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- Prospects and Solutions

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I Introduction

Since the eruption of widespread debt crises in mid-1982, a large number of actions have been taken by governments (of industrial countries as well as major developing country borrowers), by international financial institutions (such as the IMF) and by private banks - to reschedule debts and seek adjustment by debtor economies; this adjustment of debtor economies was largely geared to assure that within the current international environment, the debtor countries can continue servicing their (usually rescheduled) debtors. As Enrique Iglesias, the Chairman of the Cartagena Group pointed out clearly[1]: "In the majority of debtor countries, the debt problem has been administered, but not solved".

The focus on debt crises administration and the way in which it has been conducted has implied two fundamental problems. Firstly, debt crises management has been very effective in achieving the creditors' main objective (safeguarding the survival of individual banks and of the stability of the international financial system as a whole at least in the short-term), but very ineffective in contributing to achieve the main objective of debtor developing governments, the growth and development of their economies. As is increasingly perceived, slow growth or even absolute declines of debtor economies' output levels has not only been harmful to the people of debtor economies but also to economic agents in industrial countries who benefit directly from growth in debtor countries, e.g. exporters to those countries and multinational companies that have already invested in these countries or would like to do so.

The fact that the cost of the debt crises has been mainly borne by the debtor economies is inconsistent with the fact, now broadly recognised, that the responsibility for the widespread debt crises is shared by debtor governments, creditor banks and industrial governments. Undoubtedly, incorrect domestic policies in developing countries - and particularly in some of them - carry a significant share of the responsibility. Furthermore, the willingness by many developing governments to borrow large sums from private international banks, though understandable, was cleary imprudent (naturally this becomes clearer with the benefit of hindsight). Similarly, it is evident that private bankers were excessively enthusiastic and insufficiently cautious in their willingness to lend large sums to developing countries. (Again this becomes far clearer with the benefit of hindsight, though some observers had cautioned against the dangers since the mid or late 1970s). Governments of industrial countries also bear an important part of the responsibility. Firstly, they did not supervise or restrict sufficiently the international lending which their banks carried out in the 70s. More importantly, the type of policies adopted by industrial countries to control inflation in their own economies since the early 1980s has had a deflationary impact on the performance of the world economy; particularly harmful to the ability of developing debtor governments to service their debts has been high international interest rates and sharply falling (in real terms) prices of commodities.[2]

A second negative feature of debt crises management, as practised in the 1982-85 period is that if focussed on damage containment in the short-term, rather than seeking more fundamental transformations which would make debt crises less frequent, less likely and less damaging in the future, as well as contributing to make international financial intermediation more appropriate to the long-term needs of developing countries.

Increasingly widespread dissatisfaction with debt crises management since mid-1985 has accelerated the search for new "formulas" to deal with the crises of debt and development. One of the most radical responses to this widespread dissatisfaction was the Peruvian action to limit unilaterally debt service payments to 10% of exports for the period of one year. An important change in the position of the main industrial government, the U.S, occurred in October 1985, with the announcement of the so-called Baker initiative. U.S. Treasury Secretary Baker began his speech at the World Bank/IMF Annual Meeting in Seoul,[3] where he announced his plan, by stating that he would focus on "policies for growth within the context of the international debt strategy". The governments of the majority of the debtors nations welcomed the increased flexibility in the U.S. position and its' concern for growth, but saw the Baker initiative more as a first positive and constructive step in the right direction, but clearly insufficient in relation to the magnitude of the problem; the Cartagena group of debtors therefore called in December 1985 for further measures, which would both increase the total impact on net transfers of financial resources from and to debtor nations and widen the number of countries that would benefit.

The debate on rather fundamental changes in the way the current debt crises should be handled and the measures in which international financial flows to and from developing countries should take place in the future seems therefore no longer a purely academic exercise, as it did in the past few years, but one with important policy relevance. The purpose of this paper is to explore a policy package of measures that would seem to be appropriate for the "middle powers" to pursue; it will refer both to measures which can only be taken multilaterally and also to measures which individual countries or groups of countries can pursue on their own. The latter may be particularly important as debt crises management since 1982 has proceeded on the basis of finding measures that were the lowest common denominator to satisfy all creditors, which has been an important limit on the actions taken.

In the next section (II), we will explore further the increased need and urgency for substantial action on the debt front, as well as the factors which at the beginning of 1986 seem to make such action more likely. In section III, we will discuss briefly the criteria with which to evaluate the contribution of different measures to the resolution of widespread crises of debt and development. The main part of the paper (section IV) will discuss the proposals for a package of measures that could be taken by the "middle powers" which would make an important contribution to more long-term and fundamental solutions to the crises of debt and growth.

II Increased need, urgency and likelihood for action

Amongst the factors - that in early 1986 - increase the need, the urgency and hopefully the likelihood of more fundamental transformations in the way debt crises have been handled till 1985 and in changing the process of international financial intermediation are the following:

A. Negative evolution in the international economic environment in 1985 and increased uncertainty beyond

1. New bank lending stagnates

During 1985, the assumptions on which debt crises management had operated since 1982 were seriously eroded. Since 1982, private bank "involuntary" lending was sustained by banks' expectations that countries' debt servicing would continue. Debtor countries' willingness to continue servicing their debts was stimulated by the promise of significantly enhanced future new private lending, once the country had become "creditworthy" by adjusting; a return to "voluntary" lending to the major debtors was originally forecast by institutions like the IMF to occur by 1985 or 1986. In its' 1983 World Economic Outlook, the IMF projected for 1986 a resurgence of the non-oil developing countries' current account deficit to U.S.$93 billion, which was based on the assumption that there would be sufficient finance to fund a deficit so large. The comparable figure projected in the October 1985 IMF World Economic Outlook is exactly half this amount, reaching only U.S.$42 billion!

The crucial assumptions of debt crises management have been increasingly questioned, particularly since mid-1985. On the one hand, debtor governments are increasingly concerned that net new private credit has not materialised in spite of their large and widely recognised sacrifices in terms of adjustment, nor have other sources of external finance become available. On the other hand, private banks seem increasingly unwilling to increase their lending, whether "involuntary" to developing countries, and in particular to Latin American or African debtor countries. As can be seen in Table 1, net new lending to non-oil developing countries fell systematically not only from its 1980-81 peak, but also continued doing so after "involuntary" lending packages were implemented (this decline was sharpest for Latin America and Africa); furthermore, during the first quarter of 1985, net flows to non-OPEC developing countries in general (as well as to Latin America) <u>became negative</u>, implying an <u>actual decline in banks' exposure to those countries</u>. (see Table 1 again). This was indeed a far cry from the rapid restoration to voluntary lending that those who believed the debt crises were merely a short-term conjunctural problem had projected. Unless further major measures are taken, it seemed evident that not only "voluntary" but also "involuntary" lending to large parts of the developing world were petering out.

Table 1

New net flows from private banks to non-OPEC developing countries, Latin America and Africa, 1980-84 (U.S$ billion)

	1980	1981	1982	1983	1984	1st quarter 1985	2nd quarter 1985
Latin America	27.3	30.5	12.2	8.1	3.6	-0.4	0.2
Africa	2.0	2.0	1.7	0.3	0.2	0.0	0.3
Total non-OPEC LDCs	39.0	39.9	19.8	11.9	8.8	-1.2	2.8

Source: B.I.S. 1985 Annual Report. p.116. (Coverage of information has been slightly enlarged from 1984) and B.I.S. International Banking and Financial Markets Developments. October 1985, Table 4.

The increasing slowdown in bank lending to developing countries was clearly linked to a perception by banks of the increased risk of debt service arrears, moretaria or even default by those countries. It was however reinforced by other trends. Particularly important in this respect is the new pattern of current account payments surplus and deficits in the world economy, notably the disappearance of the OPEC surplus, the emergence of the Japanese surplus and particularly the emergence of the U.S. deficit. The new surplus agents, e.g. Japanese insurance and pension funds, have a greater preference for long-term investment as opposed to bank deposits; their high level of risk aversion and the availability of profitable investment of long-term funds opened up by the U.S. economy's need to absorb large foreign savings channel those funds overwhelmingly towards the U.S. As Marris[4] has pointed out clearly, in the 1973-80 period, large oil price increases generated a large ex-ante surplus of savings by raising world savings and depressing investment; surplus savings were mainly absorbed by international banks as deposits which they onlent mainly to non-oil developing countries. This is in sharp contrast with the post 1981 situation, when U.S. high budget deficits and private investment have according to Marris created an ex-ante shortage of world savings. Investors of surplus funds, (originated mainly in Japan and West Germany) both can and wish to place their money directly in the shares and papers of borrowers, with a clear preference for those from industrial countries (and particularly from the U.S.).

