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WAYS FORWARD FROM THE DEBT CRISIS

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I. INTRODUCTION

The widespread debt crises of developing countries and their impact have since mid-1982 become the focus of world-wide concern. Far less attention, particularly in industrial countries, has been placed on the crises of growth and development that have accompanied debt crises in the debtor nations.

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 to seek adjustment by the debtor economies; this adjustment of debtor economies is largely geared to assure that within the current international environment, the debtor countries can continue servicing their (usually rescheduled) debts. Most of the actions taken since mid-1982 till the present can be broadly classified as forming part of "debt crisis management", as these actions have been usually taken *after* debt crises have occurred and have been mainly geared to avoid the more disastrous immediate potential effects of debt crises, mainly on the stability of the international banking system.

The focus on debt crises management and the way in which it has been conducted has had 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

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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. In the case of Latin America, in spite of "debt restructuring and involuntary bank lending packages", the region as a whole made very significant negative net transfers of financial resources to the industrialised countries and particularly to the U.S. This transfer is estimated by the UN Economic Commission for Latin America and Caribbean (ECLA until 1984, ECLAC since 1985) (1985) to have averaged U.S. $25 billion a year between 1982 and 1985, and been equivalent to over 25% of the region's total exports of goods and services. Together with an important deterioration in the terms of trade of the region and fairly slow growth of world trade during this period, the large negative net transfer of financial resoúrces have been a crucial variable for explaining the decline in per capita output that occurred in the region. In 1985, GDP per capita in Latin America was on average almost 10% below its 1980 level; this has meant a reversal of previously uninterrupted growth during the last thirty years.

In its' 1985 *Annual Report*, the Inter-American Development Bank (IADB) (1985) concludes its' detailed evaluation of the adjustment policies thus "Although in a technical sense adjustment policies were successful in most countries in that they facilitated the generation of both the trade surpluses and the domestic resources needed to cover most of the interest payments on the external debt, they cannot be said to have produced - so far - the basis for the longer term structural transformations of the Latin American economy that is required to put the region on a new growth path. The adjustment in the 1982-84 period was to a large extent a negative one, based on simultaneous reductions in imports and investment. The social cost in terms of reduced living standards, high inflation and high unemployment has been tremendous and unequally distributed, and there is little likelihood of significant improvement over the near term" (p.9.89). As the IADB study and other sources report, the decline in investment has been very sharp; for the seven largest Latin American economies (Brazil, Mexico, Argentina, Venezuela, Chile, Peru and Colombia), the aggregate investment ratio fell from 24% of GNP in 1980-82 to 18% in 1983-84; private sector investment was hardest hit; within public investment, investment in social areas, such as education, health and water supply was particularly affected, as state investment shifted to areas aimed at strengthening the balance of payments. The reduction in living standards is also reflected in large increases in unemployment (which doubled in some Latin American countries between 1981 and 1984!) and in large declines of real wages in most countries, which were particularly severe in the two largest debtors, Mexico and Brazil, where between 1981 and 1984, real wages fell by 30% and 23% respectively.

This negative economic evolution has not only been harmful to the economies and peoples in Latin America, but also has been harmful to those economic agents in industrial countries which benefit from growth in that region, e.g. entrepreneurs and workers whose output is or was exported to Latin America, multinationals that have already invested or would like to invest in the region and who prefer an expanding market there. More broadly, world economic recovery from the recession of the early eighties has been slowed down by decline in output or slow growth in Latin America as well as Africa.

A second negative feature of debt crises management, as practised in the 1982-85 period is that it 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.

As a result of the seriousness and pervasiveness of the debt crises and their negative impacts as well as the perceived insufficiency of the measures taken so far, a large number of proposals have emerged which suggest more fundamental changes in the way the current debt crises should be handled and in the manner in which international financial flows to and from developing countries should take place.

It is the main purpose of this paper to review and evaluate the proposals made from different perspectives and to reach some policy conclusions.

Before carrying out this task, we wish first to stress that though there has been a large amount of proposals,[2] the main problem has been that they have remained just that, instead of being transformed into blueprints for immediate action. As a result of the lack of willingness by creditor governments and institutions to take any major initiative and lack of sufficient pressure from debtor governments to use their new, yet unexploited bargaining strength (see below) for demanding such changes, the discussion on major reforms to reduce the "debt overhang" or generate a new system of international financial intermediation has been to a large extent hypothetical, and the changes introduced fairly minor, *particularly in relation to the magnitude of the problem.*

There are however a number of reasons which in early 1986 seem to make the adoption of at least some more fundamental transformations more likely. This changes the potential impact of discussion of different proposals from a purely academic exercise to one with policy relevance.

Amongst the factors that seem to increase the likelihood of more fundamental transformations in the way the debt crises are handled and in changing the process of international financial intermediation are the following:

1) As regards economic trends, the assumptions on which debt crisis management has operated since 1982 have been seriously eroded. Since 1982, private bank "involuntary" lending (occurring under pressure from official institutions like the IMF or central banks of industrial countries) was sustained by banks' expectations that countries' debt servicing would continue. On the other hand, 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. The assumptions on both aspects were increasingly questioned since mid-1985. On the one hand, debtor governments are increasingly concerned that new net private flows have not materialised in spite of their large sacrifices in terms of adjustment. On the other hand, private banks seem increasingly unwilling to increase their lending, whether "voluntary" or "involuntary" to Latin American or African debtor countries; during the first quarter of 1985, banks' exposure to developing countries actually declined in absolute terms. This seemed linked to a perception by banks of an increased risk of debt service arrears, moratoria or even default.

   These problematic trends in financial markets were clearly linked to and reinforced by the slowdown in world trade during 1985, and particularly by the further weakening of commodity prices during the year, as well as the pessimistic projections of most authoritative forecasting institutions, including the IMF itself (IMF (1985)).

2) There has been an important shift within the government of the largest industrial country, the U.S., in its perception of the debt problem and its impact, as well as in the range of policy options which it is willing to contemplate. This has been most clearly reflected in the so-called Baker Plan, an initiative launched by U.S. Treasury Secretary James Baker at the 1985 Annual World Bank/IMF meeting. Though the magnitudes involved in the Baker Plan are broadly seen as insufficient by debtor governments and though there are problems about its implementation, the underlying shift in attitude is clearly welcome; this shift basically gives far greater priority to debtor economies' growth than in the past, and furthermore accepts the need for industrial governments' action to further this objective, as well as that of stability of the international banking system.

3) There has been increased pressure from debtor governments, particularly in Latin America, 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 (which includes all the major Latin American debtors) reacted to the Baker initiative not only by

[2] A small literature has indeed emerged to assess the different proposals. Perhaps the most complete study is that by Bergsten, Cline, and Williamson (1985); see also, Stewart (1985); for a Latin American perspective, Guerguil (1984).

welcoming it but by launching its own, more radical, counter-proposal in mid-December 1985.

The increased toughening of Latin American governments' position 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, and which feel that there is an increasing conflict between the two.

Perhaps most importantly, debtor governments in Latin America are beginning to perceive that the *massive and pervasive* negative net exports of financial resources that they have had to undertake since 1982 are not only 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.

When net transfers of financial 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.

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.

II. EVALUATION OF DIFFERENT PROPOSALS

In this section we will attempt an evaluation of the different proposals which have been put forward for dealing with the problems that have arisen in recent years in international lending and borrowing between developed and developing countries. Given the large amount of schemes that have been suggested, we will concentrate our analysis more on those schemes which we believe would attain better the twin objectives of sustaining growth in LDCs and improve the resilience of the international banking system and which seem more feasible at the time of writing.

