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DEBT - THE UNWANTED HERITAGE OF TODAY'S CHILDREN

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Debt. The Unwanted Heritage of Today's Children

I. Introduction

The Task Force on Child Survival has estimated that an additional amount of 80 billion dollars is needed to speed up the implementation of the child survival and development revolution in the coming decade.

One of the tragedies during the last decade of this century is that the debt crisis is forcing many developing countries to repay and service a large amount of loans. The debt servicing often puts a claim on a considerable part of a country's export earnings (as we will discuss later), and with the absence of new loans and a stagnant level of aid resulting in decreased levels of imports. The debt service payments also result in a net resource outflow out of the country, often to a magnitude of several percentages of the countries G.D.P. and often larger than expenditure on education and health combined.

Table 1: Debt Service and Expenditure on Education and Health as a percentage of G.D.P. (1987)

	Debt Service	Education Expenditure	Health Expenditure
Low and Middle income developing countries	4.5%	2.5%	1.1%
Highly indebted developing countries	4.3%	1.9%	1.2%

Source: World Bank. World Development Report 1989.

With such a squeeze and contraction of the economy, it becomes difficult and often impossible for even a well-willing government to safeguard, let alone expand its social programmes for children. In many debt distressed developing economies, especially in Latin America and Sub-Saharan Africa, public per capita expenditure on education and health either in absolute real numbers or as a percentage of G.D.P. is declining. Such reductions in countries with a relatively low level of social expenditure, even if governments are capable of spending their money more efficiently, will necessarily reduce the value of a country's human capital and so hamper future growth.

We could say that: "The Debt Overhang Represents an Unwanted Heritage in the 21st Century of Today's Children". In order to disinherit today's children in the next century of this unwanted heritage, we will discuss briefly how debt relief can be a socially acceptable instrument, not for the sake of debt relief in itself, but as part of a package to foster human and social development for children and adults.

We will first briefly describe the main problems of the debt overhang and some general solutions (Chapter II). This is followed by a more in-depth discussion of the particular debt problem in two of the most vulnerable regions - Sub-Saharan Africa and Latin America, and what could be seen as measures contributing to solutions (Chapters III and IV).

From the ensuing discussion, it will become clear that the debt problem can only be resolved by a co-ordinated and international approach in which the debtor countries, the banks and multilateral institutions and the creditor countries co-operate together. Until now, national laws and regulations have often prevented countries from undertaking decisive international measures. We discuss, therefore, the important issue of changes in laws and regulations to arrive at a more co-ordinated approach to solve the debt problem (Chapter V). A last part of the paper (Chapter VI) provides some general conclusions and discusses some specific actions which UNICEF could undertake.

II. Major Problems of the Debt Overhang

Although it is a truism, the point ought to be made that debt per se is in general a positive element in financing development. A problem arises either when the debt cannot be serviced (repayment and interest payments) or when the value of debt is larger than the value of the assets owned by the holder of the debt. The latter point is, however, mainly relevant in the private spheres, it is also difficult and internationally not acceptable to "liquidate" countries.

In an international context, debt becomes a problem when it cannot be serviced anymore, or when the servicing of the debt put such a large claim on domestic and foreign resources that future growth is hampered, leading to a vicious circle of difficulties in repayment and lower growth. To avoid such a situation in a national context, bankruptcy laws have been made. However, such is not the case in an international situation, resulting in a number of institutions and actors co-operating (or not co-operating) to grapple for solutions.

As we will discuss in detail in the other chapters, not only the magnitude of debt and debt servicing differs considerably among countries, also the composition of the debt. Debt in the majority of the poor countries (and especially in Africa) is mainly due to "official creditors" (multilateral agencies, bilateral donor agencies or governments) while in the other countries, it is mainly due to private institutions. The percentage of all debts due to official creditors in 1988, according to IMF, is 40%. However, in Sub-Saharan Africa the figure is 70% and in the Highly Indebted Countries it is "only" 28%, and currently rising.

However, notwithstanding the fact that debt is mostly private in Latin America and mostly public in Africa, both continents face large obligations to service their debts, resulting in negative resource transfers.

A first priority in any solution to the debt crisis, therefore, is the reversal of the negative resource transfer.

It took sometime in the international circles to handle the debt problem as an international problem warranting international solutions. As is well known, an initial solution to solve the debt problem was proposed in October 1985 by the then Secretary for the US Treasury, Mr. James Baker, when arguing for new private lending (on a voluntary basis) in order to allow their economies to grow and for countries to service old debts.

This process has clearly failed, as is now generally recognised. Between 1985 and 1988, only a handful of voluntary loans to heavily indebted countries were made. Almost all lending was involuntary (e.g. rescheduling with accumulation of interest payment of old debts). Hardly any new money was available. As a consequence, the negative resource transfer became huge1/ (Table 2) and amounted for most countries to several percentage points of their GDP equal or larger, for example, to the combined annual education and health budget (as we showed earlier - Table 1).

To put these figures into perspective, it should be noted that resource transfer of the U.S. Marshall Plan assisting in the reconstruction of Western Europe, totalled some 2% of U.S. GNP for 4 years. The present transfers from developing countries have been proportionally double that of the Marshall Plan and have been sustained already 8 years in the case of Latin America and 6 years in Africa.