The ability of developing countries to attract foreign private credit depends thus not only on a restoration of their "creditworthiness", (which as we shall see below is extremely difficult given likely future trends in the international economy and their existing levels of "debt overhang") but also on a significant change in the U.S. economy's position as a major net absorber of "foreign savings", which crowds out savings available for developing countries.

Recent declining trends of private bank lending to developing countries, the overhang of past debt and the "general abhorrence of balance of payments lending to developing countries" widespread among private banks since 1982 seem to make significant increases in private credit flows for the rest of the decade extremely unlikely. It is noteworthy that in their 1985 reports, the major international institutions who do authoritative forecasts (the IMF, World Bank and UNCTAD) projected very low levels of net private lending in the medium-term.[5]

More broadly within the existing environment and policy framework, a significant increase in other types of flows towards developing countries for the rest of the decade seem extremely unlikely. It is the lack of a new agent/s willing and able to channel significant flows to developing countries in the eighties, together with the unwillingness of agents previously channelling those flows to continue doing so at the same level, combined with the need to service previously incurred debts that creates the risk for large parts of the Third World of continued negative net transfers of financial resources till the end of the decade and even beyond.

Indeed, even for developing countries as a whole, according to UNCTAD estimates[7], net transfers of financial resources ceased to be positive in 1984 and were estimated to have become negative by 1985, reaching over U.S.$16 billion during that year, which was equivalent to around 3% of all developing countries' exports and are projected to remain so for the next few years, unless policy actions are taken. As can be seen in Table 2, this "perverse transfer of resources" from developing countries to industrial ones has occurred, because total interest and remittances continued to rise while net capital flows declined (due to a stagnation of official flows accompanied by a slow-down of both international bank lending and IMF lending since 1983).

As we shall discuss below, major negative net transfers have been a feature of Latin America's balance of payments since 1982; it is perhaps less well known that since 1984, negative net transfers also characterise the total of all developing countries.[8] It should be stressed that the countries most heavily indebted to the private banks (most of them in Latin america) account for practically the total of all this negative net transfer; as a result, the rest of the developing world had a net transfer close to zero in 1985.

Table 2

Developing countries' net capital flows and net transfers (U.S.$ billion)[(a)]

	1983	1984	1985	1986
Total Net capital flows	60.0	51.8	42.3	46.6
Concessional official bilateral flows	16.7	16.7	17.4	17.4
Other official bilateral flows	3.6	3.6	3.6	3.6
Multilateral flows	11.3	11.3	10.5	10.0
Private flows	31.5	24.0	21.4	20.3
IMF lending	10.7	4.6	1.5	-4.7
Other capital, errors and ommissions.	-11.8	-8.4	-12.1	0.0
Total interest[b] and profit remittances	42.9	52.0	59.0	62.6
Net transfer	19.1	-0.2	-16.7	-16.0

(a) 1984 figures are estimated; 1985 and 1986 are forecast

(b) Excludes interest on short-term debt and IMF drawings

Source: UNCTAD, Trade and Development Report Table 9.

2. Deterioration of international environment during 1985

Industrial countries' growth during 1985 slowed down more than expected, to an estimated 2.75% which was significantly lower than the 4.9%

achieved during 1984.[9] The slowdown in OECD growth was mainly explained by the rapid decline in U.S. output growth (6.8% in 1984 to 2½% or less in 1985), accompanied by a small decline in growth both in Japan and OECD Europe.

The slowdown in industrial countries' growth was accompanied by an even more rapid slowdown in the growth of the volume of world trade, from 8½% in 1984 to around 3½% in 1985.

These trends have been reflected in reduced growth of developing countries' export volume (which is estimated by the OECD to have declined from 12½% in 1984 to below 5% in 1985) and in a weakening of primary commodity prices (estimated to have fallen during 1985 by about 10% in SDR terms). As a result, export earnings of developing countries are estimated by the IMF to have shrunk during 1985 by 2½ per cent (in dollar terms), which is in sharp contrast with their 8 per cent increase in 1984. The deterioration in export trends was more marked for Latin America, region more directly affected by the rapid slowdown in U.S. growth. After increasing by 11.5% in 1984, the value of Latin American export earnings actually declined by almost 6% in 1985; this was caused by a 4% decline in the average price of exports, accompanied by a fall of around 2% in the volume of exports, which declined for the first time since 1975.[10]

The above mentioned decline in commodity prices was a source of particular concern, as it followed on previous reductions in the early eighties, which had not been fully compensated by the temporary (and weak) increase in commodity prices during 1983/4. As a result, the UNCTAD dollar price index of non-oil commodity prices had, by mid-1985, fallen about 30% since 1980; relative to export prices of manufactures, non-oil commodity prices are close to their post-war lows. In its' recent report, the OECD projects that in real terms commodity prices will remain flat at best during the next two years, and that the terms of trade of non-oil developing countries may fall further in that period.

The slowing down of industrial countries' growth during 1985 has been accompanied by more pessimistic forecasts of their future performance by authoritative institutions like the OECD, IMF and the World Bank. Growth for OECD countries is projected in the baseline forecasts mainly at a rate below 3%, though usually not below 2½%. Furthermore, several of the forecasts (e.g. that by the IMF) explicitly state the greater risks of a lower outcome than of a higher outcome.

Recent trends in the world economy during 1985, as well as somewhat increased pessimism about future prospects, have led to a candid recognition even in industrial countries that statements in 1984 that "the debt crises are over" were clearly premature. The new realism is well reflected in the recent evaluation by the OECD[11]: "Taking a somewhat longer view, if OECD area activity to 1990 were to growth at the 2½ to 3 per cent annual rate projected for the next eighteen months, and if the evolution of "problem" debtors' export revenue in relation to OECD growth were to be in line with past experience, then these countries would have to increase their debt by 3 or 4 per cent per year in order to finance stable per capita import volumes. The source of such financing could be problematic. Official or officially guaranteed capital flows to these countries are not likely to be sufficient to increase debt by more than 1½ per cent per year. Direct investment in these countries has almost ceased, while the bond market is closed to them and indeed these countries are faced with a need to redeem maturity bonds". The Report later adds "the debt situation with require further import retrenchment in the LDC's - unless additional sources of financing are forthcoming. Further import reductions would add to economic and social distress in those countries. They would also represent a further drag on growth in the OECD area".

However great the problems for indebted developing countries assuming OECD growth in a range of 2½-3%, such problems would be clearly exacerbated if growth in industrial countries were lower. According to OECD estimates, a 1 percentage reduction in OECD growth over the medium-term would require more than a 5 percentage reduction in market interest rates to avoid the need for developing country imports to drop to a lower level.

As pointed out above, several of the forecasts (including that made by the IMF in its October 1985 World Economic Outlook and that made by the Economist[12]) attach a higher probability - and risk - that a "low scenario" will occur rather than a "high scenario". In late 1985 and early 1986, there was widespread concern about the "downside risk" for world economic growth. In the medium-term, such a risk is most generally linked to the danger of a "hard landing" for the dollar accompanied by recession in the U.S. not compensated by sufficiently reflationary policies in the rest of the industrial world. In the short-term, the risk of new shocks to the world economy and in particular to a large group of debtor nations is clearly illustrated by the damaging effects of a "very hard-landing" for the oil price, which at least temporarily has occurred in late 1985/early 1986. (It is possible though that lower oil prices may have benefitial impact on industrial countries' growth).

In the medium-term, the risk of further slowing down of growth by the industrial countries is linked to the unbalanced geographical nature of the recovery to the last recession, leading to very uneven current account positions among industrial countries and accompanied by a high exchange rate for the country with the largest current account deficit, the U.S.