(i) Adaptations to the Current System

New SDR Issue

A general form in which the external financial problems of developing countries could be eased would be by a renewed issue of SDR's.[3] The case for renewed issues of SDR's has received widespread support, based on evidence that in the early eighties, SDR's declined significantly as a proportion of non-gold reserves and that for most developing countries, the ratio between reserves and imports was well below their levels in the late seventies. Furthermore, according to BIS figures, global non-gold reserves were in 1983 below their 1981 level. Also, in the context of the debt problem, it is particularly important that SDR allocations provide new liquidity, thus easing present foreign exchange constraints *without* creating repayment obligations and, therefore, without generating future debt problems. Finally, an attractive feature of SDR allocations is that they do not require *an expansion of PSBR* of industrial countries nor do they require parliamentary approval by the member Governments of the IMF (this is particularly relevant for the case of the U.S. Congress).

A more radical version of a new SDR issue would change its distribution, from its current criteria to a distribution based towards developing countries or towards using SDR's (as in the Soros plan

[3] A study which argues the case in some detail is Williamson (1984).

discussed below) to alleviate indirectly foreign exchange constraints of debtor developing economies. Given the resistance of certain industrial governments to any SDR issues at all, it seems counter productive to press at the same time not only for renewed SDR issues but for a change in their distribution.

Expansion and adaptation of existing compensatory financing facilities, to offset also fluctuations in interest payments

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 Facility. In a special IMF Pamphlet on the Compensatory Financing Facility, Goreux (1980) spells out its main purpose:

- "Ideally, the facility would enable a member to borrow when its export earnings are high and financial reserves are low and to repay when they are high, *so its import capacity is unaffected by fluctuations in export earnings caused by external events*" (my italics)

In the seventies and early eighties, the CFF became a major facility for providing payments assistance by the IMF to developing countries. However, different studies showed that borrowing under the facility remained rather modest considering the terms of trade deterioration experienced in the early eighties by developing countries. The main problems with the existing *modus operandi* of the CFF have been identified by Griffith-Jones (1983) as the quota limits on maximum drawings (which is the most important constraint); the calculation of export shortfalls in nominal terms and a formula for repayments not linked to the recovery of export earnings. A number of analysts have suggested a liberalisation of the CFF so as to provide full coverage of export shortfalls, basically by eliminating the link between the size of the drawing allowed and a percentage of the country's quota. The advantage of such a change would be that by stabilizing export earnings, it would have a very desirable impact both on developing countries and the world economy and would contribute significantly to breaking vicious circles of poor trade performance and financial distress. Thus both the stability of the international banking system and the stability of developing countries' growth would be enhanced by such a measure. One objection to this measure could be the risk of "moral hazard"; this is minimal as the Facility is granted only if the "export shortfalls were largely attributable to circumstances beyond the member country's control". The more fundamental objection is that of cost and the problem of safeguarding the liquidity of the Fund were the CFF to be significantly expanded.

Linked to the emergence of widespread debt crises, there has arisen in many different circles,[4] 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 which deals with the more traditional sources of instability from export earnings. Conceptually perhaps the most precise aim for a modified CFF would be to attempt to stabilize countries' real import capacity (and compensate for fluctuations in export prices, import prices and interest rates beyond the country's control, in cases of balance of payments need).

The calculations for the estimated additional cost of an interest rate window for the CFF are quite complex; only very rough magnitudes have been estimated (for example in the Commonwealth Secretariat Report (1984) also known as the Lever Report and Cline (1984), based exclusively on the variable interest debt. Such a definition of the facility would mainly take account of the needs of the large debtors and neglect the fact that even official flows are subject to some (though smaller) fluctuations of interest rate. The magnitudes involved would also 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 one. If quota limits on CFF drawings were not significantly expanded, or removed, the net cost of introducing an "interest window" into the CFF would be relatively low, but its beneficial counter-cyclical additional effect

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[4] See, for example, the Mexican Government's proposal and in The Economist (1983).

would be equivalently small; if the quota limits were linked to liquidity availability in the Fund, there would be the danger that 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 would seem vital 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. Clearly, an expanded CFF, which would include compensation for interest rate increases, would give the IMF a broad capacity to finance temporary needs caused by international economic shocks; it would also provide significant counter-cyclical funding, crucial both to the developing countries affected and to the world economy.

The problem with an "interest window", implying a large expansion, would be its additional cost. A maximum limit is given by the variation of interest payments for all developing countries, except capital surplus oil exporters, (*assuming debt outstanding is constant in nominal terms*). The largest such increase was between 1980 and 1981, reaching the sum of U.S. $4.2 billion for that one year. Such a figure could probably be accommodated with relative ease, particularly considering that clearly not all countries who had rising interest rate cost had a balance of payments need. The problem of cost would arise in periods such as the recent one, when real interest rates have systematically risen during a long period; discounting the effect for the increase in the value of the debt, interest payments of all LDC's (except surplus oil exporters) rose by U.S. $19.6 billion between 1978 and 1982![5]

Given the magnitudes involved, the issue of providing appropriate liquidity to the Fund to finance such an expanded and modified CFF would be crucial. An interesting idea suggested by Cline (1984) is to finance the proposed interest rate window of the CFF with the emergency funding conditionally already available to the IMF through the significant expansion of the General agreements to Borrow GAB; in December 1983, the IMF had its lines of credit available from the GAB increased from SDR 6.4 billion to SDR 17 billion, to be used "to forestall or cope with an impairment of the international monetary system" (IMF (1984)). If the participants in the GAB (the ten major industrial countries) would authorise such a use, the initial liquidity problems posed for the IMF by a new interest rate window could be significantly reduced or even eliminated, without additional requirements of financial contributions from industrial countries. An important problem would be that use of the GAB facility would seem to require high conditionality upper credit tranche arrangements with the IMF, whereas the CFF has till now on the whole had much less stringent conditionality.

Other funding possibilities (such as finance by SDR's, funding by the IMF in the market, or even possibly quota expansion) are also feasible.

Two final caveats seem necessary on the subject of the CFF. Firstly, an expansion - both conceptual and quantitative - of the CFF does pose important problems. However, similar problems would be raised by other mechanisms to deal with the existing problems of instability in terms of trade, world inflation and the interest rates. The clear advantage of using the CFF would be that it is already an existing mechanism (with an existing infrastructure for its operation) and that in spite of its limitations, previous experience with it has been extremely positive.

A final caveat needs to be made about the assumptions on which the CFF's design was based. The Compensatory Financing Facility was designed in the early sixties assuming correctly then that the main source of external instability for developing countries was the value of developing countries' exports and that their value fluctuates significantly, largely following the cyclical pattern of activity in the industrial countries. A further important assumption was that these cycles of economic activity in industrial countries were short and occurred within a *long-term trend of sustained growth*; this latter assumption - which was basically correct in the fifties and sixties - no longer seemed to hold as obviously true in the seventies and even less in the early eighties. If stagnation or slow growth in the industrial countries were to persist for long periods, as well as their detrimental effects on developing countries, perhaps even a more fundamental review of the

5 Calculations based on data in World Bank (1984).

CFF than has been suggested above may become necessary, to reflect and incorporate the changing pattern of growth in the world economy. Were there for example to be a systematic trend toward decline of terms of trade of all or, more probably, of some categories of developing countries and/or sustained high real interest rates, even a modified and expanded CFF would be insufficient to deal with those problems.

Interest "capping" of various types

Alternative, or perhaps possibly complementary, forms of reducing interest payments - either temporarily or permanently - have been proposed under the general title of "interest capping". It seems worth stressing that the idea of interest cap has been raised or strongly supported by some of the most senior U.S. monetary authorities,[6] and that such a proposal may therefore have some potential support from U.S. authorities.

