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Debt and Development in Poor Countries: Rethinking Policy Responses

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ABSTRACT

The world's poorest countries face enormous challenges to development, with economic issues presenting some of the greatest obstacles. High on the current public policy agenda, including in the U.S. Congress, is the decision whether to finance increased debt relief through the Heavily Indebted Poor Country (HIPC) initiative. Indebtedness is not a new development issue, but there is a renewed emphasis n expanding debt relief to poor countries, explicitly to tackle the twin problems of poverty and underdevelopment. This report discusses how debt fits into the broader development picture including, defining the circumstances that lead to heavy indebtedness, drawing specific lessons from the Latin American and African cases, and evaluating the success and failure of earlier debt policy responses. This report will be updated if events warrant.

Debt and Development in Poor Countries: Rethinking Policy Responses

Summary

The poorest countries face enormous challenges to development, with economic issues still presenting some of the greatest obstacles. High on the current public policy agenda, including in the U.S. Congress, is financing increased debt relief for the poorest countries. Indebtedness is not a new issue. In the 1980s, Latin American middle income countries became severely indebted to private banks, causing a financial crisis with prolonged economic and social consequences. Today, the Heavily Indebted Poor Countries (HIPCs), mostly located in Sub-Saharan Africa, face worse economic prospects and relatively large debt burdens to official creditors.

For most developing countries, debt is a marginal issue and not the primary obstacle to growth and development. For the HIPC countries, however, debt may be a drag on economic growth and so debt forgiveness may afford an opportunity to boost the development process. Total HIPC country external debt amounts to $206 billion and current HIPC proposals anticipate total debt reduction costs for all creditors in 1999 net present value terms to be $28.2 billion, not large amounts by developed country or global standards, but as yet mostly unfunded.

A decision on financing HIPC debt relief falls to Congress. If debt reduction is desired, experience argues that it be comprehensive and timely, but probably not unconditional, which could be counterproductive if it is a replacement for, or diminishes incentives to effect, broader economic, political, and social reform. For debt relief to support growth and development, it is arguably best used if supported by a well-managed, long-term investment strategy that ensures clearly productive public and private use of debt. This point speaks to the larger issue of addressing the need for improved social, political, and economic institutions to encourage political participation and entrepreneurial activity that will help create an environment conducive for attracting foreign and domestic capital investment.

For their part, developed countries and international financial institutions might consider how best to support developing country attempts to reform and adapt to changing international economic trends. Solutions that prolong debt relief may delay development; this has led to recent changes to the HIPC initiative intended to quicken and deepen debt reduction. Also, foreign aid can be helpful at the margin and may be used to help with immediate social needs, but cannot finance all long-term development needs. Other policy support, such as removing trade barriers to developing country goods, would strongly complement debt relief.

Diminishing poverty in poor countries has become a major new emphasis of the HIPC debt reduction initiative, yet debt relief is no guarantee of success. Debt does not necessarily cause poverty, so more than debt reduction many be needed. Also, because financial resources are largely fungible within government budgets, debt relief cannot assure that social program spending will be given priority. In summary, given the myriad factors that must work together for development to take place, the benefit of debt relief may be limited unless it becomes part of broader program for social, political, and economic change.

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Debt and Development in Poor Countries: Rethinking Policy Responses

The poorest countries face enormous obstacles to development, a process that often requires nothing less that a wholesale "transformation" of society.[1] Economic growth and poverty reduction still present the greatest challenges, and to help achieve these goals, developed countries are contemplating more debt reduction for the poorest countries. The current policy discussion centers on whether to increase financing for the Heavily Indebted Poor Country (HIPC) initiative.[2] The 106th Congress will consider President Clinton's request for $847 million in appropriations for HIPC debt reduction for fiscal years 2000-2003.

