interagency workshop with the Ghanaian government's Social Sector Task Force that focused on five main areas for possible intervention—employment and redeployment; food, nutrition, and health; education and adult literacy; small farmers and women in development; and shelter. Some seventeen short-term interventions were identified, among them a special, two-year program of priority labor-intensive urban works, the so-called priority works project, which would build on activities now being undertaken under the IDA-assisted Accra Rehabilitation Project.

Six months later, $10.6 million in IDA funds were approved to help finance the project, which, authorities believe, will generate about 10,000 productive jobs over a two-year period. The two main components of the project—infrastructure-rehabilitation and maintenance in four cities, together with an urban-upgrading component in Accra, are essential items that need to be undertaken in any case and are justified on their own merits. But about three quarters of project expenditures will directly or indirectly benefit the urban poor (beyond the element of employment) through reduced vehicle-operating costs, travel time, traffic congestion, and accidents; improved health, sanitation, water supply, street lighting, and other amenities; an improved environment; and increased housing supplies.

Others contributing to the financing of the project include the Federal Republic of Germany (DM10 million) and the OPEC Fund for International Development ($5 million).

Source: World Bank, Annual Report 1988, pp.66-67.

APPENDIX 2

DEBT RELIEF PROPOSALS

Debt Relief Proposals

As the critical nature of debt problems became widely recognized by early 1983, advocates of innovative solutions put forward a variety of debt relief proposals. Their schemes were divided between those favoring solutions through an increase in debt and those favoring solutions that would reduce it.

Schemes of the former type saw debt problems as being mostly problems of liquidity, capable of being eased and eventually resolved by an increase in lending. The proposal put forward in 1983 by **Lord Lever**, the former British Minister, advocating a substantial increase in official loan guarantees through export credit agencies, was characteristic of this approach.

By contrast, debt-reducing schemes focused on debtor solvency. Their proponents argued that without an easing of the debt service burden, many countries would be unable to recover financial strength. They claimed that both the countries and their creditors would be better served by agreeing to an early financial reconstruction and drew analogies with Chapter 11 arrangements under US bankruptcy laws. If negotiated under appropriate international supervision, they believed agreements would restore growth to the debtor countries, improve the global economy, and offer banks the prospect of eventually recovering a higher proportion of their lending than if they continued to seek full repayment.

Schemes put forward in 1983 by **Peter Kenen**, a professor at Princeton University, and by **Felix Rohatyn**, former chairman of New York's Municipal Assistance Corporation, proposed the creation of a new international agency to take over claims owed to commercial banks and have responsibility for adjusting terms with the debtors. The initial cost would be borne by banks, which would sell their loans to the agency at a discount. However, the residual credit risk would then pass to the agency and its official shareholders.

These early schemes required official support and financial commitment at a level that was not politically feasible. They lost favor as global recovery set in from mid-1983. However, the slow-down of the world economy after 1984 and the failure of the problem debtors to resume adequate growth resulted in the initiative of US Secretary of the Treasury, **James A. Baker III**, in September 1985, that has subsequently guided official policy. Interest in new ideas was revived, and since mid-1986 several new proposals have been put forward. These reflect changes in the debt situation since 1983, especially the expansion of the secondary market for developing-country loans. They range from schemes linking debt service to a fixed proportion of the debtor's export earnings (imposed unilaterally by some countries) to schemes requiring the creation of new international agencies, as in the Kenen and Rohatyn proposals. Four of the proposals are described below:

Bradley Proposal. US Senator Bill Bradley put forward a scheme for interest and principal relief in June 1986. While not spelled out in full detail, the scheme would require creditors to provide annual relief over a three-year period roughly equal to 3 percentage points off interest rates and a 3 percent writedown of principal, conditioned on the country's need and its willingness to adopt an approved adjustment program.

Herrhausen Proposal. Alfred Herrhausen of Deutsche Bank suggested the creation of an Interest Compensation Fund (ICF) to stabilize and limit the interest payments of eligible developing countries (eligibility being determined by need and the debtor's commitment to an approved adjustment program). The ICF would be financed jointly by governments, international financial institutions, and banks on the basis of their respective exposure to the debtor, and would be managed by the IMF. It would limit interest rates to a preagreed level, but allow for a recovery of earlier unpaid interest if rates subsequently fell below this level.

LaFalce Proposal. US Congressman John LaFalce proposed, in March 1987, the creation of an International Debt Adjustment Facility to purchase a country's loans at a discount in the secondary market and to restructure them to pass on the benefit of the discount to the debtor. The purchase program would be initiated by a request from the country but only after agreement on a detailed plan of future economic management. The facility would also seek to use debt-equity swaps and commodity-linked bonds to expand the degree of restructuring.