Two different versions of interest capping have been proposed: capping designed to stabilise interest payments overtime (liquidity gap) and concessional capping. The liquidity cap would set a ceiling on interest rates on both new and rescheduled loans. If market rates rose above this ceiling, the difference between the market rate and the ceiling rate would be added to the loan's principal due upon final maturity (that is, the increase in interest would be capitalized). If subsequently the market interest rate fell below the ceiling rate, the ceiling rate would continue to be paid and the difference would be deducted from that additional principal that had been accumulated earlier as capitalized interest. This liquidity cap would have considerable short-term advantages, in that it would provide essentially needed cash to developing countries and would avoid unnecessary disruptions to their development and hardships to their population, due to temporary reductions of imports. It would imply a greater degree of equity (greater than the current case-by-case approach to rescheduling) in that such a measure would follow a general rule, applicable to all countries with bank variable interest borrowing - even though it would implicitly discriminate against those countries which did not wish to, or could not, borrow on those terms in the past. Several operational and institutional questions would need to be resolved before such a proposal could become a reality; bank regulators and accountants would have to be prepared to treat deferred interest favourably; an evaluation of potential negative stock market reaction to such a proposal being implemented would be required, even though the negative reaction to the interest cap may be compensated by a perception in the market that this significantly enhanced in the medium-term countries' willingness to service the debt rather than take unilateral action. The key problem with the cap is that *If* real interest rates were to remain high, the postponement of interest would merely transfer the problem into the future. *If* international real interest rates were to decline significantly in the near future, a cap would provide timely and valuable temporary relief. Thus, an interest cap, accompanied by the adoption of policy measures in the main industrial countries conducive to a reduction in international real interest rates would make an important contribution to relieve the short-term debt burden of developing countries and indirectly, to increase the stability of the international banking system.

While uncertainty remains about the future of interest rates, it may be desirable to consider the need for concessional capping.[7] Such concessionality would seem more feasible to justify and implement if it were temporary (e.g. for three years) and were shared by private banks and central banks. One possible mechanism would be that the difference between the market rate and the ceiling (e.g. 9-10%) would be forgiven and the cost distributed amongst lower bank profits and a subsidy to the private banks from their central banks.

We will estimate the implications of such concessionary capping for the largest U.S. banks. According to Cline (1983) in 1982, the nine largest U.S. banks had a gross profit (before tax) of U.S. $5.5 billion and at the end of that year, total loans to non-oil developing countries and

6 Anthony Solomon, president of the Federal Reserve of New York proposed an interest cap, see Journal of Commerce (1984). Henry Wallich, Governor of the Federal Reserve Board, broached a wider proposal for interest capping, such that any interest in excess of inflation plus a normal real interest rate would be capitalised. (Wallich (1983)).

7 As has been discussed, for example, in *The Amex Bank Review* (1984), Dornbusch (1984).

non-capital-surplus OPEC countries of U.S. $78 billion. Each percentage of interest subsidy would have implied a maximum of U.S. $780 million of cost for those banks, equivalent to a maximum of approximately 14% of their total pre-tax earnings. A subsidy of 2% by those banks would have implied a reduction of less than 30% of their profits, which though significant would seem bearable. Were such a subsidy to be accompanied by one provided in this case by the U.S. Fed for an equivalent amount - *U.S. $1560 million* - a significant reduction on interest rate cost (4%) would have been achieved without a disruptive impact on the banking system nor a very significant expansion of the U.S. money supply (for example, if compared with the cost of the Continental Illinois rescue). An undesirable effect would be that lower bank profits would imply a slower expansion of banks' capital and thus reduce the expansion of their rate of capital to developing country assets, which banking regulators have tried to encourage. However, if a concessionary interest cap would significantly increase the likelihood of repayment by developing countries (and thus the quality of the assets), such a move may be acceptable to bank regulators, particularly in Western Europe. (Bergsten, Cline and Williamson (1985) and O'Brien (1986). Compared with the CFF interest window proposal and an interest cap which merely redistributes interest payments over time, a concessionary interest cap has the clear advantage of providing short-term relief to developing countries, *without* increasing the future debt burden. (The CFF interest window could perhaps accommodate some concessionary terms for the low-income countries, but - given the IMF's Articles of Agreement and current modality of operation - would probably provide much more limited levels of relief). Such clear cut relief as a concessionary interest cap could give, could be expected to encourage a very positive political response from debtors' governments (who would see the principle of burden sharing of the debt crises applied to some extent) enhancing their willingness to continue servicing their debt.

Internalising debt servicing obligations

An interesting variation on the "interest cap" approach discussed above is one suggested by Massad and Zahler (1984), two ECLA economists. Similarly to the "interest cap", it assumes a "reference" interest rate, which in this proposal is equivalent to the long-term average of real international interest rates plus "average spreads". If the market rate is higher than the reference one, national debtors pay the total market interest to their Central Bank, which pays the creditors only up to the "reference rate"; if at a later period, the market rate is below the reference one, the Central Bank will draw on existing accumulated national currency to pay the reference rate (the Central Bank would assume the exchange rate risk, though not the commercial one). The advantage over the interest rate cap would be that the existence of funds in national currencies could provide a better guarantee of future repayments to international banks and their regulators than a mere commitment to pay.

Increasing repayment flexibility

Another approach attempts to adapt countries' servicing of debt to their "ability to pay". One mechanism would be to introduce "bisque clauses" in lending arrangements (either existing or new ones), which would allow governments to defer part of repayment instalments, because of changed conditions, to be repaid when the original maturity expires; such arrangements could be linked to clauses implying acceleration of repayment when the situation was more favourable than anticipated.[8] Obviously the flexibility would have to be clearly limited, so as to avoid becoming non-enforceable.

A number of proposals have been made to link debt service payments explicitly to ability to pay, by fixing a maximum limit on countries' foreign exchange earnings which would be devoted to servicing the debt. For example, the Cartagena consensus suggests that "external debt service must not engage export earnings beyond reasonable limits". Even though it does not suggest a particular limit, this document suggests some rather general criteria for determining it "compatible with sustaining adequate levels of domestic productive activity, always taking account of the particular features of each country's economy". The Latin American institution, SELA (1984)

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8 For a discussion of "bisque clauses" in the context of developing countries' external finance, see Harvey (1981). Bisque clauses have been introduced in international loan agreements in the past, e.g. the Anglo-American Financial Agreement of 1946.

suggested a maximum limit of 20% of exports to be allocated for debt service. Bailey et al (1983) suggested linking debt amortization to countries' foreign exchange earnings (thus including sources of earnings such as workers' remittances). These concepts imply a welcome increase in risk sharing between lenders and creditors, as the higher the exports, the higher the servicing of the debt. It is attractive for debtor countries in that it makes debt servicing more counter-cyclical. It may be somewhat problematic for lenders, however.

Improving terms of debt reschedulings, within existing framework

If new financial flows to developing countries (both from private and official sources) were readily available, more equitable and possibly more efficient solutions to the external financing problems of these countries would be mainly achieved by new flows rather than relieving the most heavily indebted countries of part of their debt servicing. However, as new flows are very scarce and often linked to rescheduling packages, while net transfers have been declining and are in many cases negative, higher debt rescheduling or relief becomes extremely valuable and important.

Related, but sometimes clearly separate issues, arise from private bank debt rescheduling and the Paris Club reschedulings of official debt. In both cases, debtors governments - as well as institutions such as UNCTAD[9] - have requested longer consolidation, grace and maturity periods; they have also emphasized the significance of discussing new flows in the same or related fora as reschedulings are being agreed and the need to change the nature of the IMF adjustment programmes required by the creditors as a condition for debt rescheduling.