Heavy indebtedness is not a new development issue. Latin America in the 1980s experienced a severe debt crisis with prolonged economic and social consequences. Today, the prospects for heavily indebted Sub-Saharan Africa are even worse. The policy focus has shifted, however, from entertaining options for safeguarding the solvency of U.S. banks (the Latin American case) to finding solutions to poverty and underdevelopment (the African/HIPC case). Nonetheless, amidst these differences are common lessons that can be applied in understanding how debt relief can make a difference to poor countries. This report discusses how debt fits into the broader development picture, including defining the circumstances that lead to heavy indebtedness, drawing specific lessons from the Latin American and African cases, and the implications of earlier debt policy for current initiatives.

Determinants of Growth and Development

Countries commonly use foreign debt to finance growth and development. In fact, the United States has relied on debt throughout much of its history. Why, then, is debt considered a major obstacle to growth in some parts of the world? The distinction appears to be that the poorest developing countries are experiencing a "debt hangover," which is to say that they are so deeply indebted relative to their economic performance that without relief, debt repayment and development cannot take place. If this reasoning is correct, then it is important to understand why debt

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[1] For more on how development is a multifaceted problem, see: Stiglitz, Joseph. *Participation and Development: Perspectives from the Comprehensive Development Paradigm*. The World Bank. Web site: [http://www.worldbank.org].

[2] For a detailed discussion of congressional proposals and U.S. bilateral debt relief policy, see: Nowels, Larry. *Debt Reduction: Initiatives for the Most Heavily Indebted Poor Countries.* CRS Report RL30214. Updated periodically.

may have supported the development process in some parts of the world, but hindered it in others.

Table 1 provides a brief summary of selected development indicators for three regions. Given that most of the HIPC countries are located in Sub-Saharan Africa (33 of 41), it is not surprising that data for the Africa show very poor economic performance. For example, over the period 1965-97, real growth in per capita gross national product (GNP) in East Asia grew at an average annual rate of 5.4%, narrowing the income gap with the developed world and allowing economic transformation to take place. By contrast, in Sub-Saharan Africa average annual real per capita GNP declined by 0.2%, pointing to a part of the world that is actually far worse off now than it was three decades earlier. Latin America's long-term per capita GNP growth (1.3%) exceeded Africa's, but it has been uneven, with no progress in the 1980s following the debt crisis and only slow-to-moderate expansion in the 1990s.

Table 1. Selected Development Indicators

Region	Avg. Annual Real Per Capita GNP Growth (%)	*Gross Domestic Fixed Investment Growth (%)	#Primary School Gross Enrollment Rate (%)		Life Expectancy (years)		Infant Mortality (per 1,000 live births)	
	1965-97	1965-97	1980	1996	1980	1997	1980	1997
Latin America	1.3	1.8	105	113	65	70	60	32
East Asia	5.4	9.7	111	118	65	69	56	37
Africa	-0.2	-0.3	78	77	48	51	115	91

* Average annual % growth in of fixed assets of the economy.
# Because of many estimation problems, such as students repeating grades, the ratio can exceed 100%.
Source: The World Bank, *World Development Indicators 1999,* pp. 26, 80, 112, 260

Economic growth is a necessary condition for development to occur and these regional trends raise the fundamental question of what factors distinguish fast growers from slow ones. Numerous studies suggest that fast-growing economies tend to have high rates of investment, stable macroeconomic conditions over the long run, and well established rules and institutions that encourage political participation and economic enterprise. The benefits and perils of globalization (openness to trade and capital markets), so hotly debated at present, may be a secondary consideration given that countries successfully developed using a varying approaches to openness.[3]

More specifically, economic growth is highly correlated with the level of investment in physical and human capital, and growth in total factor productivity (TFP - a measure of efficiency gains, including those from enhanced technology). For the poorest countries, the lack of capital investment by definition is an important factor. **Table 1** displays the dramatic differences in investment growth in the developing world. Over more than three decades, East Asia's gross domestic fixed investment

[3] This theme is presented in Rodrik, Dani. *The New Global Economy and Developing Countries: Making Openness Work*. The Overseas Development Council, Policy Essay No. 24. Washington, D.C. 1999.

grew at an average annual rate of 9.7%, compared to an actual decline in Africa of 0.3%. Human capital investment is also critical, and as a limited measurement proxy, the primary school enrollment rate in Africa is shown to be considerably lower than in East Asia or Latin America, and actually declined slightly from 1980 to 1996.[4]