Fears have been expressed that if the U.S. government does effectively reduce the huge U.S. budget deficit, at a time when both the U.S. and world economic activity are already slowing down, and compensatory stimulatory action were not taken in the rest of the industrial countries, then the U.S. economy - and the rest of the world - could slow down even further. To this risk is added the fear that such slowing down of the U.S. economy accompanied by the huge size of the U.S. current account deficits and the accumulated effects of past U.S. deficits may cause a sharp decline in capital inflows into the U.S. and a large decline of the dollar. If as Marris op.cit and others fear, the dollar were to overshoot downwards and fall very rapidly, this would force the U.S. government into restrictive monetary policies, which would push up interest rates and provoke a U.S. recession. Under somewhat pessimistic assumptions, Marris estimates that if such a hard landing occurred (and no compensatory expansionary action were taken in the rest of the industrial countries), OECD growth could fall to around zero for around two years, world trade would stagnate or decline at the same time as U.S. interest rates increased; as a result, "for developing countries this would involve an unpleasant replay of the 1981-83 crisis. As then, the purchasing power of their export earnings would be severely hit by slow OECD growth, deteriorating terms of trade and high U.S. interest rates". The only positive feature for the developing countries would be the decline in the dollar, which would reduce the real cost of debt servicing. The probability of such a pessimistic outcome materialising is difficult to evaluate, but its' possibility cannot be denied (and contingency planning required for it) while major imbalances persist among industrial countries. The likelihood of a recessionary hard landing of the U.S. dollar has been somewhat reduced by the concerted action agreed by the G-5 countries on exchange rates, which has significantly reduced the dollar exchange rate (particularly against the yen). This has not only reduced the risk in the medium-term of a recessionary hard landing for the U.S. dollar, but also pushed back prolectionist pressures in the U.S, whose impact could have been very damaging for developing countries.

However, a major dilemma still persists due to differential and uncoordinated macro-economic (and particularly fiscal policies) among industrial countries. Under current policies, this dilemma implies that rapid but unbalanced growth by the U.S. (accompanied by huge U.S. budget and trade deficits as well as large capital inflows from abroad) is unsustainable in the medium-term, and has in fact already been petering out. On the other hand, as the U.S. stops playing the "locomotive" role it played in 1983 and especially in 1984, and while other industrial countries continue to be unwilling to replace it in such a role, industrial countries' growth can stay at its' low 1985 level or even decline further, dragging down the developing countries with them.

B. Deeper understanding of debt problem and its pervasiveness

The need, the urgency and the likelihood of more fundamental changes in the way debt crises are handled is also enhanced by a broader understanding of the magnitude of the crises of debt and development, as well as of their pervasiveness.

Both the problems and the possible ways out are now fairly well understood. Different future scenarios, different policy options and the impact on debt and development prospects have been fairly exhaustively explored. Furthermore, a small literature has even emerged to assess the different proposals and their potential effect.[13] This is in clear contrast with the situation in 1982-84 when the magnitude of a fairly new problem overwhelmed policy-makers, politicians and academics.

Negative net transfers of financial resources from developing countries in general, and from Latin American ones in particular, have become a major source of concern. Their inconsistence with international equity are increasingly widely recognised, not just in developing but also in industrial countries.

The pervasiveness and magnitude of negative net transfers of financial resources from Latin America (see Table 3) as well as their negative impact on the region's growth and development (and particularly the negative impact of the most vulnerable groups in those societies) have become a major source of concern amongst Latin American governments and peoples.

Table 3

Latin America; Net inflow of capital and net transfer of resources

(U.S.$ billion and percentages)

Year/s	Net inflow of capital	Net payment of profits & interests	Net transfer of resources	Exports of goods & services	Net transfer/ Export, goods & services
	(1)	(2)	(3)=(1)-(2)	(4)	(5)=(3)/(4)
1973-81	21.2	11.0	10.2	64.4	+15.8
1982	19.8	38.7	-18.9	103.2	-18.3
1983	3.0	34.2	-31.2	102.4	-30.5
1984	10.3	36.1	-25.8	113.9	-22.7
1985	4.7	33.1	-30.4	108.0	-28.1

Source: CEPAL <u>Balance preliminar de la economia latinoamericana durante 1985</u>. December 1985.

Negative net transfers from Latin America of over U.S.$100 bn during the last four years, at the time of a large deterioration of the terms of trade, required the adoption of recessionary policies to generate the large trade surpluses that made these large transfers possible. The policies pursued with this purpose contributed in a major way to the decline of output that occurred in the region as a whole during this period, which implied that in 1985, GDP per capita was at almost 10% below its' 1980 level. This has meant a reversal of previously uninterrupted growth during the last thirty years. Furthermore, even the most optimistic forecasters do not expect 1980 per capita GDP to be recovered before 1990, and many talk of a "lost decade" for Latin America.

In Africa, net inflows of financial resources have declined during the early eighties and may well continue to do so, in spite of the urgent needs of external resources to help reverse economic decline and hopefully restore growth and development in the region.[14]

The perception that debt crises were mainly a short-term "liquidity" problem, which would be rapidly overcome - so prevalent in industrial countries and international financial institutions in 1983 and 1984 - is practically no longer heard. Nor is it stated anymore, that <u>if</u> the international economy behaves as expected, and if debtor countries "adjust" as they should, debt positions can be <u>easily</u> made to manageable <u>at the same time as</u> debtor countries can achieve adequate growth rates.[15]

The need for change in the debt crises management strategy, and for the start of a new phase in which growth of debtor economies has a high priority is widely accepted, at least in the analysis and in the rhetoric. This change is perhaps most clearly reflected in Jacques de Larosiere's recent statement that "We are entering a period when growth will be just as necessary to sustain adjustment as adjustment will be to sustain growth".

There is however a risk that the very welcome change in attitude and in rhetoric of the U.S. government and within international financial institutions may not be reflected in actions with a sufficient impact on net transfers of financial resources to and from developing countries and for enhancing debtor countries' development prospects. This is not mainly a criticism of the measures being proposed by the U.S. government which are imaginative and constructive, but of the magnitude of the problem to be tackled.

As regards the magnitude of the flows, the Baker proposals set as a target that for 15 highly indebted middle-income countries, commercial banks should increase their exposure by U.S.$20 billion net in the next three years, implying a rate of growth of slightly over 2% a year; though a welcome reversal of 1985 trends, when banks' exposure to those countries stagnated, it still implies a very small increase (and in particular, a decline in real terms). The Baker proposals also suggest that multilateral development banks increase their exposure to these 15 countries by another U.S.$20 billion in the next three years, which implies a welcome increase of around 50% above recent levels. If the Baker initiative actually resulted in the proposed flows, (which is by no means certain) this would imply net inflows of U.S.40 billion over the next three years for the 15 heavily indebted, middle income countries which compares with those countries estimated payment of interest of almost U.S.$40 billion per year; as a result, the 15 countries are offered, on average, new money for roughly one third of their interest payments; most of the rest - almost two thirds - would have to be generated by continued trade surpluses, thus continuing for most of these countries the negative net transfer of resources of the past four years, albeit at a slightly lower level. As the Mexican Finance Minister Silva Herzog has pointed out, "a level of interest rates three per cent lower is equivalent to the Baker plan", and would have the added advantage of not implying accumulation of further debt. In this sense, recent declines of international interest rates (at least in nominal terms) makes a clearly positive contribution to ameliorating the debt problem. Besides the critique that the Baker proposals imply clearly insufficient net inflows for the 15 middle-income heavily indebted countries targeted, a further problem is its' exclusion of many small middle income heavily indebted countries, such as the Central American ones.

In the context of a difficult international economic situation, of increased understanding of the problems implied in the crises of debt and development, of a new flexibility and a far more positive approach by the U.S. authorities, as well as of increased pressure for change by debtor governments (see below), the role which the "middle powers" can play becomes particularly influential, both in terms of supporting or indeed expanding multilateral initiatives (such as the Baker plan) as well as in taking individual initiatives, that may be both valuable in themselves as well as have positive "demonstration effects" on other governments involved. We will return to a discussion of proposals for such action in section IV.

C. Increased pressure from debtor governments

The search for new internationally negotiated solutions has received a particularly strong impetus from a toughening of debtor governments' positions and their increased pressure, particularly since mid-1985, for fundamental changes in the debt crisis management strategy. This has been perhaps best reflected in the fact that the Cartagena group of Latin American debtors reacted to the Baker initiative not only by welcoming it, but by launching its' own, more wideranging counter-proposal in mid-December 1985. It was also underlined by the decision of two debtor governments (the Peruvian and Nigerian ones) to unilaterally put a ceiling on the level of debt servicing as a proportion of their exports.