Some countries have already been granted somewhat more favourable terms in their reschedulings on an ad-hoc-basis. As is well known, Mexico and a few other Latin American debtors obtained multi-year reschedulings; as is less known, some low-income African countries have recently obtained rather generous terms in their rescheduling of official debt at the Paris Club. For example, Sudan, both in 1983 and 1984, obtained a debt rescheduling covering 100% of its debt due in those years, with grace periods of over 6 years and with a total maturity of 16 years or more; Madagascar obtained almost equally generous terms.[10] It would be interesting to understand why these three (and a few other) countries obtained more favourable terms, to what extent those more favourable terms enhanced growth and development and the cost to creditors of the more generous reschedulings. This could provide valuable evidence of the impact which reform proposals (e.g. to extend consolidation grace and maturity periods) would have, if applied more widely to all countries seeking to reschedule their debt. An examination of existing implicit, as well as the definition of desirable, criteria to reschedule debt for different categories of countries seems an essential task, which has as yet not been undertaken.

Before finishing this section, it seems relevant to make a final point. Although the measures discussed here are relatively minor and above all would not require major institutional adaptation, the *adoption of several of them* would imply a rather significant change in the way that international flows to developing countries occur. Therefore, too sharp a distinction between "minor changes" and "fundamental reforms" seems analytically incorrect, particularly as the undertaking of several relatively minor changes may imply the first steps towards more fundamental reform; furthermore, such sharp distinctions may unnecessarily polarize debates on changes in the international monetary system.

(ii) More fundamental reforms

Some analysts have stressed the need for more fundamental reforms of the international financial system based on their perception of major gaps and distortions in the existing structure of international lending to developing countries, recent severe discontinuities in the normal operation of international capital markets and views that growth of industrial economies and of world trade will not return to their post World War II dynamism and that a less favourable international environment will imply the need for a different structure of international financial flows.

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9 See, for example, UNCTAD (1984).

10 See, Griffith-Jones (1984).

We will distinguish three categories of proposals, those destined to:

1) encourage new private credit flows,

2) enhance the stability of the international banking system and of the flows of private lending to developing countries,

3) reduce the "debt overhang".

Encouragement of new private loans

Increasing attention has been devoted to the creation of mechanisms, which would provide insurance or guarantees for new loans. Several of the proposals seem broadly based on an extension of the principle applied by existing export credit guarantee insurance to cover bank lending to developing countries, not directly tied to particular goods or projects. Most of the proposals give an important role to the Bretton Woods institutions. On the whole, they attempt to avoid the creation of new institutions; Bolin and Del Canto (1983) summarize clearly the attitude shared by many of those making proposals in this field, in saying "the world doesn't need another public or private bureaucracy to increase loan activity - just a different balance sheet".

A recent paper by Henry Wallich (1984) discusses the different options for insurance of bank lending to developing countries. The problem faced is stated as:

> "Continued lending, although on a more moderate scale is necessary for the good functioning of the world economy and the health of the international monetary system. Banks especially smaller ones, feel considerable reluctance in that regard. Insurance may ease this problem".

Rather than make a very specific proposal, the Wallich paper discusses different options. It favours more the insurance of total loan portfolios (rather than particular loans) up to some fraction against loss; the latter introduces an element of co-insurance. The crucial issue of the proportion of the portfolio of loans to be insured is discussed, but no figure is clearly chosen; on the assumption that banking risk is modest, a suggestion for insuring 2% of banks' loan portfolio is made. The assumption of international banking risk behind that figure seems excessively conservative. Perhaps of greater interest is the criteria offered for determining an adequate insurance fund, as one whose receipts are sufficient to take care of losses and, more crucially, that an amount sufficient to generate confidence that even occasional very large losses can be met. As Wallich points out, the international lending field differs from many others in that actuarial calculations of both magnitudes are very uncertain.

Different options are discussed, as regards the sources of funds. Pooled insurance (based on the banks' own contribution) is seen by Wallich as too limited. The need for an outside source of funds is emphasized in this proposal, though it is defined as temporary; this outside source would take care of peak loads in bad years and provide an emergency reserve, but should be paid back over time. A parallel is drawn with the "pipeline" into the U.S. Treasury established at the inception of the Federal Deposit Insurance Corporation; though *never used*, it gave credibility to U.S. deposit insurance in early years. The source of outside funds is not clearly defined, though existing official agencies which already have insurance or guarantee powers (such as some national export credit agencies or the World Bank) are suggested.

As an illustration of the amounts involved, Wallich assumes U.S. $20 billion of new lending annually, a 1% annual premium paid and 25% of the liability to be borne by the lender; after five years a total insurance pool would accumulate, equal to around 13% of the maximum interest loss chargeable to the fund, (if an interest rate of 10% is assumed); or equal to 4% in the case of principal loss. If existing institutions were used, and no special funds allocated for this purpose, the problem of "additionality" is a key one. To what extent would the new private lending generated replace lending that would have otherwise been made by these official institutions, given that for example the World Bank's charter reduces its' capacity to lend by the same amount as the guarantee? However, if the guarantee would cover only a small fraction of the loans (as Wallich suggests), and if such a scheme is effective in promoting significantly larger private flows, the gearing ratio of the funds provided by the official institution should be far higher than its' direct lending; as a result, there would be net additional lending.

Such a scheme would present certain advantages to banks, in addition to the insurance itself, such as reduced taxes for the part of their spread channelled into the insurance pool and the prospect that supervisory treatment of insured loans would be liberal. The problems are the additional cost to the banks and the fact that insurance will provide rather incomplete protection.[11] Borrowers may benefit from larger flows, if these materialize. They may have to bear part of the cost and may face pressures from the insurer, additional to those coming from the creditors.

A far more ambitious scheme to encourage new private lending is the proposal by Harold Lever, (1983) to extend the power of the export credit guarantee agencies to insure export of capital (for covering current account deficits), as well as exports of goods. Besides sustaining developing countries' growth and the growth of world trade, such a scheme would contribute to the servicing of trade credits, (most of them insured by their export credit insurance agency) thus avoiding defaults or arrears in those credits. The Lever proposal suggests that export credit agencies set up a central agency, which would fix total and national limits for insured bank lending to developing countries; these limits would be linked to IMF programmes agreed with the borrowing countries. Given that this scheme enhances the role of the IMF, Harold Lever stresses the need for Fund programmes to adequately recognise political and economic problems of LDC's adjustment.

The new lending would be coming from private banks, but would be insured by national export credit agencies, within the aggregate limit determined by the central insurance agency. This aggregate limit would cover the trading deficit and interest payments on existing debt. Thus, three main features would characterise the new private lending:

i) it would be limited and related to monitored adjustment programmes,

ii) it would be totally insured by the export credit agencies and

iii) given the quality of the guarantee, it would be long or medium-term and thus more suitable to the needs of development finance.

The scheme does not involve the explicit creation of any new institution but does imply a significant extension of the role of existing agencies, as well as significantly closer co-ordination amongst them. The difficulties of achieving such a high degree of co-ordination as the Lever proposal would require is illustrated by the serious problems for achieving the far more limited existing "consensus" agreements among export credit agencies.

The scheme is estimated by its author to require initially U.S. $40 billion - U.S. $60 billion of new commercial lending annually for the first year or two, an amount that would be expected to decline over time. The large magnitude involved would imply, on the one hand, that such a scheme could make a significant contribution to the problem. On the other hand, it has the difficulty that industrial countries' Governments would have to accept to give these additional guarantees at a time when existing export credit guarantee schemes are already in financial difficulty; this seems the key problem of such a scheme. As a reply to this type of objection, Lever[12] has stressed that on assumptions far less optimistic than those on which present policies of industrial governments are based, these government guarantees would not be called upon (and therefore, the cost to the taxpayers would be zero); he further argues that if the debt problem proves more intractable than policy now assumes, the governments' ultimate liability would merely be a substitution for what would otherwise be an insupportable further exposure by the banks.

As the Lever scheme may seem too ambitious, particularly in the existing climate of opinion, more modest schemes - following the same principles could be explored. Some elements discussed by Wallich (such as co-insurance, only partial guarantees) could be introduced. This would both

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11 This last point was stressed in an interview with a senior banker.