Table 2: Total Debt Service as a Percentage of GNP *

	1980	1982	1985	1988	1989
All Developing Countries	3.7	4.6	5.1	5.0	5.2
Latin America & Caribbean	5.5	6.8	6.1	5.4	5.5
Sub-Saharan Africa	2.4	3.1	5.1	5.3	7.0

* Source: World Bank: 1989-90 Debt Tables.
This figure provides the gross outflow which does not take into account flows of new loans or new investments.

1/ The resource transfer would have been even higher if all interests and amortizations owed had actually been paid (rather than, as often, being upaid and carried forward into next year's total of outstanding debts).

Various new proposals have, therefore, been made. Most proposals for debt reductions are based upon one or upon a combination of the following:

- a decrease in the amount of actual debt.

- a decrease in the interest rate.

- a new or extended grace period, without accumulating the foregone interest payment during the grace period.

The two most commonly known debt reduction proposals are currently the **Toronto Proposal** and the **Brady Plan:**

The **Toronto Proposal** from the G7 meeting in June 1988 deals with official bilateral debt in the low-income countries (mainly African countries). It gives creditor countries the choice between a reduction of 1/3 in the principal, or a reduction in interest payment by 50% (or a reduction in the interest rate by 3.5 percentage points, whichever was lowest) or a stretching out of repayments over 25 years with a grace period of at least 14 years.

The **Brady Plan,** launched by the present US Secretary of Treasury in March 1989, replaced the Baker Plan. It tries to provide a stimulus for the reduction of private debt, facilitated by a fund set aside by the Bank, ECE, IMF and Japan, to buy back debts, to guarantee debts or to finance lower interest rate payments.

These proposals will be discussed in more detail in the next two chapters dealing specifically with Sub-Saharan Africa and Latin America.

III. The Debt Situation in Sub-Saharan Africa

During the 1980's, Africa's debt quickly increased. The relative increase in debt in Africa was larger than that of Latin America. See Table 3.

Table 3: Sub-Saharan African Debt

Year	1980	1982	1985	1988	1989
. Total Debt ($billion)	56.2	70.2	96.2	137.6	143.2
(public and publicly guaranteed debt)	40.5	52.2	70.3	112.4	119.7
. Debt Service ($billion)	6.3	7.4	12.4	10.5	10.7
. Debt Service as % of exports	11.0%	19.3%	30.8%	27.2%	27.6%
. IMF Purchases minus IMF debt service ($million)	730	590	-433	-492	-618

Source: World Bank. 1989-90 Debt Tables

Africa's debt is mainly from official creditors (although the situation varies considerable among different countries) and is in many cases contracted upon "soft" conditions. Despite this, however, debt service - export ratios have reached high proportions, and would in some cases be over 100% - i.e. payments on debt service exceed export earnings, were it not for continuous rescheduling arrangements. In most of these rescheduling arrangements, however, the debt is rolled over and interest payments capitalised, so that the debt burden is shifted to the future, as Table 4 illustrates. For countries in such situations, the correct description is nothing else than a "muddling through".

Although the average picture on African debt is rather dismal, there are wide variations. Debt service - export ratios range from a manageable 4% to 14.3% in Botswana and Mauritius to a clearly unmanageable 39% in Somalia, 52% in the Sudan and 40% in Sierra Leone, before these countries rescheduled or stopped servicing their debts unilaterally in 1988 or 1989.

The difficulties most African countries have in servicing their debts has led to a number of related problems, which seriously impair proper functioning of already fragile economies. The frequent calls on rescheduling of the debt mostly to the Paris Club of creditors has led to an increased attention in the national administration to "crisis" management and damage control, at the cost of regular economic policymaking. It resulted, also, in a preponderant influence of views from financial ministries in national decision making.

A part of the debt is in the form of trade credits, which have often been accumulated at high commercial conditions with large penalties. One could, therefore, argue that the actual debt figures are in fact inflated through the unreal high cost of arrears in Sub-Saharan Africa.

Delays in repayments of trade credits can seriously hamper normal commercial relations, which are often vital in order to obtain additional foreign exchange. The shortage of foreign exchange has also meant that gross international reserves are totally inadequate, compounding the already mentioned problem of deteriorating trade relations.

The problems of servicing debts has, in a number of countries, also affected the repayments to the IMF, the World Bank and the African Development Bank - the so-called preferred lenders. Not servicing the obligations to these international institutions make countries automatically ineligible for further credit from these institutions and blocks access to Paris Club reschedulings - pulling these countries into a vicious circle.

Causes of Africa's debt have been intensively debated. Here we deal only with these insofar as they are relevant in aggravating or blocking solutions to the debt situation in the future.

An important factor in the quickly emerging debt problem in Africa is the dependence of many African countries on commodity markets as the major source of foreign exchange. The upswing in commodity prices in the seventies has led to a large amount of loans and export credits on the assumption that apart from some fluctuations, the level would remain higher. However, the large amount of credits and loans quickly surpassed the capacity to repay.