The increased toughening of debtor governments' position in Latin American may be attributed to several factors, besides the economic ones outlined above. Firstly, the transition towards more democratic regimes in several debtor nations (including two of the major ones, Argentina and Brazil) has increased both the internal legitimacy and the international respectability of those governments. Secondly, democratic forms of government imply that such governments must take account of the wishes of the electorate, at a time when there is a groundswell of public opinion in debtor nations (and particularly in Latin America) which attaches far less priority to servicing the external debt than to restoring growth and development, after several years of economic stagnation and which feel that there is an increasing conflict between the two. The perceived incompatibility between acceptable levels of growth and debt servicing under present circumstances and rules, as well as the need to give priority to the former, has been very clearly articulated by Latin American politicians. President Alan Garcia, in his inaugural address, stated that "The main creditor of Peru are its' people"; at the beginning of 1986, Silva Herzog, the Mexican Finance Minister put it equally clearly: "The limit of the responsibility to our creditors is the responsibility to our people".

Furthermore, debtor governments in Latin America are beginning to perceive that the <u>massive and pervasive</u> negative net transfers of financial resources that they have had to undertake since 1982 and which are likely to persist in the near future are not only absurd and extremely damaging to their economies, but have implied a fundamental shift in the bargaining position of debtors and creditors, which they have not yet fully used till now. When net transfers of finance flow towards a developing country, the greater bargaining strength lies in the lenders, as it is they who must ultimately decide to make the new loans and transfer the funds. This implies that the lender can easily impose all types of conditions. However, when the net transfers are negative, the greater bargaining strength has potentially shifted to the debtor government, as it must decide to repay and ultimately to make the transfer of funds. Consequently, the debtor is in this case not only in a position to resist the conditions of the lender, but even more fundamentally to impose his own.

As a result of their increased perception of their "substantial unexploited bargaining strength", debtor governments seem to be increasingly re-defining the minimum deal that is acceptable to them in bargaining on debt rescheduling and new flows; this minimum is not defined in the abstract, but is related to acceptable "minimum" levels of growth for the debtor economies, linked to acceptable levels of both consumption and investment. In the past few years, debtor governments have accepted the need for often draconian adjustment of their economies, in order to stay within their financing constraints posed by an unfavourable world economic environment and the need to service their debts. Since mid-1985, several debtor governments have begun to shift towards the view that to a far greater extent it is the international financial system which has to adjust to their pressing growth and development needs, and that if it does not do so sufficiently they will be forced - even though regretfully - to take unilateral action so as to lift the negative net transfer burden. Sympathy and even some support with such an approach has been forthcoming not only from those concerned with the plight of poor people in developing countries, but also from those who benefit directly from growth in debtor economies (such as exporters to and investors in them) and those who believe that stagnation or slow growth in debtor economies is an important factor in lower world economic growth.

Support from non-financial actors in the developed world for a form of dealing with the debt problem far more favourable to growth in debtor economies than has occurred in recent years can be clearly seen in the following statement by the Vice Chairman of Phillips, one of the largest multinationals operating in Latin America:[16] "Under the rules established by the IMF and the commercial banks, almost total priority is given to the purely financial aspects of the problem, and, in particular, to servicing outstanding debts... It is urgently needed that within the framework of international consultation (on the debt problem) the vital interests of industry are properly considered on comparable terms with those of the financial institutions". (my underlining).

III Criteria for evaluating debt proposals

Before examining diffeent measures to deal with the crises of debt and of international financial intermediation, it seems necessary to define the criteria with which such measures would be evaluated.

A. The measures (or more likely the package of measures) would need to imply a significant change in the magnitude of the net transfers of resources, leading to a very sharp reduction or hopefully the elimination of negative net transfers from Latin America and an important increase in positive net transfers to low-income countries.

This implies clearly going well beyond the type of focus during debt renegotiations in 1984 and 1985, which stressed issues - such as multi-year debt rescheduling, reductions of fees and spreads - which though clearly achieving important results led to changes which were very marginal, particularly in relation to the magnitude of the problem.

Though this criterion would require fairly radical changes in debt crises management and international financial intermediation, it is by no means radical in itself, as practically all schools of economic thought assume that the normal direction of flows of financial resources should be from relatively richer, capital abundant industrial economies to the relatively poorer, capital scarce developing economies, and certainly not in the opposite direction. A drastic reduction or a cessation of negative net transfers is a condition for restoration of growth in developing countries, and would hopefully be a first step towards restoration of positive transfers of resources to them. This was clearly recognised for example in the Commonwealth Secretariat Report on The Debt Crisis,[17] which emphasized: "It is a matter of urgency to put an end to the premature outflows of resources from developing countries".

The urgency of the need for change is linked both to economic reasons (the need to restore levels of investment so as to avoid slow growth or stagnation becoming a chronic feature in important parts of the Third World) and even more importantly to human reasons (poor, vulnerable individuals have very limited ability to survive or weather without major damage the large costs which drastic adjustment requires); this is perhaps clearest in the case of children, as declines in nutrition levels or health facilities during a few crucial years may lead to damage which <u>cannot</u> be repaired in the future, <u>even if many more resources were then available</u>.

B. Particularly, but clearly not only, when some element of concessionality on debt or interest relief is involved from creditor banks and/or governments to middle income countries, it seems essential to assure that: i) the resources freed are used in the context of a development plan leading to sustained economic growth and increased welfare of the population, particularly of the more needy sectors ii) a significant contribution in resources is made by wealthy citizens of debtor countries towards adjustment and funding development. The containment of capital flight and an attempt to return capital already fled would be an example, as would be increased direct taxation on the wealthy, restrictions on imports of luxury goods, etc.

C. The package of measures should not be excessively biased towards favouring only or mainly large debtors, whose potential bargaining strength is enhanced by the drastic effects of their potential default, as well as by the fact that at present they have such large negative net transfers. Debt crises in low-income countries (and particularly Sub-Saharan ones) began earlier, are even more damaging to those countries' economies and cause even far greater human hardship. Across the board bank debt forgiveness or interest concessionality would tend to favour more heavily indebted countries (to banks) and have some bias against countries that could not or did not wish to borrow commercially so much in the past; however if such measures were combined for example with some forgiveness of official debt or increased official flows for low-income countries this problem could be overcome. Measures focussing on new flows, e.g. guarantees, higher lending by multilateral agencies, lack at least potentially a bias towards big bank debtors, and may thus be more equitable internationally, even though they have the problem that they increase further already very high levels of debt.

D. The changes introduced should also have a positive effect on the growth of the world economy, both in the short and in the medium-term. The reduction of foreign exchange constraints on imports by the debtor countries would clearly have such an impact in the short-term. The introduction of counter-cyclical elements could in the medium-term make an important contribution to more stable trends, not just for the debtor economies but for other countries and agents (particularly those who export to, invest in or lend to them) and for the world economy. In this broader context, safeguarding the stability of the international banking system would continue to be a very important objective, but <u>not</u> such a dominant one as in recent years, as the interests both of non-financial agents in the industrial countries <u>and</u> of economic growth in debtor economies should be equally - if not more - important.

IV Lines of action for middle powers

The complexity of the problems involved and particularly the magnitude of the external financing gap, if comparisons are made between the level of flows required for meaningful economic growth to be restored in debtor economies and the likely level of flows if no major initiatives are taken, would seem to require a package of measures.

The problems raised by the crises of debt and development are essentially global ones and can technically best be tackled by multilateral solutions. However, given the different national perceptions, ideologies and interests of individual governments, solutions that may be ideal from an economic viewpoint in an increasingly inter-dependent world may not be politically feasible, or may be feasible to a limited extent. In this context, the role for the "middle powers" would be valuable at two different levels:
A) pressure for multilateral initiatives that seem technically desirable and B) take independent bilateral or group initiatives. The latter offers the possibility of immediate effective action (even though naturally more limited in scope).