12 Based on interview with Harold Lever. See, also Lever (1984).

reduce the so-called "moral hazard" problems, as well as reduce the magnitude of the guarantees required; on the other hand, the desired positive effect on encouraging new lending may be reduced.

A rather similar proposal to that of Harold Lever, has been made by Bolin and Canto (1983). Its main focus is to provide future credit for developing countries' imports of capital goods; the scheme is based on a perceived gap in development finance and on the need for a scheme with strong political appeal, based on support from exporters of capital goods in industrial countries. The fact that this proposal received very favourable evaluation in a recent document produced by Business International for the Global One Hundred (1984) would indicate that this type of scheme is likely to be supported by large industrial multinational companies.

Like the Lever scheme, this proposal suggests an organisation backed by the export credit agencies of the main industrial countries; the Bolin and Canto scheme contemplates a new organisation closely linked to the World Bank, but legally separate from it, which would allow it to be more highly leveraged; such an institution would have access - for a fee - to World Bank analyses and loan judgements. This new organisation would lend within a particular range of maturity, beyond the normal maturities of private banks (7-8 years) and below the longer (over 15 years) maturities of the World Bank, funding itself in the floating rate market. Like the previous scheme, export credit institutions or some multilateral institution would guarantee repurchase of the notes if necessary.

Credits thus granted could involve a package of different maturity loans from different sources, with evaluation by the World Bank and the private banks and possibly linked by cross default clauses. The possibility of extending the use of the pilot World Bank co-financing scheme to this type of credit, could imply the important additional advantages for the borrower that the loans would not only have a long-term maturity (clearly longer than the average commercial credit) but could also carry a fixed interest rate for the borrower (with the World Bank carrying temporarily the cost of interest payments if the market rate went above the fixed rate, when market rates rose above that level). One of the issues which is not discussed in the proposal is the links between the credits granted by the new fund and the national export credit agencies; for example, to what extent would it be additional to - or substitute for - existing lending?

Furthermore, as Bolin and Canto themselves point out, there are a number of issues which need further study and clarification; several of these refer both to their scheme and that of Harold Lever. The key questions to be examined are whether national export credit organisations could take a broad co-operative view of their exporters' interests and modify charters or policies to co-operate in a joint effort. Could these organisations promote financing not directly and immediately linked (- dollar-for-dollar and mark-for-mark) to exports from their own countries? At a more institutional level, there are questions about the legal capacity of various export credit organisations to invest in a central institution, or their ability to acquire such authority where it does not exist. (The Lever proposal would seem to imply less legal problems in that credit would be still granted nationally - albeit in an internationally co-ordinated manner).

From the point of view of developing countries, such a scheme would be positive in that it would contribute to fund new investment, but would not deal with - or could even accentuate - the problem, particularly evident in some sectors and countries of Sub-Saharan Africa, of under utilisation of existing capital due to shortages of foreign exchange for financing imports of spare parts, raw materials, etc.

The underlying issue in these schemes - accentuated in some of the more complex and ambitious proposals outlined below - is that the internationalisation of private financial flows has occurred far faster than the internationalisation of regulatory, supervisory and other governing rules,as well as government institutions. Many of the proposals being discussed imply steps towards the development of public international institutions corresponding to the rapid development of the private sector. (There is a clear - though not a mechanical - parallel with the development of national central banking long after the development of private national banks). The issues raised of *feasibility* of proposals are therefore not merely technical, but are closely linked to an understanding of international political and economic forces.

For a proposal to be feasible, it must be both technically desirable in an economically and financially inter-dependent world and politically acceptable in a world of independent nation states.

Among the few proposals that explicitly recognise that their implementation would imply a further step in the evolution towards a world central banking structure is that made by George Soros (1984). The Soros proposal is based on a diagnosis, which emphasizes two aspects of the developing countries debt problem - the negative resource transfer in the short-term and the chronic long-term problem related to the "debt overhang". The scheme proposed attempts to reduce the weight of the debt burden, *without* choking off new credits.

The essence of the scheme is interest rate insurance which would cap interest rates above a certain level; (the cap could be fixed in absolute terms, - e.g. 10 or 12% - or indeed to a debtor country's terms of trade). A government agency associated with the central banks would ensure lenders in case their cost of funds rose above the cap. The lenders would pay an insurance premium for this service and the agency would use the proceeds from this premium to subscribe to the equity capital of a new institution, the International Lending Agency (ILA). The ILA would provide the new credit necessary to ensure that debtor countries can pay their interest on outstanding loans and secure economic growth. Thus, *the ILA would act as the residual or balancing supplier of credit* (in this respect there are some parallels with the previous schemes and in particular, the Lever one).

The capital of the ILA would have two components: contributions by the holders of existing loans and by the debtor countries of a certain percentage of their outstanding debt. Furthermore, *initially* the ILA's credit would be guaranteed by the industrial countries, for example, through a contingent allocation of SDR's which would be gradually phased out. As a first approximation, the size of the initial guarantees is suggested at around U.S. $40-80 billion.

The ILA would establish aggregate country limits. The criteria to determine country limits would be fixed in advance. The particular feature of the ILA's construction is that with stable interest rates, the growth of its capital would keep pace with the growth of its liabilities. If interest rates fluctuated excessively, the ILA's capital base would be endangered, as its interest equalization account would be overburdened. According to Soros, this should put pressure on the industrial nations in general - the the U.S. in particular - to prevent excessive interest fluctuations.

According to Soros, the quality of banks' loan portfolio would be enhanced and additional loan loss reserve allocations would become superfluous; in effect, insurance premiums would take the place of loan loss reserves (thus providing interest relief rather than being sterilized in the form of reserves).

The Soros scheme is one of the most detailed proposals, in that it makes explicit the mechanisms of the scheme's operation; it is also very complete, in that it would attempt to tackle a number of the crucial problems raised by the debt crisis. The Soros scheme, partly because of its completeness, is, however, extremely complicated. Furthermore, it does not seem to build enough upon existing institutions, but concentrates on an entirely new institution, the ILA. Though in abstract terms, new institutions can have important attractions (such as more appropriate criteria to the new problems being faced), in practice they may imply duplications of functions with existing institutions without necessarily leading to major innovations. It is noteworthy also that since the late seventies, many new public international institutions have been suggested (e.g. World Development Fund by the Brandt Commission) but no such institution has been created. Even if the proposal for creating an ILA were not implemented, there are interesting ideas in the Soros proposal (such as contingent use of SDR's for guarantees, or even, the concept of a residual or balancing supplier of credit).

More limited but interesting schemes to encourage new flows (as well as contribute to deal with the debt overhang) are now under discussion or beginning to be implemented. An example is the establishment of investment trusts for individual developing countries. Trust shares could be issued to new investors as well as to interested commercial banks in exchange for some of their existing loans. The trust's manager (probably an investment bank) would try to swap the loans for equity stakes in local enterprises. An advantage of the scheme would lie in the eventual marketability of investment trust shares, which particularly if backed by the International Finance Corporation might be attractive to institutions such as pension funds; one perceived attraction would be the fact that the scheme addresses both LDC's immediate financial problems caused by excessive debt, as well as their more long-term problem of insufficient foreign equity capital. Though there may be a need to shift the balance of development finance to non-credit flows, it is, however, doubtful to what extent many developing countries' governments would welcome large increases in foreign ownership of their assets, particularly so in cases where they do not represent new inflows but conversion of debt already contracted.