Table 4: Debt and Debt Service Obligations for some African Countries

(US$ millions)

	Long-term debt		IMF Credit		Debt Service[1/] Export ratio %		Actual Debt Service	Debt Service Pipeline
	80	88	80	88	80	88	88	93
Burkina Faso	284	805	15	3	5.9	10.4	53	64
Niger	687	1542	16	95	21.7	49.8	175	176
Sierra Leone	315	510	59	109	23.1	28.8	35	50
Nigeria	5,302	28,967	0	0	4.1	29.3	2,263	3,847
Kenya	2,616	4,869	254	455	22.1	37.8	711	545
Tanzania	2,093	4,100	171	69	23.3	24.6	123	460
Zambia	2,232	4,194	447	940	25.3	14.2	177	423
Zimbabwe	696	2,281	0	70	3.8	32.4	584	392

Source: World Bank 1989-90 World Debt Tables

1/ This represents actual debt service, and reflects non-compliance and rescheduling.

Prices of commodities have declined substantially in the eighties after peaking in the last part of the seventies. Prices have reached a rather low level and most projections foresee a stable or slightly downward trend, but no increases. Decreasing prices were and are, however, not the only problem - export volume also decreased, which was partly as a consequence of a number of policy mistakes in agriculture and partly the consequence of the economic crisis and the breaking down of public service infrastructure. Increasing the export volume of commodities will require special efforts and additional resources.

It has been estimated that if the export trends of Africa in the 80's would have kept pace with past experience, the debt service ratio would have been one-third lower, a sizeable reduction but still leaving the African continents with an almost unmanageable debt burden.

The difficulties of the mid-eighties many Sub-Saharan African countries were facing have also led to active interactions and credits from the IMF. Initially these credits were due in a relatively short time and sub-Saharan countries needed to repay these credits before their economic and social problems had been resolved, in many cases only aggravating their problems. Partly as a response to this and partly out of conviction that Africa's problems were much more of a structural nature and their deserving long-term support rather than short-term balance of payment assistance, special facilities have been created for low-income countries in the end of the eighties - the Structural Adjustment Facility (SAF) and the Enhanced Structural Adjustment Facility (ESAF) which allows countries to receive funds on a longer term basis and concessional rates. Sub-Saharan African countries form the majority of the countries which are making use of these facilities. However, notwithstanding the creation of these facilities, since 1985 the IMF has been a net receiver of funds from sub-Saharan Africa, as Table 3 shows. It is extremely worrying that such a situation not only exists over such a long time, but moreover that the negative outlow of resources is growing each year.

In the Introduction we already described the broad outline of the Toronto proposals made in the summer of 1988 in order to solve the official debt problem in Sub-Saharan Africa. Despite the rhetoric, the actual achievements are still very limited. The World Bank reports that at the end of 1989 only 12 African countries have rescheduled their debts at the Paris Club under Toronto terms. The short-term cash flow benefit is seen to be rather small. The estimated savings on interest payments for these countries amounts to about $50 million in 1989 or 2 percent of their service falling due in that year.

Some progress is also made in forgiveness, but if all the new plans proposed by bilateral creditors are fully implemented, the reduction in the stock of Sub-Saharan debt would amount to $5 billion to $6 billion or only 8% of the outstanding debts in 1989, also cash flow relief from these measures is not likely to be large.

These figures are of such a small magnitude that one could not imagine that this was the intention of the world leaders of the Group of 7 when they announced the proposals for debt relief in Toronto two years ago.

It becomes, therefore, clear that implementation of the Toronto terms by bilateral donors and the Enhanced Structural Adjustment Facility of the IMF, together with the Special Programme of Assistance to Africa of the World Bank, should be carefully scrutinized and largely expanded.

Although a large part of Sub-Saharan debt is official debt, there is a sizeable amount of commercial debt (US$34 billion guaranteed and US$6 billion non-guaranteed) which is concentrated in a smaller number of countries. However, only two Sub-saharan African countries (Cote d'Ivoire and Nigeria) were included in the Baker Plan, while none were singled out in the Brady Plan. Rescheduling of commercial debt took place in the so-called London Club, often in various rounds. An effort is made to put in place a system of multi-year rescheduling agreements (MYRA's), but this has often run into problems because of the little interest paid on commercial debt, which is a prerequisite for the agreements. The terms of rescheduling commercial debt, have remained rather tough and much tougher than official debt, although they eased somewhat with an extension of grace periods from 5 to 7 years and a somewhat lower spread above LIBOR, . However, only two countries, Congo (US$60 million) and Cote d'Ivoire (US$151 million) received new credits at the end of the decade. Commercial debt in all other countries increased because of accumulated arrears.

The amount of commercial debt, although important for some individual countries, represents only a small part of total exposure of commercial banks, most of which has been written off already. There are, thus, no practical objections against commercial debt relief in Sub-saharan Africa. A solution depends, therefore, mainly upon changes in the regulatory and tax frameworks in creditor countries which we will discuss in Chapter 5.

<u>How much debt reduction is needed in Africa and under which modalities?</u>

The question of how much debt reduction is needed is difficult to answer in general terms. Debt reduction should be part of a package in each country to finance a minimum level of imports and to stimulate economic growth and social progress. For some countries, this requires only partial debt reduction, while for other countries it could mean a 100% reduction.

Various estimates have been made to assess the resource flows needed in Sub-Saharan Africa to maintain a reasonable level of imports and to start growing again.

The Advisory Group on Financial Flows for Africa, consisting of international bankers and their advisors, established by the Secretary-General of the United Nations, reported in 1988 a financing gap of at least $5 billion per annum for Sub-Saharan Africa for the coming years in order to offset the deteriorations since 1980. The group proposed that the financing gap was partly financed from additional flows (US$3 billion) and debt relief (US$2 billion).