A. <u>Support for multilateral initiatives</u>

1. <u>Measures regarding liquidity and financial flows</u>

a. <u>New SDR issue</u>

This measure is often not discussed within the context of proposals to deal with the debt crisis; however, a renewal of SDR issues - by providing additional liquidity to developing countries, thus easing their present foreign exchange constraints <u>without</u> creating new repayments obligations -, would clearly make some contribution to easing the present debt crisis without creating additional problems for the future; furthermore, issuing of SDR's need not be a one off exercise, but could provide a more appropriate source of liqudity particularly while new commercially created liquidity channeled to LDCs is so unstable and at such a low level. It is perhaps a sign of the "perverted logic" with which decisions on international economic policy are often taken, that a policy instrument that could contribute to easing the severity of debt crises and foreign exchange shortage has in fact not been used at all, precisely since the debt crises became so acute: this is particularly surprising given that international agreement on SDR issues should be eased by the fact that SDR allocations do not require an expansion of the public sector borrowing requirement (PSBR) of industrial countries nor do they require parliamentary approval by Fund member governments.

b. <u>Expansion and adaptation of existing compensatory financing facilities</u>

The first change in the rules of the game of the international financial system that developing countries succeeded in securing was the introduction of the IMF Compensatory Financing Faiclity, which attempted to smooth imports for countries facing fluctuations in export earnings caused by external events. As the main constraint for greater lending through the CFF are the quota related limits on maximum drawings, the Group of 24 (representing developing countries in international monetary matters) have recently called[18] for "relating drawings under this facility to calculated export shortfalls rather than quotas". Linked to the emergence of widespread debt crises, there has arisen in many circles, the proposal that the IMF's compensatory financing facility could also provide loans to offset fluctuations in nominal interest payments. Such a broadening of the CFF would have the merit of introducing one of the key new sources of international economic instability (large fluctuations in interest rates) into a mechanism that deals with the more traditional sources of instability (that of export earnings).

The magnitudes involved and their inter-country distribution would be crucially influenced by whether the expanded and modified CFF drawings would continue to have quota related limits and, if so, whether these would be significantly higher than existing ones. If quota limits of CFF drawings were not significantly expanded, or even better removed, the net cost of introducing an "interest window" into the CFF would be relatively low, but its' beneficial counter-cyclical additional effect would be equivalently small; there would be the danger than funds would be diverted from compensating for export fluctuations (to a greater extent, possibly a low-income country problem) to compensating for interest rate fluctuations (clearly a more important problem for middle-income large debtor countries). Therefore, it is crucial to put the proposal of an introduction of an interest rate window for the CFF in the context of an expansion of quota limits on drawings or, even better, in the context of a removal of quota limits on CFF drawings. The problem with an "interest window" for the CFF would be its' additional cost, as well as its' temporary nature; the latter could become a major potential problem should interest rates remain high in the medium-term.[19]

A more modest modification to the CFF would be to reverse the tightening of its conditionality, which has occurred in recent years, tightening which makes access to this facility more complex and more problematic.

C. Interest "capping" of various types

An alternative, or possibly a complementary, form of reducing interest payments paid to the private banks - either temporarily or permanently - could be through some form of interest capping. Initially the idea for an interest cap was raised or even supported by some of the most senior U.S. monetary officials.[20] Increasingly, Latin American debtors - seeing continued high interest rates as perhaps the key variable in determining the pervasiveness of net transfers from their economies - have placed greater emphasis on the need for some form of interest capping, while international interest rates do not decline to historical levels (in real terms) and particularly while no significant new bank lending materialises.

Detailed discussion on interest capping has shown that this type of mechanism seems more attractive to certain categories of banks (e.g. U.S. regional banks) or to banks of particular nationalities, given the differences both in corporate objectives and especially in national accounting and regulatory treatment. In particular, it has been reported[21] that the option of interest capping was more attractive to European bankers, as regulatory practice in some European countries (and specifically in West Germany but also reportedly in Switzerland and Sweden) provides tax relief for interest capitalised instead of received currently. Thus if interest receivables are capitalised, they provide a means of building up "hidden reserves"; as they do not enter into current income, they generate tax savings, which have an important impact given very high marginal rates in countries such as West Germany. There may however be potential limits to this process, based on tax deduction capacity.

Because banks have focussed on <u>collective action</u> in debt crises management, via the so-called steering committees, (mainly perhaps to present a united front to debtors) they may have not considered some opportunities for measures that could be taken only by banks of certain size or nationality, which would alleviate debt service for developing countries in a way that would cause minimum cost or damage to creditor banks. Interest capping partly covered by tax savings are perhaps an ideal way of governments subsidising indirectly part of a reduction in debt servicing, which probably could be easily implemented, and would not seem to require new legislation. The principle of more equitable sharing of the debt crises between debtor countries, creditor countries' governments and creditor banks so often raised in a general manner could be concretely implemented through interest capping.

It should be stressed that it is for obvious reasons illogical that interest capping would be implemented at the initiative of banks and that the issue of interest capping would have to be negotiated at the initiative of debtor governments either with creditor banks' governments and/or groups of creditor banks.

As we have pointed out, differential approaches to new money or interest capping in different creditor countries by the banks themselves and by their regulatory and accounting authorities may imply that the mixture adopted would not necessarily be uniform across countries. On the other hand, there would be clear advantages to an across the board interest cap, as its impact on debtor economies would be greater and as it would imply greater equity amongst creditors.

In this respect, it needs to be stressed that there is no technical reason why accounting treatment in the U.S. (which in its' present form does not allow deferred interest to be included in current profits, and thus would have a negative impact on banks' profits) could not be modified. Careful reading of in-depth studies on the subject clearly conclude that U.S. accounting treatment could be changed <u>if</u> regulators so wished. Thus, Bergsten, Cline and Williamson, op.cit. believe that "accounting treatment might change if there were a strong signal from federal regulators that substantial interest capitalisation were desirable on policy grounds." Similarly a fairly detailed legal study of the issue,[22] concludes: "regulators need not adopt wooden interpretations of the regulations. The regulators would not be bound to require additional reserves or disclosure under the Allocated Transfer Risk Reserves (issued in January 1984) and the Securities and Exchange Commission regulations if they viewed capping arrangements as contractual arrangements fixing the interest due at any payment date to the stated cap rate and treated the amount due under a separate legal obligation. Such an interpretation of the regulations and guidelines would allow sovereign borrowers and their creditors to pursue different capping schemes without concern as to the potential impact of such schemes on bank reserves or disclosure statements, thereby contributing to a more stable environment for banks and their borrowers".

There have been a variety of interest "cap" proposals; it is important to distinguish between i) "a liquidity" cap that merely postpones payments beyond a certain level of interest till some future date (either till interest rates fell again below the cap or till the maturity of the loan expires) and ii) concessional capping, which implies that either part or all of the difference between the market rate and the cap is forgiven during a certain period.

Even a liquidity cap would have important short-term advantages for debtor countries in that it could provide significant debt service postponement (and therefore reductions or even elimination of negative net transfers) in the short-term, contributing towards immediate improvement in living standards and growth prospects, even though there would be the potential long-term problem of increased debt overhang. The benefits of capping for developing countries would clearly be enhanced (particularly the medium and long-term ones) if there were some concessionality involved, such that for a period (e.g. three or five years) the margin above the cap would be forgiven; the cost of such concessional capping could for example be distributed amongst lower bank profits and a subsidy to the private banks from their governments. As calculated elsewhere,[23] the cost of a fairly large concessional cap, though very significant, would be bearable even by U.S. commercial banks, particularly if accompanied by lenient regulatory and accounting treatment and/or some explicit subsidy from the monetary authorities.

Interest "capping" therefore seems to offer a number of advantages from the point of view of several of our criteria (fairly large positive impact on net transfers of foreign exchange and a significant amount of front loading).

It would be important that capping should be put in the context of development plans, carefully monitored by international institutions. An interesting proposal was made by the Inter-American Development Bank's President[24], who suggested that part of the interest due to be paid by debtor countries to commercial banks would go into a trust fund administered by the IADB and the World Bank to be rechannelled to the country as long-term fixed rate development loans for particular projects.

d. <u>Measures to increase new flows</u>

The main options as regard new flows include: i) a significant expansion of new official flows (e.g. through multilateral or bilateral agencies) ii) a significant expansion of government guarantees, insurance or lender of last resort facilities to encourage private flows iii) a significant expansion of non-bank credit private flows, via foreign direct investment, portfolio investment, quasi-equity flows, bonds and others.[25]

Clearly proposals to diversify private flows to developing countries into new channels and through new agents (option iii) are of great importance, but are unlikely to have more than a fairly marginal impact in the short-term, particularly while the crises of debt and development are continuing. In the current circumstances those non-banking private flows as well as private bank flows to developing countries seem likely to materialise at a meaningful level, only to the extent that they would be backed by government guarantees. Nevertheless, innovations in the third category of flows are valuable, both because they do make some contribution to LDC external finance and also because they can contribute to a more appropriate future structure of liabilities of developing countries than emerged in the seventies. We will refer below to those measures in this field which would be more appropriately applied by the "middle powers", who seem particularly well suited to take some initiatives in this field.