More broadly, the problems created in the past with debt instruments - and particularly their repayment pattern, which is independent of the borrower's unexpected changes of terms of trade, changes in international interest rates, success or otherwise of particular projects - have focussed attention on the greater need of equity-like financial instruments that would link repayments to outcome. In addition to direct foreign investment, other arrangements with this type of feature would include loans indexed to commodity prices or trade levels, non-recourse project loans and production shares.[13]

At an even wider level, there have been suggestions that the World Bank should expand its role in bringing together developing countries' governments and potential sources of new private credit, quasi equity or foreign direct investment, to be discussed within the framework of the *country's medium to long term resource needs in the context of its development programme*; this activity would expand the role which the World Bank has played in the past in relation to aid consortia. Such World Bank activity could be linked to - or follow immediately after - debt renegotiations; the emphasis would, however, not be on debt crisis management but on recovery of growth and development.

Enhancing the stability of the international banking system and of the credit flows to LDC's

Closely related to some of the proposals discussed in the previous section, but analytically distinct, are schemes whose primary objective would be to enhance the stability of the international banking system, as well as of private credit flows to developing countries. One way to achieve these objectives is via an explicit clarification of Central Banks' role as international lenders of last resort accompanied by more stringent and effective supervision. For discussion of these proposals see Griffith-Jones and Lipton (1984), Guttentag and Herring (1983) and Johnson and Abrams (1983).

Such schemes emphasise that a large part of international banking activity has been located in the gaps between national regulatory systems, so as to take advantage of the asymmetries in relatively strict banking regulations applying to domestic currencies and residents and far looser banking regulations applying to foreign currencies and non-residents. As a result, there are important gaps uncovered by national lender of last resort and supervisory authorities. The lack of appropriate explicit international lender of last resort arrangements - parallel to those already established at a national level - are seen to make two undesirable developments more likely. Firstly, there remains the possibility that widespread financial distress now characterising the world economy may turn into a major financial crisis; secondly, and more plausible, the combination of reschedulings and fear of defaults may continue to constrain private banking lending to developing countries, as it increasingly has done in recent years.

A proposal made by Griffith-Jones and Lipton (1984) to deal with this set of problems is for central banks of the major industrial countries to make explicit and formal their commitment to international lender of last resort arrangements. This would imply the announcement of a contingency plan, to be activated if a bank(s) were "in trouble" as a result of their international lending. Such a commitment should contribute to *sustain private lending* during periods when it would otherwise tend to contract, generally linked to recession and/or financial problems, nationally and internationally. It would be accompanied by far more stringent supervision, which would imply moderating excessive expansion of credit in periods of boom or "euphoria"; it would also encourage more appropriate form of lending to developing countries (e.g. in relation to maturities).

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13 An interesting review of some of these ideas can be found in Lessard and Williamson (1985).

A scheme, of international lender of last resort (ILLR) if effective, would contribute indirectly to reducing the pro-cyclical nature of private flows - both at country level and world-wide. It has been increasingly argued that interest rates, terms of trade and the supply of lending often inter-act perversely, generating vicious circles of recession and financial distress for individual countries and in the international economy. Hence arises the growing importance of mechanisms that act as shock absorbers and that play a counter-cyclical role. Just as the CFF generates directly counter cyclical flows to compensate for fluctuations in export earnings and cost of cereal imports, an interest rate window of the CFF and/or interest "capping" would diminish the impact of fluctuations in interest rates, mechanisms such as an explicit ILLR (accompanied with greater supervision) would reduce fluctuations in private lending. These three mechanisms combined could make an important, mutually re-inforcing contribution to more stable trends nationally and internationally. Given that one of the main features of the world economy since the early seventies has been increased instability in key variables and that this instability and the resultant uncertainty is seen as negative by different types of economic agents and by different schools of economic thought, measures to enhance prospects for future stability may have a broad base for support.

An important argument against an explicit declaration of an international lender of last resort is the Central Bank authorities' repeatedly expressed concern with "moral hazard", namely the risk that banks would be tempted into imprudent lending if the terms and conditions for ILLR are known in advance. Because of concerns about moral hazard, Henry Wallich, the member of the U.S. Federal Reserve Board most closely associated with international banking problems, has argued that:[14]

> "There are dangers in trying to define and publicize specific rules for emergency assistance to troubled banks, notably the possibility of causing undue reliance on such facilities and possible relaxation of needed caution on the part of all market participants".

To overcome the problem of "moral hazard", it has been suggested by Griffith-Jones and Lipton that Bagehot's original concept of "onerous terms" (good collateral and a penal rate) could be adapted to present international lending. This could be done by adapting one of the debt restructuring schemes, which has an element of debt discounting (see below), and converting it into a *contingency plan*, to be used as an ILLR when particular banks would be "in trouble" as a result of their international lending. The discounted debt would then be rescheduled at more flexible terms to the debtors. Stringent supervision would provide a second line of defence against "moral hazard".

Other schemes have been suggested which would enhance both the stability of the banking system and of financial flows to developing countries. An interesting proposal made by Johannes Witteveen (1983), former Managing Director of the IMF calls for the creation of a facility within the IMF that would ensure bank loans against political risks applicable to debtor countries complying with the performance criteria of Fund programmes; Witteveen sees this linked to a major initiative in supervision (via measures such as international reserve requirements under the IMF's control, and appropriate solvability ratios) which would curb excessive credit growth in the future. Witteveen's proposal would require, as the amount of insured credit grew, an expansion of the Fund's resources, perhaps through guarantees by participating governments. As in several of the proposals discussed above, the key issue would be obtaining support from the major industrial countries for increased guarantees on a significant scale, (without reducing other flows to developing countries) as well as support for significant changes in supervision (the issue of reserve requirements for the Euro-currency market were already discussed in the seventies and shelved then). Witteveen's proposal also would imply a far greater role for the Fund in regulating international private liquidity and in increasing the role of IMF conditionality for obtaining new credits; the former - clearly an important measure in the long-term - may perhaps not be acceptable at present; the latter would tend to create resistance amongst developing countries' governments unless IMF conditionality was modified.

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[14] Personal communication from Henry Wallich in June 1983. Also Wallich (1977).

Reduction of the debt overhang

Proposals for a more or less generalized reduction of the "debt overhang" became particularly fashionable at the peak of the debt crisis (mainly in the first half of 1983). As the debt crisis was seen to have become "manageable" (at least for the banking system), in 1984 these proposals were increasingly seen as contingency plans that would be activated only *if and when* the "debt crisis" would again be perceived as worsening or not improving sufficiently. This would seem more likely if as seemed the case in early 1986, the internation economic environment for a large number of developing countries continued to be unfavourable and/or if the debtors governments themselves pressed strongly for a reduction in the value of their debt and its servicing. The continuation in the medium-term of high levels of negative net resource transfer from some areas or countries of the Third World and increased resistance to them within debtor countries may probably re-open the debate on generalised measures to reduce the "debt overhang".

Simplifying somewhat, most of the proposals to reduce the "debt overhang" have two main characteristics: mechanisms for shifting some or all of the accumulated stock of "non-performing" (or potentially non-performing) loans from the books of the banks in return for more marketable and/or less risky assets and an easing of developing country debt burden in the short and medium-term, through a combination of principal or interest relief or a more limited stretch out of repayments.

One of the relatively more modest proposals - and therefore, possible the more feasible - is that suggested by Peter Leslie[15](1983). The problem stressed by Leslie is that a large proportion of banks' balance sheets will be locked in "immobilized debt" for a long period, the problem being particularly serious in lending in currencies different to those in which most of the banks' deposits are denominated; this would imply that for reasons of profitability, capital adequacy and national prudence, banks may become unwilling to undertake significant new lending, even for normal trade finance. Leslie proposes to mobilize part of the medium-term debt, which has arisen as part of rescheduling, on the basis that the proceeds were used to create fresh lending. It is proposed that the scheme could be linked to export credit, whereby the corresponding agency or Central Bank would extend facilities to a bank for it to "discount" a certain amount of a country's debt, provided that the bank then used the additional cash to make a new export credit to the same country.