The UNCTAD Trade and Development Report of 1988 sets a somewhat higher target, namely a per capita income and consumption growth of 3% per annum and concludes to an additional inflow of resources of $3 billion in the beginning of the decade to $10 billion at the end of the decade. However, although the majority of the debt is bilateral official debt, which often carries low interest rates, interest payments on bilateral debt accounts only for 20% of total interest payments. The UNCTAD report concludes, therefore, that even if all official bilateral debt and commercial debt would be eliminated, still an additional flow of about US$3 billion a year would be needed.

The World Bank in its latest report on Africa (Sub-Saharan Africa from Crisis to Sustainable Growth) also indicates that: "Africa cannot escape its present economic crisis without reducing its debt burden sizeably" and is assuming that adequate debt relief is provided, in order for debt service payments to remain at least at the same level as present. In order to achieve a GDP growth rate of 4 to 5%, domestic measures, according to the Bank report, are not sufficient and net ODA should be increased from 11 billion dollars in 1986 to 22 billion dollars in 2000 (all 1990 $ values). The Bank remarks that if debt relief is not adequate, required ODA needs to be increased proportionately, while, if debt relief is more than anticipated, projections of ODA could be lowered.

Keeping in mind the discussion above, we would argue that there are a few principles on which solutions for the debt problem in Sub-Saharan Africa should be based:

- Discussions on official debt should be based upon the capacity of the countries and their abilities to provide essential economic and social services to their population.

- All measures for relief of commercial as well as for official debt should result in immediate reduction of debt service payments and in a flow of new resources.

- The different official and unofficial fora of discussions on debt relief (Paris Club, IMF drawings, bilateral assistance) should be merged.

- The debt to multilateral organisations should be regarded as negotiable.

These principles would result in a number of concrete proposals:

- The discussion in the Paris club should be only of a technical nature. All decisions on debt should be taken in expanded and prolonged consultative group meetings, which also would discuss IMF conditionality.

- Bilateral donors should cancel their concessional and non-concessional debt to African countries after presentation and discussion of an economic and social action programme. This may take the form of so-called "Development Contracts" in which creditor countries agree to guarantee debt relief and external support while developing countries would set out a long-term sustainable development path based upon sound macroeconomic management, poverty alleviation and guarantee of individual human rights.

- Bilateral donors should co-ordinate their own approaches and offer a concerted agenda of debt relief to Sub-Saharan African countries. Debt relief from one creditor country should not be used to create room for payment to another creditor country.

- Net transfers of IMF and World Bank to Sub-saharan Africa should be greatly increased. ESAF and SAF should be phased out and merged with IDA loans of the World Bank.

- A solution should be quickly found for the countries in arrears to the IMF and the World Bank, either through using some of the newly created S.D.R.'s or through the sale of part of the gold holdings of the IMF as suggested in the "Fraser" report.2/

IV. The Situation in Latin America

Since 1989, creditors (and more particularly their governments), agree amongst themselves, and with debtor governments, about the need to reduce the debt of middle-income debtor countries, most of which are in Latin America. In this sense, the Brady Plan implied an important step, in that it recognised the need for middle-income countries' debt reduction as the main way to reduce large negative net resource transfers (see Table 5); furthermore, in its

Table 5: Latin American Debt

Year	1980	1982	1985	1988	1989
. Total Debt ($ billion)	242,699	333,498	389,415	427,463	434,063
. Debt Service ($ billion)	46,053	59,045	53,923	55,670	58,038
. Debt Service (as % of exports)	36.9	47.6	42.7	40.5	39.7
. IMF Purchases (minus IMF debt service ($ million)	-172	+1,329	+508	-1,954	-358
. Net Transfers ($ billion)	-1,534	-6,252	-30,630	-26,941	-27,606

Source: World Bank 1989-90 Debt Tables

2/ Africa's Commodity Problems Towards a Solution. A report by the United Nations Secretary-General's expert group on Africa's commodity problems, UNCTAD, Geneva, 1990.

context, industrial governments and international financial institutions started taking concrete measures to encourage such debt reduction. As a result of the Brady Plan, the discussions between industrial and developing countries have become far more pragmatic. They are based on issues such as:

How much debt reduction is required in different countries? Will existing mechanisms, in the context of the Brady Plan, be sufficient to achieve the required debt reduction quickly enough? How can the Brady mechanisms be further developed and improved? Should these mechanisms not prove sufficient, what other measures could be taken to encourage required debt reduction?

In this section, we will attempt to answer some of these questions, focussing especially on concrete policy proposals. Before doing so, it seems important to emphasise the key factors determining the required level of debt and debt service reduction. The required level of debt and debt/service reduction needs to be linked to the needs of individual debtor countries to command sufficient resources, both in domestic savings and in foreign capital, to grow at a reasonable rate. Given the high growth rate of population in Latin America (over 2 per cent a year), this would imply that Gross Domestic Product would need to increase by more than 2 per cent a year to maintain living standards, and preferably by more than 4 per cent a year to allow for improvement of living standards. By contrast, in the 1980's, GDP grew in Latin America by an average of only 1.3 per cent a year, leading to a decline of 8 per cent in per capita product for the region, which implied a severe social cost for the region as a whole, and in particular for the most vulnerable groups.