In a separate (non-World Bank) estimate of individual country total factor productivity growth rates, the poorest countries, particularly those in Sub-Saharan Africa, had significant declines in productivity from 1984-94.[5] Productivity growth is essential for standards of living to rise. It is related to capital investment through technology transfer, among other factors, that accompanies use of more sophisticated equipment and machinery. Africa's poor productivity growth suggests that many factors are at work limiting the quantity and quality of investment.[6] Given this poor economic performance and poor policy responses (see African section below), it is not surprising that two basic development indicators in **Table 1**, life expectancy and infant mortality, are also significantly worse for Africa than other developing regions.

Among these variables, the debt issue is most directly related to the role of capital investment. This is still considered one of the most important single factors linked to long-term economic growth, particularly for poor countries, which are by definition, capital constrained.[7] Poor countries tend to have very low saving rates and are generally considered poor candidates for foreign capital investment. Africa's saving rate has been one-third that of Asia over the past decade, pointing to a potentially strong role for foreign investment.[8]

For this reason, many studies argue that developing countries need to pursue policies leading to greater opening of their economies to global capital and goods markets. If barriers inhibit capital goods imports (those used to manufacture other goods), the cost of capital or investment rises and technology transfer is impeded, diminishing growth potential. It is in the context of paying for these needed imports that developing countries often adopt trade reform to increase exports. To the extent that they run trade deficits, they must borrow abroad, using foreign financial capital to underwrite their investment strategy. Indeed, a good case for assuming debt rests on its use by a developing country to import capital goods.[9]

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[4] For a textbook discussion of these basic principles as they relate to developing countries, see: Hogendorn, Jan S. *Economic Development, Third Edition.* New York, Harper Collins, 1996. pp. 75 and 272; and also for recent evidence, The World Bank. *World Economic Outlook*. October 1999. pp. 17-20.

[5] Rodrik, *The New Global Economy*, pp. 72-73.

[6] World Bank. *World Economic Outlook*. October 1999. p. 22.

[7] The correlation between investment and growth is "erratic" in the short run, but has shown to be "key" over longer horizons in cross-country comparisons. See: Rodrik, *The New Global Economy*, pp. 15 and 49.

[8] Ibid, p. 18.

[9] Collier, Paul and Jan Willem Gunning. Explaining African Economic Performance. *Journal of Economic Literature*. March 1999. pp. 74 argues for the critical nature of trade openness on growth. Defining capital imports as the key to the importance of openness is emphasized (continued...)

Capital alone, however, is no guarantee of development. Also required is macroeconomic stability, government regulation of domestic markets and trade that encourages investment and production, efficiency of government institutions in the protection of personal property and safety, political stability, and supportive structural factors such as reasonable population growth rates. Various studies have pointed to extreme cases of institutional failures faced by some countries such as indiscriminate violence (war, terrorism), poor financial regulatory institutions, and government mismanagement or corruption. Regional security issues are a critical factor, for example, in many Sub-Saharan African countries. One lesson that emerges is that overall, social, economic, and political systems that do a poor job of reconciling competing interests frequently end up with policies benefitting only the few, leading to fractionalized societies that deter the development process.[10]

Development and External Debt

Countries with low domestic saving rates have little choice but to try to close their saving-investment gap by tapping into foreign financial resources. Foreigners, for their part, lend and invest capital abroad, including developing countries, when the prospect for above average return compensates for the additional risk. Theoretically, this arrangement should be mutually beneficial. Given the relative scarcity of capital in developing countries, foreign investment should be productive, generating comparatively high rates of return, and economic development should be enhanced with the additional resources. The global financial markets should ideally serve to link the supply and demand for capital around the world, helping to define opportunities and costs of these investments.[11] Yet the poorest countries (Africa) have been unable to attract private capital, particularly since the 1980s debt crisis, because of their low rates of productivity and return to capital, stemming from a lack of social, political, and economic infrastructure or what some have characterized as their "capital-hostile environment."

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[9] (...continued)
in Rodrik, *The New Global Economy*, pp. 24-32.