In this proposal, the rediscounted debts would come off the balance sheet of the commercial bank, thus no longer requiring appropriate liquidity and prudential capital support; however, the author proposes that these "discounted debts" would need to be treated as contingent liabilities as, 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. There seems to be some contradiction in the proposal; if the debt continues to be the bank's contingent liability, should it not then continue to require prudential capital support? However, it should be noted that contingent liabilities are accepted to require less prudential capital support; for example, contingent liabilities are weighted at only half those of direct liabilities in the Bank of England's capital system.

Leslie's proposal seems to have important similarities with the schemes presented by Lever, as well as Bolin and del Canto; the emphasis on linkage to export credit would make it particularly attractive to those involved in exporting to developing countries. Given that export credit agencies are already in financial difficulties, schemes on a more modest scale such as Leslie's would seem to be particularly valuable, especially as a possible first step in a new direction.

A number of far broader proposals for restructuring the debt overhang have been made. For reasons of space and because their implementation seems rather unlikely, we will describe the main ones only briefly here; we will discuss their limitations and advantages at the end of this section.

15 Also based on author's interview with Peter Leslie.

i) The more radical discounting schemes

Perhaps the broadest proposal for debt discounting has come from Felix Rohatyn (1983a, 1983b);[16] his proposal was to create a mechanism that would stretch existing bank loans significantly to 25 or 30 years, with a low interest rate (i.e. 6%); this would imply substantial debt relief for borrowers. A subsidiary of the World Bank or of the IMF or a totally new institution, guaranteed by Western governments, would acquire the banks' credits in exchange for long-term low interest obligations of their own. The banks would clearly suffer loss of current income; Rohatyn does not make explicit whether banks would also have to accept a capital write-off, at the time of swapping their credits for the new instruments. Rohatyn's proposal would be on a large scale, as he refers to a sum of around U.S. $300 billion. A similar, though more limited proposal was made by Peter Kenen (New York Times, (1983)) who proposed the creation of a new international institution, with capital subscribed by industrial countries' governments. This agency would issue long-term bonds to banks in exchange for developing countries' debts, the latter being exchanged at a discount (e.g. of 10% on their book value). The corporation would reschedule the LDC debts on a one-time, long-term basis using half of the discount for modest debt relief by either reducing interest rates or granting grace periods. All banks would be given a limited period of time to decide whether to participate, the agency would deal only with the debts of those countries which have recognised it as successor claimant to the banks.

Weinert's scheme (1983) has important similarities with Rohatyn's and Kenen's proposals, but is somewhat more complex. It proposes that the World Bank swaps its bonds for LDC debt held by private banks; the additional capital that the World Bank would require for such an operation would be provided through unpaid subscriptions, that would not have immediate budgetary impact. The interest rate on the bonds could be below commercial levels thus implying gradual absorption of losses by banks; the total value of the banks' assets would not decline as the World Bank bonds would constitute sound assets, thus, the scheme would seem not to require a capital write-off. Interest rates on the bonds would be related to countries' capacity to pay the debt for which they were swapped, to be set annually by the IMF, based on a formula including export volume and terms of trade. The bonds would also carry a minimum rate to assure banks of the income level required to stay sound; if this minimum exceeded a country's capacity to pay, then the World Bank would pay the necessary difference. Debtor countries' principal payments would be extended over a long period of time. Just as Rohatyn's proposal parallels the Municipal Assistance Corporation - the entity created to revive New York City from bankruptcy, - Weinert's proposal follows closely the financial arrangements used by U.S. banks to reschedule their lending to real estate investment trusts, (REIT) in 1974-5.

Another proposal, which like Weinert's, suggests that repayment is linked to real, measurable capacity to pay is that made by Norman A Bailey and his colleagues (1983). According to this scheme, the central banks of the debtor countries would issue equity-like exchange participation notes (EPNs) to their private and official lenders on a pro-rata basis to replace the existing amortization schedules; the EPNs would constitute claims on some prudent level of current and future foreign exchange earnings. The notes could be negotiable on the secondary market.

ii) Evaluation of debt restructuring schemes

The more radical proposals that attempt de facto to reduce the total value of developing country debt are based on the correct perception that, unless major changes in the international environment occur, future servicing and amortization of the debt will continue to be an excessive burden for many LDC's, constraining their growth and development. Recent forecasts for the world economy by international institutions project as likely that - in 1990 - many developing countries with debt-servicing difficulties would still have per capita income levels at or below their 1980 levels.[17]

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[16] Rohatyn is chairman of the Municipal Assistance Corp of New York and a partner in the investment banking firm of Lazard Freres & Co.

[17] For a useful review of projections by the IMF, World Bank, UNCTAD and others, see Page (1985).

There are, however, a number of problems with the more radical proposals for reducing the debt overhang described above. One serious problem would be their potential negative impact on bank capital; given the large size of developing country debt in comparison with private banks' capital, any significant write-off of such a debt would mean a very large cut in banks' capital thus reducing their future capacity to lend. Such a problem would be dealt with if regulators allowed a gradual write-off, if the new assets which the banks would receive would have lower interest but not a lower book value or if there was a major injection of public funds to compensate banks for their capital write-offs or income reduction. Even if a large proportion of such a public contribution were through a contingent liability and/or spread through time, the large magnitudes involved clearly make such a public contribution unlikely. It would be even more unlikely for industrial countries' Governments to set up special agencies for this purpose, as advocated in some of the schemes. Even if feasible, a large write-off of total developing country bank debt financed in an important proportion by public flows would reduce availability of new public flows; as such a write-off would very probably be proportional to existing debt, it would favour more those countries able and willing in the past to borrow more, discriminating against countries that could not borrow (particularly low-income ones) and those that followed more cautious development programmes.

Another important critique of most of the more radical debt restructuring schemes, except that by Leslie, is that they show little concern with new private lending and in fact could contribute to choking it off. It is argued that new lending will be far less likely as banks will fear that such future debt, like past debt, may also be partly written-off, discounted or turned into a low-interest asset; moreover, banks would lose their current incentive to back up their existing debt with new "involuntary" lending. A partial counter-argument (important in the short and medium-term) to the latter point is that what matters to developing countries' governments is the net resource transfer to them, and that at least in the medium-term debt write-offs would reduce gross borrowing requirements for any given volume of new lending; furthermore, net "new lending" has been declining dramatically anyway.

Another criticism of such plans is that of "moral hazard", in that developing countries would seek debt restructuring or relief even when they could have continued to meet orderly payments. This argument is weakened at a time when at least two-thirds of developing countries' debt is estimated to have been restructure or its payment otherwise delayed, reflecting a generalized inability of developing countries to repay their debts on schedule in the conditions at which they were contracted.

Finally, many of the debt restructuring proposals are considered as too radical and too sweeping in most international financial circles and as too sharply opposed to the case-by-case approach till now adopted. It would, therefore, seem more likely that progress could be achieved in reducing the debt burden, while attracting new flows, by studying and defining *general guidelines which would provide a reference framework for individual negotiations of countries in existing* fora, (e.g. Paris Clubs, private debt reschedulings, consultative groups, etc). Clearly such guidelines could not be uniform for all developing countries, as they would need to distinguish, for example, between countries by level of income and by the composition of their trade and its price responsiveness as well as having some flexibility to adapt to the particular conditions of individual countries.

Given that the Paris Club is a long established rescheduling forum, with total institutional flexibility (it follows no written code of rules), it could clearly provide a useful starting point for the definition of more general guidelines for the restructing of official debt. These could cover aspects such as longer consolidation periods, also known as multi-year reschedulings, as well as minimum grace and repayment periods. More complex, though obviously important, would be the establishment of greater uniformity for interest rates, hopefully implying that the total present value of the debt after rescheduling would be smaller or equal than it was before rescheduling. Uniform policies for prompt restoration of export credit cover once rescheduling has been agreed would also be important. At a later stage, such a framework could be broadened to co-ordinate the actions of industrial countries as lenders and donors with their role as creditors, which would allow discussions of overall resource transfer flows in a medium-term framework. Again this is not a new idea, but builds on procedures already used recently for some countries (e.g. Sudan) and long-established in somewhat different contexts for other countries (e.g. aid consortia for India).