Another important element in considering the required debt reduction is the need to provide sufficient incentive for debtor countries to continue their ongoing efforts towards pursuing macro-economic stabilisation and desirable structural reforms, often under difficult external and internal circumstances, and in a context where commercial banks are increasingly reluctant to provide any new money to highly indebted countries. Furthermore, the strengthened commitment by debtor governments to adjustment, reinforced by debt and debt service reduction operations, can have a very desirable and significant impact on the return of flight capital and increased foreign direct investment. This is well illustrated by the positive initial reaction of the private sector - both domestic and foreign - to the Mexican debt/debt service package agreed in the context of the Brady Plan.

Finally, another element in considering necessary levels of debt reduction is an estimate of new lending that will be available from private banks. Forecasts in this aspect have become increasingly pessimistic, as recent trends show growing reluctance by private banks to make new loans to heavily indebted countries.

How much debt reduction is needed?

Naturally the level of debt/debt service reduction required to help restore sustainable growth in heavily indebted countries has to be determined on a country-by-country basis.

However, several international organisations and independent observers have estimated the approximate level of debt/debt service reduction required to provide sufficient resources for growth. In 1989, the World Bank estimated that for the most highly indebted countries (HIC's) to achieve 4.5% per annum economic growth in the coming years, additional net resources from the commercial banks of around $8 billion would be required, as, if as seems likely, no new additional lending will be available from banks, equivalent debt reduction would be required; this would be equal to an immediate average 30% net reduction in debt service on medium and long-term bank debt across all the HIC's. Similarly, UNCTAD has estimated that for the "Baker 15" countries to achieve restored growth, the minimum reduction required was about 30 per cent of all their debt to commercial banks, which is equivalent to 36 per cent of their medium and long-term debt to such creditors. The WIDER study group, headed by Johannes Witteveen, former Managing Director of the IMF, estimated in its report a minimum net debt reduction in commercial bank debt of around one-third, which is equivalent to a reduction on the non-guaranteed part of bank debt of around 50%.

Other estimates suggest that higher debt/debt service reduction will be required. For example, SELA (Sistema Economico Latinoamericano), an institution representing Latin American and Caribbean governments, in an early 1990 study estimated that one of the conditions for Latin American and Caribbean countries to restore growth to their 1961-80 level would, on average, be a 75% reduction of debt servicing to private creditors.

Will existing mechanisms be sufficient?

In recent discussions, the issue has been raised whether the existing mechanisms, implemented through the Brady Plan, will allow for sufficient and timely enough levels of debt and debt service reduction, to achieve the goal of restoring growth. This concern was particularly clearly voiced by Barber Conable, President of the World Bank, when in a March 1990 Memorandum to the Bank's Executive Board he agreed that: "In terms of number of countries and share of total debt involved, progress under the new (Brady) program has been modest". Starting from a positive evaluation of the Brady initiative, Conable's Memorandum expresses, however, two major concerns: 1) the overall adequacy of financing plans, to assure that the net external financing available after the debt and debt service reduction operation is sufficient to support countries' adjustment (and growth) programmes, and 2) the maintenance of flexibility to protect against adverse developments in the future.

The first - and crucial - point emerges already from the structure of the Brady initiative and the size of international public funding available to finance it. Different sources[3/] have estimated that even if the $30-35 billion available, mainly from the World Bank, IMF and the Japanese government, were fully used to encourage debt reduction, debt burdens would be reduced by only 15-20 per cent; this latter figure is significantly smaller than the estimates given above, ranging from 30-75 per cent of debt reduction

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3/ See, for example, UNCTAD Debt and Managing Adjustment; Attracting Non-Debt Creating Financial Flows and New Lending, 19 Feb. 1990 TD/B/C.3/234.

required to restore sustainable growth, encourage continued adjustment efforts and contribute to restored creditworthiness.

Up until early 1990, no major regulatory or fiscal returns were being promoted in the U.S. Europe or Japan. However, there is some evidence of increased flexibility by U.S. authorities to interpret supervisory, accounting and other regulations to aid the implementation of the Brady Initiative. For example, the U.S. regulatory authorities allowed special treatment to par and discount bonds in the Mexican deal, so that banks do not need to take a loss about acceptance of these (even though they imply some debt/debt service reduction). It is hoped that U.S. regulatory authorities continue with an increasingly flexible approach. In cases where losses need to be recognized in certain deals, the U.S. and other regulatory authorities could allow losses to be spread over a number of years. (Precedents for such treatment exist in the 1987 treatment by U.S. authorities of some agriculture loans, where losses were amortized over seven years.)

Another source of concern is the speed with which debt agreements can be implemented. At the time of writing, only three agreements in principle had been concluded, in the context of the Brady strategy (Mexico, Philippines and Costa Rica). Of these, only two (Mexico and Costa Rica) were "comprehensive", covering all the reschedulable commercial debt. Even these agreements took a long time to arrange.