A package of measures that would lead to a meaningful change in the net transfer of financial resources to developing countries would imply as regards new flows, either a significant expansion of new official flows (through multilateral or bilateral agencies and/or an expansion of government guarantees, insurance) or lender of last resort facility. The attractiveness of the latter option is that it requires far less immediate disbursement of public funds (and indeed most of it may always remain only as a contingency commitment), and may therefore be more feasible; this seems particularly relevant at a time when the U.S. government, though more committed to a growth oriented solution to debt crises is even more committed to public spending cuts and while fiscal conservatism continues to dominate in most of the other major industrial countries); the danger is that unless the official guarantees offered are very strong and very explicit, the impact on additional private flows may be fairly marginal. Schemes that merely or mainly provide "comfort" to bankers (such as most co-financing with the World Bank and apparently the Baker plan) may fail to generate sufficient new flows. On the other hand, there is a wide range of options and proposals for explicit government guarantees, either through bilateral agencies, such as the export credit agencies or through multilateral institutions, such as the World Bank. A disappointing feature of the Baker Plan, is that in fact official export credit agencies are not being asked to increase their exposure to developing countries; nor was any major policy change suggested for allowing a large increase in the amount of guarantees that the U.S. government or the World Bank can give (e.g. by changing its' gearing ratio), thus assuring that the larger projected bank lending proposed will actually materialise. A large field of action is potentially open here, for which there are many useful proposals[26] as well as practical experience by the World Bank (e.g. on partial guarantees as part of involuntary packages) and by export credit agencies, which could be built on.

It seems necessary to stress again here that recent trends and present circumstances imply that if significant new flows to developing countries are to be generated in the short and medium-term, it is crucial that these occur directly through public institutions and/or through firm and explicit government guarantees (either individual or collective). Assumptions that private banks or other private agents will spontaneously significantly increase their lending or investment while the debt crises rumbles on and while debtor economies stagnate or grow slowly are not only unrealistic but also counter productive, because they suggest a way out which is extremely unlikely to actually take place. If and when the crises of debt and growth are successfuly overcome, then private agents may wish again to play a larger role (though hopefully a more regulated one).

2. Policy conditionality

Increasingly under discussion are not merely the issues related to the size of financial flows to and from developing countries, but also the conditionality attached to lending to LDC's. Indeed some concern has been expressed by debtor governments that the measures suggested under the Baker Plan could potentially increase further the leverage of multilateral institutions to improve conditionality or even cross-conditionality; these concerns relate particularly to greater pressure for increased freeing of market forces (both domestically, through privatisation and in external relations through opening up to trade flows).

Particularly while net transfers of finance flow <u>from</u> developing countries, the justification for conditionality on loans by multilateral agencies is weakened, instead of strengthened. If anything, it would be logical therefore that multilateral institutions would wish to "impose" and particularly debtor governments be willing to "accept", less conditionality than in the past. Specifically, it will be harder for the IMF to impose strict conditionality where countries are not drawing new credits from it, but only rolling over existing ones, or even repaying existing lines as is becoming increasingly the case; indeed increased resistance to accepting IMF upper credit tranche conditionality seems to be spreading throughout Latin America.

More broadly, there seems increased support for the view that conditionality should be altered in two aspects: i) Relatively less weight should be given to purely financial performance criteria (possibly focussing <u>only</u> on one target in the financial field, that for current account surplus or deficit rather than for a range of financial indicators) and more focus should be placed on performance criteria related to growth and possibly even more broadly, development. An important indicator for growth performance could be the rate of investment as proportion of GDP; appropriate indicators for development could focus for example on targetted levels of government spending to defend or increase nutrition, health and education of the population, particularly the poorest and more vulnerable groups. The shift towards greater emphasis of monitoring of growth and development in conditionality and less emphasis on financial performance criteria would imply a concrete application of the Baker initiative's endorsement of "policies for growth".

ii) Secondly, though there is a clear case for conditionality ensuring that international loans are used to generate sustainable and hopefully equitable growth and that emphasis is placed on the balance of ayments evolution to assure repayment feasibility, there is no similar justification for conditionality to extend to the type of economic agents through which such growth and development should be achieved. Not only are these matters that should be best decided by sovereign governments; furthermore, there is clearly no conclusive evidence (either in favour or against) that "freeing market forces" in developing countries guarantees higher growth rates and/or more development. Therefore, there is no solid intellectual base for the type of conditionality that attempts to define the agents that would best carry out development.

3. Policy Coordination for industrial countries macro-economic policy

It would be imcomplete to discuss measures to relieve the crises of debt and growth without mentioning the key significance of industrial countries' own growth performance, the level of their interest rates and the extent to which they increase protectionist measures, on the evolution of the debt problem.

As discussed above, the prospects for industrial countries' growth in the medium-term are widely seen as rather poor. However, this prospect is not an inevitable one, but is based on a continuation of what to a large extent are policy-induced disequilibria. If coordinated macro-economic action were taken by industrial countries' governments that would simultaneously imply less expansionary fiscal policies in the U.S. and more expansionary fiscal policies in the surplus industrial countries, significantly faster growth in industrial countries would seem technically feasible. Recent attempts to coordinate policies by G-5 governments to try to reduce interest rates are naturally of great relevance to debtor nations.

Pressure from "middle power" governments for increased coordinated action by industrial countries to stimulate growth and lower interest rates, as well as their own macro-economic initiatives would be of great value. The influence of "middle power" governments on such multilateral initiatives may be somewhat limited by the fact that a great deal of macroeconomic policy coordination discussions are being conducted in the G-5 forum, in which these governments do not participate. Given the impact which the evolution of the major industrial countries has on the rest of the world economy, it would seem desirable that more consultation occurred between G-5 governments and other governments, so that full account could be taken by the major industrial governments of the global implications of their policy actions.

B. Independent initiatives by middle powers

A number of the initiatives discussed above in Section A can only be applied multilaterally, and usually require the consent of most industrial countries, including the U.S. This is true for example of renewed issues of SDR's, broadening the CFF, increasing the capital base of the World Bank or expanding the role of World Bank guarantees by decreasing the backing required by the Bank's own capital.

On the oher hand, several of the initiatives discussed above could be implemented independently by one or a group of countries, for example by the middle powers. This may in fact fit particularly well into what seems a likely shift to more differentiated policy solutions amongst creditors, both in debt crisis management and channelling new financial flows. As pointed out above, this could for example imply that European banks could prefer to do some interest capping while U.S. banks would prefer to continue with involuntary new lending.

More broadly, a differential approach could enable creditor governments to develop schemes which are not only more suitable to their own creditor banks' aims and needs (in the context of existing national regulatory, accounting and tax treatment) but which are also specially taylored to the extent and manner in which those governments wish to support debtors' development. In some cases, initiatives successfully pioneered by one or several countries may at a later stage be adopted either by other countries or even endorsed multilaterally.

1. Developmental interest capping

While international interest rates remain high (and several of the middle powers at the moment have fairly high interest rates), some form of interest capping (preferably with a concessional element or if of a liquidity variety, postponing the margin capped for a long period of years) could be applied by individual creditor countries. It would seem desirable that such interest capping would be directly linked to investment or expenditure of the highest priority from a developmental point of view, according both to the creditor and the debtor governments, and rigorously monitored either by the creditor government itself or by a multilateral development institution chosen by it.[27]

If applied on a bilateral basis, (hopefully by several creditor countries), each creditor government could lay particular stress on those developmental expenditures to which it attaches high priority (within a range of expenditures to which the debtor government itself attaches also importance). For example, a creditor government particularly concerned with the "human aspects of development" and the erosion of incomes and relevant public expenditure on these aspects that has resulted from the recent "adjustments" to the debt crises, could link all or part of any interest relief which it would grant on debt owed to it, increased cost-effective and targetted expenditure in aspects such as health or nutrition. On the other hand, a creditor government concerned particularly that recent adjustments have implied a decline in investment in foreign exchange earning activities, thus endangering future growth and long term ability to repay foreign debt, may wish to link all or part of the interest relief with increased spending or investment in foreign exchange earning activities. Though the funds would be channelled by the central government of the debtor country, they would not necessarily imply government expenditure or investment as their final use, as part of such funds could be channelled to private or mixed enterprises, local communities, etc. Differential preferences by different creditor governments would ensure greater plurality of uses than the monolithic approach characterising creditors' groupings at present.