Furthermore, a similar attempt could begin to be made to define general guidelines for private debt reschedulings, referring to aspects similar to those just mentioned for the Paris Club. Again arrangements already made with particular countries e.g multi-year rescheduling for Mexico in 1984 - could be broadened for other countries. However, the guidelines could go well beyond that, some of the more modest schemes discussed above - such as interest capping, either in its liquidity or its concessional version - could be relatively easily introduced within such a framework. Some of the broader proposals, linking debt restructuring to new flows (e.g. Leslie's scheme) could also be accommodated within a revised and broader framework of existing procedures for bank debt rescheduling.

III. CONCLUSIONS AND POLICY RECOMMENDATIONS

The time seems ripe for fairly major changes in the way debt crises are handled and in the way which international financial intermediation is carried out.

The pervasiveness of the problems which the 1982-85 debt crises management strategy implied are widely perceived. Though the decline in nominal U.S. interest rates during 1985 provided some grounds for optimism, the slowdown in the growth of world trade - and particularly the poor performance of commodity prices as well as the further slowdown of bank lending to Latin America and Africa - accentuated the seriousness of the problem.

Both the problems and the possible ways out are now fairly well understood. Different future scenarios and different policy options have been fairly exhaustively explored. This is in clear contrast with the situation in 1982-84 when the magnitude of a fairly new problem almost overwhelmed policy-makers, politicians and academics; others contributed to a response which gave priority to fire-fighting rather than reducing the chances of fires breaking out and helping the victims of the flames!

The new flexibility in the U.S. Administration's position both reflects and significantly enhances widespread dissatisfaction with debt crises management and the willingness to explore new options.

Last, but *certainly not* least, debtor governments are exerting stronger pressure for change; this pressure is reflected in the willingness of some of them to take unilateral action (e.g. the Peruvian government) or more broadly to formulate counter-proposals to the current debt crises management strategy, as the Cartagena group of major Latin American debtors did in December 1985.

Given the "substantial unexploited bargaining potential" that particularly Latin American governments seem to have (linked to the large size of their debts and the magnitude of the negative net transfer from them), it seems possible that they may increasingly *re-define* the "minimum" deal that is acceptable to *them* in bargaining in debt reschedulings and new flows. Clearly such a minimum would not be defined in the abstract, but would be made consistent with acceptable "minimum" levels of growth for the debtor economies, as well as acceptable levels of income, employment and social expenditure, particularly for very poor people.

In practical terms, the debtor governments may use their "unexpected bargaining strength" if for example (either individually or collectively) they suspended negative net transfers of financial resources during a particular finite period, or put a ceiling on the level of debt servicing (as the Peruvian and Nigerian governments have already done), while clearly committing themselves to servicing their debt in the long term. The suspension of negative net transfers would be justified not only on the need to allow for growth in the national economies for the sake of its people, but also for strengthening the country's long-term capacity to service its debt (provided appropriate adjustment and development strategies are followed).

If posed in a conciliatory form, a declaration of cessation of negative net transfers would imply that it could be made consistent with one - or far more probably - with a package of the type of proposals discussed above in section II. A cessation of negative net transfers would imply that governments would continue servicing the debt to the equivalent level at which the country is obtaining new credit or liquidity. This would imply a strong incentive for creditor governments and/or international financial institutions to expand their direct lending or their guarantees or the creation of international liquidity (e.g. by new issues of SDR's) or use some form of interest capping to reduce debt service obligations.

It is important to stress that the measures likely to emerge would in fact benefit not only the debtor economies, but also would have a potentially beneficial effect on the world economy in general and in those exporting to or investing in the debtor economies in particular.

Before outlining the features of a package of policy measures that would contribute meaningfully to overcoming the crises of debt and growth in so many developing economies, we would like to outline the main features of such a package.

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

Focus in debt renegotiations during 1984 and most of 1985 only on specific items, such as multi-year rescheduling, reduction of fees and spreads, etc. - though clearly achieving useful results, - had led to changes which are very marginal, particularly in relation to the magnitude of the problem.

b) Particularly, but clearly not only when some element of concessionality on debt 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 bargaining position 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 (if such measures were combined with some forgiveness of official debt, for low-income countries this problem would be overcome). Measures focussing on new flows, e.g. guarantees, higher lending by multilateral agencies, lack at least potentially a bias towards big link debtors and may thus be more equitable internationally.

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 from 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 or invest in them) and for the world economy.

The complexity of the problems involved and particularly the magnitude of the external financing gap of debtor economies required to sustain meaningful economic growth and development would seem to require a *package* of measures, rather than the adoption of a single one of the measures discussed in the preceding section. The problems raised for debtor economies by private international financial intermediation, particularly as practised in the seventies, and even more, the "general abhorrence of balance of payments lending" widespread among private banks since 1982 (see R O'Brien's article in this issue) seem to indicate an inevitable expansion of the role of governments and official institutions in international financial intermediation, if flows to developing countries are to be enhanced or even sustained.

A desirable package of measures would, therefore, imply as regards new flows, either a significant expansion of new official flows, (e.g. though multilateral or bilateral agencies) or an expansion of government guarantees, insurance or lender of last resort facilities that would combine "public purpose and private finance" or a combination of both. The attractiveness of the second approach is that it requires less immediate disbursement of public funds and may, therefore, be more feasible; the danger is that unless the government 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 co-financing with the World Bank and to some extent the Baker plan) may fail to generate sufficient flows.

If significant new flows are to be generated, it is thus crucial that this is done directly through public institutions and/or through firm and explicit government's guarantees (either directly or through institutions such as the World Bank).

Particularly while the value of exports in debtor economies grows slowly or declines due to the evolution of the international economy, and interest rates remain high, some interest relief seems important so as to avoid the value of the debt growing too much, in absolute terms and in relation to ex ports. In this context, some extent of concessionary capping may be clearly desirable for bank debtors and not too onerous for creditors, particularly in some countries. Specially in the case of banks (such as the German ones) that are more unwilling to increase their exposure and for which provisions against non payment of interest are tax deductable, interest capping (even with some concessional element) may be preferred by them to new lending and if carried out gradually, would clearly not threaten their stability or even endanger their profits excessively.

Differential approaches to new money or interest capping in different creditor countries may imply that the mixture adopted would not necessarily be uniform across countries. Alternatively, changes could be introduced in countries such as the U.S., in regulatory and accounting practices or an explicit subsidy given by the monetary authorities to allow for some concessional capping.

Finally, a package of measures geared at reducing the damage of current debt crises and the likelihood of future ones should include the strengthening of counter-cyclical elements. As discussed above, this would imply broadening existing compensatory financing facilities and including an "interest rate" window in them, to account for this major new source of international instability. A renewal of SDR issues also would have an important counter-cyclical element in it, as it would generate liquidity independently of countries' creditworthiness, in contrast with privately channelled liquidity that is subject to such variations in perceptions.

In this paper, we have not fully explored the important issue of long-term financial intermediation to developing countries. If a package of measures of the kind just outlined were adopted, this could provide an important step towards more appropriate mechanisms and agents for development finance than characterised the last fifteen years. Furthermore, the more long-term funding needs of developing countries may coincide with the long-term supply of funds characterising surplus agents in surplus countries (e.g. Japanese pension funds). However, the high level of risk aversion of such sources may make significant flows from those agents to developing countries difficult to encourage.

The uncertainties over the future of debt crises management and of international financial intermediation and the unlikelihood that for many years positive net transfers, 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.

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