Furthermore, in terms of <u>magnitude of debt and debt service reduction</u>, only one deal - the Costa Rica one - is entirely satisfactory; the benefits to Costa Rica of the agreed deal are large, amounting to a reduction of around two-thirds in debt and interest payment, even though the actual cash savings will be negligible, as the country was not servicing the debt in full. The fact that a definite package of debt reduction was agreed for Costa Rica has many indirect benefits; uncertainty is reduced for the domestic private sector, thus encouraging domestic investment and discouraging capital flight; foreign investment may also be encouraged. Finally, scarce senior government policy-makers' time will be freed from eternal debt bargaining to more productive tasks. The fact that one country, even though a rather small one, has achieved substantial debt reduction is naturally welcome. As regards Mexico, the cash benefits - in terms of savings on net debt service, estimated at around 10-15% of interest payments to banks - are far more limited; however, there are other benefits linked to the deal, such as a reduction of the level of commercial debt and expanded future rights to reduce further its obligations to private creditors through operations such as debt buybacks; furthermore, as pointed out, Mexico seems to have benefited indirectly, as the reinforced commitment to adjustment by the government, caused by the deal, encouraged flight capital return and increased direct investment.

Not only should efforts be made to increase the magnitude of debt reduction, but also to ensure that the foreign exchange thus freed contributes effectively to indebted countries' growth and development, as well as to lowering inflation (particularly where the latter is a severe problem). The crucial issue of defining the most appropriate mix of adjustment and stabilisation policies, that maximise growth and development objectives, escapes the scope of this paper.

V. Changes in regulatory and tax frameworks to allow a co-ordinated approach to debt relief

An important potential problem with the Brady Plan is that banks are expected to participate voluntarily in debt reduction or new money arrangements. Ultimately, it may prove difficult or even impossible to persuade a sufficient number of banks voluntarily to reduce their aggregate claims enough on particular debtor countries to levels that are sustainable - that is, fully serviceable without compromising growth objectives.

The US Treasury Secretary, Mr. Nicholas Brady, stressed when launching his plan that "creditor governments should consider how to reduce regulatory, accounting or tax impediments to debt reduction where these exist." The main common regulatory feature in Europe and Canada (as opposed to the US and Japan) has been the far more favourable attitude of the authorities in encouraging banks to make loans loss provisions, particularly through the text deductibility of such provisions. This has had the positive effect of strengthening all the banks in those countries, against potential or real losses on Third World debt, and has also provided a potential cushion for those banks to agree debt or debt service reduction, without their solvency being threatened.

However, the fact that full tax incentives are already provided at the time of provisioning implies there has been no tax incentive to accept debt or debt service reduction.

Proposals for the treatment of private debt

There is a clear alternative tax treatment of provisioning and debt reduction, which could provide far clearer incentives to European and Canadian banks to participate in debt/debt service reduction schemes, while maintaining the encouragement for banks to make adequate provisions against losses.

Tax relief would be given, at the time of provisioning. However, these tax concessions would only be maintained if within a limited time period (e.g. 3 years) the commercial bank accepted debt or debt service reduction at least equivalent to the amount of provisioning being accepted for tax concessions. If a deal was agreed within the context of the Brady Plan for a particular country within the period of 3 years, the bank would maintain tax relief only if it participated in the debt service reduction exercise (or made equivalent contributions), and the tax relief would only be maintained for the proportion of the effective debt/debt service reduction granted.

In the case banks made donations of debt to charities (with the proceeds to be used for development spending - particularly for social and/or environmental purposes - in the debtor Third World countries, in the framework of an agreement between the bank, the charity and the Third World government), the additional tax relief due would also be immediately and permanently granted.

It is suggested that tax treatment on international lending and debt is explicitly and transparently defined, as far as possible, ex-ante. This would imply that not only the desired incentives are created, as suggested above, but that bankers and debtors are aware of them.

The above suggested approach to taxation of banks would be more consistent than current practice with the basic general taxation principle that, to be accepted for tax purposes a loan loss premium must relate to the expected irrecoverability, or past irrecoverability of the debt. For example, for most business debt in the UK, tax concessions on bad debt are only obtained once the debt has gone bad, and the company is in liquidation or receivership.

It should be stressed that this policy would imply no additional cost to the taxpayers of the industrial nations; on the contrary, it could imply a higher tax income, for the governments if the banks did not agree as high a debt/debt service reduction as they had provisioned against.

The suggested course of action on tax policy would clearly be consistent with both the letter and the spirit of the Brady Plan, which seeks to encourage, by the actions of governments and international financial institutions, sufficient debt reduction so as to encourage growth and necessary structural reforms in highly indebted countries. Tax incentives for debt or debt service reduction clearly will discourage individual banks from free-riding and, perhaps more importantly, will encourage debt agreements to involve more significant levels of discount than would otherwise take place.

The British Chancellor of the Exchequer, John Major, MP, has in his 1990 Budget taken a small but very positive step in the direction of using tax incentives to encourage debt reduction. The British Chancellor has proposed to change the timing of tax relief given to banks, giving immediate tax relief only if the debt is sold back to the borrowing country; in all other cases additional tax relief will be given, but in tranches of annual installments of 5% of the debt. The British Chancellor's proposals have two important positive aspects. Firstly, they significantly clarify tax treatment will encourage the search for innovative solutions in debt management. Secondly, it is positive that the British Chancellor's proposals do provide somewhat more preferential tax treatment when debt is disposed of to the borrowing country, so that it can potentially benefit from some debt/debt service reduction. The precedent for using tax incentives to encourage debt reduction has thus been set in Europe. Unfortunately, the text incentive granted is rather limited, as it only refers to the timing of the tax relief, rather than the absolute amount. Secondly, previous massive tax concessions already granted for provisioning against Third World debt are not affected, independently of whether debt/debt service reduction took place or not. The British Shadow Chancellor, John Smith, MP, in a recent speech on Third World debt has put forward a propcsal based on that presented above and argued that, "tax concessions for banks should only be maintained if the bank agreed to participate in debt reduction packages negotiated as part of the Brady Plan". This idea was further discussed in the British Parliament during consideration of the Finance Bill.