[10] See: Collier and Gunning, ibid, pp. 74-75 and 103-05; Freeman, Richard B. and David L. Lindauer. *Why Not Africa?* National Bureau of Economic Research (NBER) Working Paper 6942, February 1999; Easterly, William and Ross Levine. Africa's Growth Tragedy: Policies and Ethnic Divisions. *The Quarterly Journal of Economics*. November 1997; Temple, Jonathan, The New Growth Evidence. *Journal of Economic Literature*. March 1999, pp. 151-52; Rodrik, *The New Global Economy*, pp. 84-89, and Stiglitz, *Participation and Development*, pp. 15-16.

[11] The theoretical expectation that developing countries should be net importers of capital has not always held. In the 1970s, oil-exporting developing countries became net exporters of capital and since 1986, the United States, the largest developed economy, has been a net importer of capital, particularly during the 1997-99 Asian financial crisis. For a comparison of saving rates between East Asian and Latin American countries, see: Gavin, Michael, Ricardo Hausmann, and Ernesto Talvi. Chapter 6, Saving, Growth, and Macroeconomic Vulnerability, in Birdsall, Nancy, and Frederick Jasperson, eds. *Pathways to Growth: Comparing East Asia and Latin America*. Washington, D.C. Inter-American Development Bank, 1997. On capital-hostile Africa, see: Collier and Gunning, ibid, p. 75.

A Developing Country Debt Profile

Debt originates from private or public sources. Large money-center banks are one source (*private creditors*) and extend credit based on risk-adjusted return. Public debt sources include national governments (*bilateral creditors*) and international financial institutions such as the International Monetary Fund (IMF), the World Bank, or regional development banks (*multilateral creditors*). Not all potential lenders choose to operate in poor countries. Private creditors have large quantities of investable capital, but because they are driven by the profit motive, they approach the poorest, high-risk countries with caution. As calculated from data in **Table 2**, the HIPC countries represented only 6% of total long-term private sector lending to all developing countries in 1970, and this ratio fell to 2% by 1998, suggesting that private lenders have never invested heavily in the poorest countries and actually have decreased their relative lending commitment over the past three decades.

Table 2. Developing Country Debt By Creditor, 1970-1998
(*Long-Term* Debt in $ billions)

All Developing Country Debt				
Creditor	**1970**	**1980**	**1990**	**1998 (P)**
Private	28.9	273.5	575.9	1,119.9
Bilateral	25.0	129.3	397.3	520.0
Multilateral	7.3	48.9	207.8	317.6
Total	61.2	451.7	1,181.0	1,957.5
Heavily Indebted Poor Countries				
Private	1.8	17.7	29.2	25.1
Bilateral	3.4	20.5	90.6	84.7
Multilateral	0.7	8.4	38.1	58.7
Total	5.9	46.6	157.9	168.5
Severely Indebted Middle-Income Countries				**1997**
Private	12.2	86.0	164.7	300.8
Bilateral	4.7	37.0	103.8	124.5
Multilateral	1.0	8.2	40.2	50.7
Total	17.9	131.2	308.7	476.0

Source: World Bank, *Global Development Finance 1999: Analysis and Summary Tables*, pp. 189, 205, and 218. P = preliminary

Other evidence suggests that patterns of private-sector lending to developing countries are highly stratified by income level. For example, private sector debt as a percentage of debt to **all developing countries** was 47% in 1970, 60% in 1980, 49% in 1990, and 57% in 1998, a significant portion over three decades. The debt picture for severely indebted **middle-income developing countries** also includes a healthy portion of private-sector participation, ranging from 68% of total debt in 1970 to 63% in 1997 (1998 data unavailable).