As discussed above, the cost of such capping could be shared by creditor banks and governments (the latter's contribution could be either direct, via some sort of subsidy, or perhaps more conveniently through use of existing or new tax payments reductions linked to the cap). It could also be arranged that banks' losses due to interest capping could be spread over a long period, so as not to provoke negative stock market reaction or other problems.

There is clearly one problem with interest capping applied by only some creditor countries particularly while negative net transfers from developing countries persists; this is linked to the fungibility of money. Even though tying the relief given to specific investments will assure that particularly crucial expenditures are made, the foreign exchange freed by the capping may at least partly be used for purposes such as repaying other creditors, who have not granted such a cap. The solution is clearly not to stop innovative measures, but to strive in multilateral fora for policies that reverse net transfers from developing countries. Also of crucial immediate importance would be that not only were specific programmes developmentally oriented and efficiently carried out but also that they were part of a clear development strategy and consistent macro-economic policies.

2. Increased official flows

An alternative or a complementary mechanism would be for particular creditor governments to increase official flows relatively more to debtor countries most serious affected by the deterioration in the international environment (e.g. terms of trade and increased interest rates) and whose governments have designed effective and targetted actions to sustain or even increase expenditure in "directly productive" activities and in "human aspects of development".

Clearly industrial governments have other criteria for deciding the distribution of official flows to developing countries, such as level of the country's income, importance of the country as a trading partner, ideological affinity between governments, etc. It seems important to add to there criteria the extent to which countries have been affected in recent years by shocks from the international environment over which they had little or nor control; in the case of countries where a large debt overhang has magnified the impact of higher international interest, it would seem desirable also to give greater support (either through higher official flows or other mechanism) to democratic governments who have "inherited" most of this debt, from previous more authoritarian regimes.

The seriousness of the external shocks received by a large number of developing countries in recent years may also provide a general argument for increasing the total level of official flows to them, though again other considerations will be important.

3. Expansion of government guarantees for private flows

Similar impact on net transfers of resources to developing countries to that achieved via increased official flows can be achieved through increased government guarantees of private flows. The advantage of this modality of finance is that it has no or fairly limited budgetary impact. Put in another way, with a small increase in government expenditure, a large increase in new flows to developing countries can be achieved.

Measures that expand export credit guarantees are obviously attractive to exporters from those countries, and therefore are one of the schemes discussed here to have the clearest political backing. When examining the measure from a developmental point of view, an expansion of export credit guarantee cover would clearly be positive in that it would contribute to fund new investment, but would not deal with - or could perhaps even in certain cases accentuate - the problem, particularly evident in certain countries and sectors of Sub-Saharan Africa, of under-utilisation of existing capital due to shortages of foreign exchange for financing imports of spare parts and raw materials. This latter problem could be overcome to the extent that in granting export credit guarantees, the government agency not only considers the commercial interests of its' exporters but also gives special priority to development needs of individual countries and sectors.

An important aspect of export credit guarantees is also the continuity of its' availability. It has been reported that even after official credits and export credit guarantees have been satisfactorily renegotiated in the Paris Club, there are often long lags before new credit is restored. Firm commitment by export credit agencies to a rapid restoration of cover in case of agreed reschedulings is an important concrete measure for export credit agencies of middle power countries to adopt.

As regards rescheduling of export credit guarantee facilities, these are carried out multilaterally in the context of the Paris Club. The only aspect determined bilaterally at present is that of interest rates; this is however an aspect that has caused concern as large increases in interest rates have been reported after rescheduling, leading to a clearly undesirable increase in the present value of future debt service obligations. It would seem a desirable policy for "middle power" creditor countries to avoid increasing interest rates after rescheduling. Indeed, consistent with a policy of interest capping on bank assets, it would seem logical to reduce also interest charges on export credit guaranteed loans.

A possible mechanism to expand further export credit guarantee lending would be to mobilise part of the medium-term rescheduled debt owed to private banks to create new lending.[28] Such new lending would be linked to export credit, with the agency discounting a certain amount of a country's debt, provided that the additional cash was then used to make a new export credit to the same country. An advantage of this scheme would be that the rediscounted debts would come off the balance sheet of the commercial bank, thus reducing the large proportion of banks assets in the balance sheet which are currently locked into "immobilised debt" for a long period. It should be emphasised that the "discounted debts" would still need to be treated as contingent liabilities because, if the debt was unpaid, a write off would ultimately have to take place in the books of the commercial bank as the original lender. The advantage of this switch for the commercial bank is that contingent liabilities are normally accepted to require less prudential capital support than direct liabilities; for example, contingent liabilities are weighted at only half those of direct liabilities in the Bank of England's capital system.

4. Encouragement of new forms of international financial intermediation

Amongst the causes of the seriousness of the debt crises have been the inappropriateness for development funding of the mechanisms involved in private bank lending and the heavy concentration of commercial banks as sources of these funds during the seventies.

As a consequence, it has been suggested that a number of mechanisms and new agents should be encouraged to achieve both an increase in - and a more appropriate structure of - flows to developing countries (see Lessard and Williamson, op.cit). Such schemes may have a fairly limited effect in the short-term, both because of the inevitable time lags involved in setting them up, but also particularly because it seems especially difficult in the midst of debt crises to encourage new agents to fund developing countries. Once the short-term potential limitations of such measures are perceived, it seems worthwhile for governments to support innovations in this field, particularly as such support does not involve major commitment of public funds or effort. Furthermore, these measures are attractive from the point of view of "middle powers" in that several of them could be - or even could be best - applied experimentally by one or a few countries.

Amongst the most relevant measure seem to be:

i) General insurance of transfer risk.

It has been argued that given the difficulties of setting up an international insurance scheme, national insurance systems may be easier to negotiate.[29]

The main problem for purely private insurance seems to be limited availability of such insurance, given the critical shortage of political risk capacity. This was reflected in the collapse of the widely publicised Citibank-CIGNA arrangement, reportedly due to difficulties in obtaining sufficient participation from insurance companies.

Thus the setting up even of a "private" insurance scheme may require at least a temporary emergency reserve from a government agency, such as that which guarantees export credit; this according to Wallich would imply that the government funds would not necessarily have to be appropriated for such a purpose. To the extent that such funds would provide only partial insurance (and/or would be combined with insurance from private sources) the higher leverage of this use of such funds would more than compensate for any reduction in other credit to developing countries.

Though innovative national insurance schemes, with contingency backing by governments, could clearly play a positive role in diversifying risks, it would not seem advisable from the point of view for individual governments to encourage increases in bank lending of their banks too far above international averages; such a trend would imply an excessive burden of potentially callable liabilities to be placed on the shoulders of particular governments and/or private insurance companies.

ii) Elimination of restrictions affecting flows to developing countries

A number of restrictions exists in industrial countries that constrain private lending to, and investment in, developing countries. It would be important that, whenever possible, individual industrial countries should either lift such restrictions or reduce them to what is required by genuine prudential need. The type of restrictions that could be lifted or significantly reduced include: prohibitions on pension funds from buying securities of developing countries, limits on the proportion of their assets that insurance companies can place in developing countries' paper and restrictions on the flotation of developing country bonds.

iii) Preferential treatment for flows to developing countries on their capital markets

As Lessard and Williamson, op.cit, point out, the removal of regulatory constraints on investing in developing country assets would probably not by itself lead to any major increase in new types of flows towards them; additional positive steps would be required, by providing preferential treatment for developing country borrowers.

One such concrete initiative that could be adopted by "middle power" industrial countries would be that for those who regulate the issue of foreign bonds by a queuing system (as indeed several of the smaller industrial countries do), preference could be given to issues by developing countries.

Positive "discriminatory" action in favour of developing countries could go beyond that, for example if particular countries issued guidelines that their institutional investors (such as insurance and pension funds) should hold at least a certain proportion of their foreign portfolios in the form of investment in developing countries. Such a suggestion is particularly relevant for Japan, so as to attempt to try to channel a larger part of that country's large current account surplus to the developing world. However, similar measures could be adopted by the "middle power" countries, particularly but not only by those who have current account surpluses. Positive "demonstration effects" of successful pilot schemes in this field from "middle power" countries could contribute to their adoption by other industrial countries.