It is hoped that other European countries and Canada will follow the British example and use fiscal and regulatory incentives to encourage debt or debt service reduction, this would be consistent both with the spirit and letter of the Brady Plan, which seeks to encourage (through the actions of governments and international financial institutions) sufficient debt reduction so as to encourage growth and necessary structural reforms in highly indebted countries.

It is encouraging that at a FONDAD (Forum on Debt and Devlopment) conference held in The Hague on 2nd May 1990, Mr. Johannes Witteveen, former Managing Director of the IMF, and Adviser to the Amro Bank's Board of Directors, endorsed in his speech the above described proposal for use of tax incentives to encourage debt reduction. The Dutch Minister of Development Cooperation, Jan Pronk, also gave strong support to this proposal. It is likely that a Bill to provide tax incentives to encourage debt and debt service reduction will be presented to the Dutch Parliament.

<u>Proposals for the treatment of public debt</u>

As the principle of debt reduction has been accepted for middle-income countries' commercial debt, there seems a clear case for a similar acceptance of that principle for bilateral official debt, which is currently merely rescheduled in the context of the Paris Club. Thus, there seems to be considerable merit in the proposal made by John Williamson[4/] to forgive the same proposition of bilateral official or officially guaranteed debt, as the banks choosing debt reduction agree to forgive. Alternatively, that proportion of the debt could be converted into local currency terms, to be spent in future years on projects in the environmental, social or educational fields, that are agreed to be of mutual interest to the creditor and debtor.

An interesting and welcome step in that direction is that taken within the new US initiative, announced by President Bush in June 1990, to forgive parts of US official debt owed by Latin American nations and allow them to service part of this debt in local currency for environmental purposes. It would be valuable if this new facility included also servicing in local currency for social spending, especially as poverty alleviation and improvement of the natural environment are so intimately linked; furthermore, it would be desirable if other government creditors (European and Japanese) followed the lead taken by the US government to forgive part of their bilateral official debt, and use those resources freed for development spending.

The latter option could be complemented by initiatives like that being suggested by the Inter-American Development Bank and UNICEF, to use hopefully additional industrial government's funds to make loan to Latin American and Caribbean governments, for these to buy-back their own debt, with the debt being serviced in local currency for social or environmental spending, in programmes monitored by the Inter-American Development Bank and UNICEF.

4/ J. Williamson, <u>The Progress of Policy Reform in Latin America</u>, Institute for International Economics, Jan. 1990, Washington DC.

Could other measures be used, if a different approach were adopted?

Fears have been expressed that, even with improvements such as those suggested above and others currently being discussed, the measures and incentives created by the Brady Plan may not lead to sufficient debt reduction to restore growth and creditworthiness in heavily indebted nations. It may be useful to begin to develop contingency plans, for the case that this should occur.

The Brady Plan is based on the premise that industrial governments and international financial institutions (IFI's)[5/] should encourage banks to give debt, debt service reduction or new credits, this encouragement is provided through mechanisms such as public guarantees, fiscal and regulatory treatment, etc.

An approach building on Brady would imply the need by IFI's and industrial governments to manage debt reduction, instead of merely encouraging it. This would imply in the first instance, similarly as is done today, that the IFI's would jointly agree with the debtor government a programme of adjustment, economc growth and of economic reform; this would include defining the amount of debt relief required and the period during which it would be required.

The IFI's would then help the debtor governments negotiate the debt/debt service reduction required to meet the jointly agreed targets, and to make the recovery programme work. Naturally IFI's and debtor governments should be flexible on the modalities preferred by different creditors (thus preserving the flexibility of different options introduced by the Brady Plan), but not negotiate on the required level of reduction of debt service which they had previously jointly agreed.

Should it prove impossible to obtain the required agreed level of debt service reduction by negotiation with the banks, the IFI's could go a step further and accept that the debtor unilaterally impose the maximum level of debt service, jointly defined by IFI's and debtor government as desirable.

It would seem that there is an appropriate mechanism available for the latter purpose. The IMF could use its powers under Article VIII 2(b) to approve exchange controls that would limit the remittance of interest income to the level approved by the IMF. There is legal support for the view that limits on interest payments could be interpreted as an appropriate exchange restriction under the IMF's Articles of Agreement.

Such an approach would have the advantage that debt reduction would be "case-by-case" and linked to formally agreed programmes of adjustment and economic reform; they would also have the advantage that it could incorporate sufficient debt service reduction to free resources for growth. The fact that the IMF has already accepted the principle that it can disburse its own loans, even in the absence of a prior agreement with banks, de facto recognises that countries' non-servicing of debt to banks does not interfere with IMF disbursements; the proposed procedure of using Article VIII 2(b) would build and develop further on this practice.

5/ IMF, World Bank, and regional development banks.

As discussed above, not only should the IMF ensure adequate levels of debt reduction are negotiated, but also the programmes of stabilisation and economic reform negotiated by the IMF with governments should attempt to maximise growth and development prospects.