Sachs Proposal. Professor Jeffrey Sachs of Harvard University has proposed that the existing debt of countries willing to participate in "an internationally supervised adjustment program" should be subordinated to any new lending made once the program was in force. The new debt, limited in any one year to 5 percent of total existing debt, would be denominated in negotiable instruments (e.g., bonds). The subordination of the old debt and marketability of the new are designed to broaden the investor appeal of the new instruments and so stimulate new lending.

Source: World Bank, World Debt Tables Vol I, 1987-88, p.xviii.

APPENDIX 3

WRITTEN SUBMISSIONS

Sub No.	Author	Page No.	Date Authorised for Publication
1.	Don. G. Miles	S2	17.2.88
2.	Australian Chamber of Manufactures	S12	17.2.88
3.	Prof G.W. Ford	S28	17.2.88
4.	Mr J.K. Yancey	S77	17.2.88
5.	Prof. R. Higgott	S79	17.2.88
6.	Mr A.E. Sandell	S152	17.2.88
7.	Mr Peter Nelson	S161	17.2.88
8.	Mr J. Hyde	S175	17.2.88
9.	Canadian High Commission	S177	16.3.88
10.	Aust. Teachers of Modern Languages Teachers Association	S328	16.3.88
11.	Confidential Submission		
12.	Mr Derek T. Stott	S344	16.3.88
13.	Mrs J. Grey	S369	13.4.88
14.	Prof P.W.G. Newman	S376	13.4.88
15.	Prof. C.B. Schedvin	S466	13.4.88
16.	Mr T. Le Mesurier	S481	13.4.88
17.	Mr T.G. Trueman	S482	13.4.88
18.	Dr M. Kennedy	S483	13.4.88
19.	Mr E. Manners	S504	13.4.88
20.	Reserve Bank of Australia	S526	13.4.88
21.	Minister for Finance	S552	18.5.88
22.	Mrs E. Herfkens, MP		20.4.88
23.	Westpac Banking Corporation	S554	18.5.88
24.	Dept of Foreign Affairs & Trade	S568	25.5.88
25.	Geoffrey P. Wilson	S635	24.8.88
26.	Northern Territory Government	S648	24.8.88
27.	Confederation of Australian Industry	S660	25.8.88
28.	NSW Farmers Association	S684	24.8.88
29.	Delegation of the Commission of the European Communities	S690	24.8.88
30.	Supplementary Submission - Mr J. Hyde	S738	19.10.88
31.	Supplementary Submission - Professor R. Higgott	S753	19.10.88
32.	Professor W. Kasper	S787	2.11.87
33.	Dept of Primary Industry & Energy	S804	23.11.88
34.	Ms L. Wilson	S806	23.11.88
35.	Dept of Industry Technology and Commerce	S834	2.12.88
36.	The Treasury	S853	6.3.89
37.	Results Australia	S966	6.3.89
38.	Australian Council for Overseas Aid	S993	6.3.89

Sub No.	Author	Page No.	Date Authorised for Publication
39.	Westpac Banking Corporation	S1032	8.3.89
40.	Australian International Development Assistance Bureau	S1035	10.5.89

APPENDIX 4

LIST OF WITNESSES

	Date	Place
Australian Council for Overseas Aid		
Mr Gregory Keven Barratt Consultant	2.12.88	Canberra
Mr Dermot John Dorgan Information Officer	2.12.88	Canberra
Ms Penelope Anne Lee Research Officer	2.12.88	Canberra
Australian Institute for Public Policy		
Mr John Hyde Executive Director	21.10.88	Canberra
Australian National University		
Associate Professor Richard Higgott Director Australian Institute of International Affairs Department of International Relations	21.10.88	Canberra
Confederation of Australian Industry		
Mr Harris James Boulton Director National Manufacturing and Commerce Council	21.10.88	Canberra
Mr Graham John Chalker Deputy Director Manufacturing Commerce Council	21.10.88	Canberra
Mr Daryl Stephen George Chief Executive	21.10.88	Canberra
Reserve Bank of Australia		
Mr Ian John MacFarlane Head of Research	21.10.88	Canberra

	Date	Place
The Treasury		
Mr Michael Kooymans Chief Finance Officer International Finance Section Capital Markets Division	6.3.89	Canberra
Mr Peter Tormey Assistant Secretary International and Development Finance Branch Capital Markets Division	6.3.89	Canberra
Mr Ewen Waterman First Assistant Secretary Capital Markets Division	6.3.89	Canberra
Westpac Banking Corporation		
Mr Anthony John Billingsley Economist, International Assessment	21.10.88	Canberra
Mr Maxwell Keith Hewer Manager, International Investment Management	21.10.88	Canberra
Private Citizens		
Mrs Evelyn Herfkens, MP - Dutch Labor Party Spokesperson on Development Co-operation and International Financial Policy	20.4.88	Canberra
Professor Carl Boris Schedvin	2.12.88	Canberra
Mrs Louise Anne Wilson	2.12.88	Canberra

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