More broadly, one of the key issues for international financial intermediation in the medium-term will be the search for mechanisms appropriate to channel a meaningful part of the long-term funds from the surplus agents in surplus countries (particularly but not only Japan) to development finance. The long term nature of such funds makes them particularly appropriate for development funding, but their high level of risk aversion, their lack of knowledge of developing countries and the existence of alternative "safe" demand for them in the industrial countries makes their attraction to financing developing countries a difficult though crucial task.

iv) Promotion of commodity bonds

In the area of promoting new instruments to attract funding to developing countries, there is one initiative for which the industrial "middle power" countries would be particularly well suited: starting issues of commodity - linked bonds to begin a market for those types of assets.

Commodity bonds would imply that interest or amortization payments or both would vary with the price of a commodity; this would have the advantage for the borrowing country that it would avoid the "scissor" movement that occurred in the early eighties when debt service obligations rose at the same time as commodity export earnings fell, due largely to declines in their prices. For creditors it would increase the likelihood of repayment, even though the projected timing of the repayment would be fairly uncertain.

Given that financial markets are reluctant to accept this type of innovations unless introduced by borrowers with very high reputation in the capital markets, it has been suggested (see again, Lessard and Williamson, op.cit) that such a new type of assets could best be pioneered by industrial countries with important primary products. This is an initiative clearly suited for "middle power" industrial countries, as almost all of them are major exporters of primary products. Once a market for such commodity linked bonds was established, developing countries could follow in the path already established, possibly even benefitting from some technical assistance from the industrial countries already involved on how to best enter that market.

The floating of commodity linked bonds by industrial countries if successful, might be of some benefit also to the industrial country involved by diversifying the range of its' funding options, and making them more suitable to the structure of their economies. The only problem with launching commodity linked bonds at present is that recent unfavourable trends and projected continued weakness of most commodity prices may make it a relatively unsuitable time to launch such an initiative. Possibly a better time would be when prospects for commodity prices are seen as somewhat better than at present.

5. Final considerations relating to "middle power" debtors

We will finish with three brief considerations, which seem to emerge from our analysis.

In certain international financial circles, the actions or proposals of debtor countries to reduce the net transfers from them or to increase positive transfers to them are generally viewed from a negative perspective, evaluating to what extent those actions could be disruptive to the stability of individual banks or of the international banking system. It seems important that debtor countries consciously attempt to change this perception showing that many of the measures suggested or taken by them to deal with the debt crises in a more fundamental way would not only be of direct benefit to their own economies, but would also have a potential beneficial effect on the world economy via a higher level of economic activity. Furthermore, the type of measures advocated - such as for example greater role for international public institutions in creating regulated liquidity and expansion of compensatory financing mechanisms as well as some increase in public flows - may imply a desirable and constructive shift towards an international financial system better suited to the needs of both industrial and developing countries in today's interdependent world. Debtor governments should see - and try to explain to international public opinion - that positive debt crises management and significant changes in international financial intermediation are to a great extent a "positive-sum" and not a zero sum, game. Understanding for this in industrial countries may be increased if the debate increasingly includes non-financial actors, such as industrial entrepreneurs, trade union leaders, representatives of ministries of industry, etc.

Secondly, there seems to be a set of policy measures that would clearly contribute towards making the debtors' crucial objective of development far more possible, without sacrificing the essential interests of the creditors. This would imply that there are potential "positive sum" elements in debt crises management which could be fairly easily implemented. To fully implement these potential "positive sum" elements in a way to effectively create conditions for growth in debtor economies, a package of measures would need to be adopted multilaterally, that though technically feasible, seems unlikely to be implemented in the present international political environment. Partial packages of multilateral action combined with bilateral initiatives will clearly be valuable, but may not be sufficient to restore growth in debtor economies.

Finally, the uncertainties over the future of debt crises management and of international financial intermediation, and the unlikelihood that for many years positive net transfers, towards debtor LDC's particularly to Latin America, on the scale of the seventies will occur, must imply that development strategies in those countries should increasingly rely on their own nationally generated resources for funding development and must avoid patterns of development intensive in foreign exchange that will remain scarce for the coming years.

Footnotes

(1) E. Iglesias "The need for a long-term solution to the debt problem and for new credits". Speech at the IADB Conference Beyond the Debt Crisis Latin America: thenext ten years. London. January 28th, 1986.

(2) This subject of responsibility for the debt crisis has been widely discussed in the literature. See, for example, World Bank, 1985. World Developmen Report, Washington D.C., UNCTAD Trade and Development Report 1985. New York, and S. Griffith-Jones and O. Sunkel The Crisis of Debt and Development. Oxford University Press 1986.

(3) Statement by James Baker III, Secretary of the US Treasury at the 1985 IBRD/IMF Annual Meeting. Press release October 8th, 1985.

(4) Marris S, Deficits and the Dollar: the World Economy at Risk. Institute for International Economics. December 1985.

(5) For a useful review of these forecasts, see S. Page Economic Prospects for the Third World, the 1985 Forecasts Financing Development. ODI (London) October 1985.

(6) Source: OECD Economic Outlook. December 1985.

(7) UNCTAD Trade and Development Report, 1985 JDR/5

(8) According to IMF figures (World Economic Outlook, April 1985) negative net transfers from non-oil developing countries was above US$10 billion in 1984 and estimated to have increased since.

(9) Source: IMF World Economic Outlook. October 1985

(10) Data on Latin America, from CEPAL Balance preliminar de la economia latinomericana durante 1985, 19th December 1985. Santiago de Chile.

(11) OECD, op. cit

(12) Economist Publications. IAS World Outlook Supplement, June 1985.

(13) Perhaps the most complete study is that by F. Bergsten, W. Cline and J. Williamson (1985). Bank lending to developing countries: the policy alternatives. Institute for International Economics Washington D.C. MIT Press; see also Griffith-Jones S. "Proposals to Manage the Debt Problem" Development Policy Review Vol 13 (November 1985); Stewart F (1985) "The international debt situation and North-South relations" World Development Vol 13, no. 12 and M. Guerguil (1984) "The international financial crisis diagnosis and proposals". ECLA Review, no. 24. Chile.

(14) For more details, see, for example, R.H. Green and S. Griffith-Jones "Sub-Saharan Africa's external debt crises" Third World Affairs 1986. Third World Foundation. London.

(15) Such an optimistic belief permeated for example the 1984 IMF World Economic Outlook.

(16) C.J. van de Klugt "Continuity is the Goal; flexibility is the key". Speech delivered at the IADB Conference, quoted above.

(17) Report by a Commonwealth Group of Experts. The Debt Crisis and the World Economy. Commonwealth Secretariat 1984.

(18) IMF Survey August 26th, 1985 "Report of the Group of 24 calls for basic Changes in the International System".

(19) For a more detailed discussion, see Griffith-Jones, S, op. cit in (1)

(20) For example, A. Solomon, president of the Federal Reserve of New York and H. Wallich, Governor of the Federal Reserve Board.

(21) See, Bergsten, W. Cline and J. Williamson, op. cit for a very complete discussion, also personal communication with John Calverley from AMEX Bank and Lionel Price from the Bank of England.

(22) J. Hurlock "Legal Implications of Interest rate Caps on loans to Sovereign Borrowers". Journal of International Law and Politics. Vol 17 No. 3, Spring 1985. New York University.

(23) Griffith-Jones, S. op cit.

(24) "IADB urges fund to aid Latin American debotrs". Financial Times September 21, 1985.

(25) This category of flows is discussed in detail in D.R. Lessard and J. Williamson Financial Intermediation Beyond the Debt Crisis. Institute for International Economics. September 1985. MIT Press.

(26) See, for example, Report by Commonwealth Group of Experts, op. cit; Bergsten, F, Cline, W. and Williamson, J. op. cit; and Griffith-Jones, S op. cit.

(27) This proposal has been made at a multilateral level by distinguished Latin American economists, including Antonio Ortiz Mena, President of the Inter-American Development Bank (quoted in (24) above); Osvaldo Sunkel in America Latina y la Crisis Economia Internacional: Ocho tesis y una propuesta. Grupo Editorial Latinomericana. Buenos Aires. 1985; and Raul Previsch in Hearings on the Debt Problem by the US Congress, July 1985.

(28) See, P. Leslie "Techniques of rescheduling: the latest lessons". The Banker, April 1983. This section also draws on an interview with Mr. Leslie, who is one of the senior executives of Barclays International.

(29) H. Wallich Insurance of Bank Lending to Developing Countries. Group of Thirty. 1984. New York.