It should be stressed that measures proposed in this section are presented as contingency proposals, in the case that the existing mechanisms, enhanced by measures such as use of fiscal incentives for debt reduction and by parallel efforts of debt reduction through the Paris Club, do not yield sufficient debt reduction to allow renewed growth of heavily indebted nations. Clearly the first step needs to be to strengthen the Brady mechanisms.

VI. Conclusions

The Toronto and Brady initiatives are important in recognising the urgent need for debt reduction, in both low-income and heavily indebted developing countries.

It is, however, necessary to ensure that levels of debt reduction and new funding should be consistent with minimum levels of growth. Higher levels of debt reduction than are likely to be forthcoming under the existing initiatives are urgently required. For Sub-Saharan African countries, one valuable step would be for the three options (reduction of principal, reduction of interest payments and stretching out of repayments), suggested in the framework of the Toronto agreement, to be simultaneously implemented by all bilateral official creditors, rather than having each creditor nation implement one of the options. Such a measure would significantly increase the relief for Sub-Saharan African nations.

However, whatever form is chosen, debt relief measures should improve the net resource flow to sub-saharan countries immediately. The decisions for such actions should be based upon economic and social analysis of the country. The decisions of the Paris Club should, therefore, be subordinated to decisions made at consultative group meetings and roundtables.

In this context, a solution must be found to reverse the flow of resources from Africa to the IMF since 1986. This would imply different lending policies and intelligent solutions to the increasing problem of countries in arrears.

In the case of heavily indebted countries, particularly in Latin America, it is also clearly necessary to achieve far greater debt reduction, than is likely to take place in the present context of the Brady Plan. Changes in regulatory and fiscal incentives of creditor nations are an important way to encourage commercial banks to accept debt reduction. In particular, for Europe and Canada, tax relief should be continued to be given at the time of provisioning, but should be maintained only if within a limited time period (e.g. 3 years), the commercial bank accepted debt or debt service reduction at least equivalent to the amount of provisioning being accepted for tax concessions. Recently, Britain has begun to move somewhat in the direction of providing some, though limited, tax advantages for operations implying debt/debt service reduction. These tax changes (which could become a European initiative) would encourage debt reduction, without implying additional costs to industrial contries' taxpayers. Other regulatory changes should also be made; it is very encouraging that, for example, U.S. regulatory authorities have been flexible in accepting that discount bonds (in the Mexican case) do not imply an up-front loss for banks; similar regulatory treatment that would reduce, eliminate or phase timing of losses for banks - particularly in the U.S. - could provide valuable regulatory incentive for debt/debt service reduction.

Furthermore, there seems to be a logical case for bilateral official (or officially guaranteed) debt of heavily indebted developing countries to have as much debt reduction as the commercial banks choosing debt reduction agree to forgive. Alternatively, that proportion of debt could be converted to local currency to be spent on projects in the environmental or social fields.

Special Concerns for UNICEF

The latter option would be complementary with the initiative of the Inter-American Development Bank and UNICEF on Debt Relief for Social Investment in Latin America. When funded, this carefully elaborated proposal would allow debt reduction to finance increased social spending, which has suffered so much in Latin America during the eighties.

More generally, the various debt reduction proposals have some important implications for UNICEF.

Any meaningful solution to the debt problem will result in more international management either by a new international financial agency organisation or by increased activities of the IMF, World Bank and Regional Development Banks, reducing the voluntary character of present proposals. This implies that debt reduction and growth potentiality of any debtor countries has to be judged against the economic and social infrastructure of the debtor country as well as against its investment pattern. It is essential that the concern for human development, which is gradually and slowly gaining momentum, continues to be a central issue, especially when large amounts of debt reduction are negotiated.

It is important, therefore, that UNICEF, in cooperation with the other UN agencies, continues the debate which started with Adjustment with a Human Face. With the likely increased involvement of the international financial agencies in debt reduction strategies, the need for human development as an important element in such strategies should be continuously documented and strengthened.

The UNICEF initiative of **Debt Relief for Child Survival (DRCS)** has a special function in the debate on debt reduction and concern for Human Development. The primary focus of DRCS is to put the concern for human development at a central point in the development debate, by emphasising the need for human development as an integral part of the development strategy. One possibility of DRCS is especially relevant in Latin America to generate additional resources through the use of local currency counterpart funds which, however, should be treated cautiously,[6/] as was discussed earlier in reference to the Debt Relief for Social Investment scheme in Latin America.

6/ The local currency counterpart funding of the debt swap should not result in overall additional government expenditure, as this will fuel inflation. Government expenditure can, of course, increase if taxes or if external grants are increased.

In the African case, UNICEF could continue to emphasise donations of privately owed debt, which has a very low market value, for a limited number of programmes. However, when it is intended to capture a large part of the private debt market in Africa, it would make sense to set up a co-operative framework between the various organisations, creditor governments and debtor countries as discussed earlier. Such arrangement should result in an orderly arrangement and so avoid isolated attempts to "swap" fractions of the face value of donated debt into project finance of different organisations. What is needed is a reasonable shift (and not an increase) in total government expenditure towards human investment! Secondly, in the creditor countries governments should instruct their regulators and tax authorities to take a joint and cooperative stand regarding donations of African and other low-income country debt. Given the political interest for Africa, only in this way a proposal for reduction of private debts may stand a chance of success.