Compare now the debt profile of the heavily indebted **poor developing countries**. In 1970, private debt was only 31% of their total debt, less than half that of the severely indebted middle-income countries on a percentage basis. By 1998 this picture had deteriorated even more so. Private creditors reduced their relative position in poor countries by half (to 15% of total debt) even as the dollar value of their total debt ballooned from $5.9 billion in 1970 to $168.5 billion in 1998. Interestingly, bilateral debt to the poor countries, such as export credit (Export-Import Bank) or direct loans, fell slightly to 50% of total debt and multilateral debt nearly tripled to 35% of the total. In effect, as the private creditors retreated from the poorest countries, multilateral institutions picked up the slack.[12]

To a great extent, the data indicate that private lenders were reacting to the weak economic fundamentals of poor countries, which suggested that they would have severe difficulty servicing their debt. **Table 3** gives one indication of this concern. At the close of 1998, total HIPC debt (long- and short-term) stood at $205.7 billion. This amounts to only 8% of total developing country debt, but the burden of this debt is plainly evident when it is compared to HIPC economic performance.

Table 3. Developing Country Debt and Debt Ratios, 1970-1998
(*Total* Public and Private Debt in $ billions or percent)

Debtor	1970	1980	1990	1998 (P)
All Developing Countries - Total ($ bil)	na	609.5	1,472.8	2,465.1
of which long-term is ($ bil)	61.2	451.6	1,181.1	1,957.5
Total debt/GNP (%)	na	21.0	33.5	37.3
Total debt/exports (%)	na	85.3	155.8	146.2
Sub-Saharan Africa - Total ($ bil)	na	60.9	177.4	225.8
of which long-term is ($ bil)	6.1	46.6	149.9	176.0
Total debt/GNP (%)	na	24.1	64.7	68.3
Total debt/exports (%)	na	66.4	209.8	232.1
Latin America - Total ($ bil)	na	257.3	475.4	735.8
of which long-term is ($ bil)	27.6	187.3	379.7	586.1
Total debt/GNP (%)	na	34.8	44.7	36.9
Total debt/exports (%)	na	201.9	256.1	202.5
HIPC - Total ($ bil)	na	58.3	188.6	205.7
of which long-term is ($ bil)	5.9	46.6	157.9	168.5
Total debt/GNP (%)	na	44.0	132.8	121.5
Total debt/exports (%)	na	174.4	503.2	386.3

Source: World Bank, *Global Development Finance 1999: Analysis and Summary Tables*, pp. 14, 26, 38, 42, and 218.
na = not available, P= preliminary
exports = goods and services.

[12] In general, a borrower's ability to repay is the critical lending factor, as opposed to say loan collateralization or credit history. This is true for the local bank making a car loan and the international bank lending to a sovereign nation. That is why even severely indebted middle-income countries are better positioned to borrow than solvent low-income countries. In fact, in 1997 private debt accounted for 63-69% of total debt for middle-income countries, whether moderately or severely indebted, whereas it amounted to only 23% for low-income countries *NOT* classified as significantly indebted.

For example, total debt as a percentage of GNP gives a sense of a country's overall indebtedness. For all developing countries, this ratio rose from 21% in 1980 to 33.5% in 1990 and 37.3% in 1998. For Latin America, it grew from 34.8% in 1980 to 44.7% in 1990, reflecting the debt crisis period, falling back to 36.9% in 1998. In Africa, debt ballooned from 24.1% of GNP in 1980 to 64.7% in 1990, rising even further to 68.3% by 1998. For the HIPC group, the numbers are even worse: debt to GNP increased from 44.0% in 1980 to 132.8% in 1990, improving slightly to 121.5% in 1998. By this measure, HIPC indebtedness is three times the average for all developing countries, although relatively small in dollar terms.

Another key ratio of debt burden is total debt to exports. Exports are a means for paying external debt, so to the extent that the ratio of debt to exports rises (falls), it suggests that any debt problem is becoming increasingly harder (easier) to manage. For all developing countries, this ratio increased from 85.3% in 1980 to 146.2% in 1998, suggesting that the burden of debt was growing. For Latin America, the ratio again reflects the 1980s debt crisis, growing from 201.9% in 1980 to 256.1% in 1990 and then retreating to 202.5% in 1998. In the extreme case of the HIPC countries, an increase in this ratio from 174.4% in 1980 to 503.2% in 1990 suggests a substantially worsening debt management problem among the poorest countries, and although the ratio improved to 386.3% in 1998, in part due to debt relief efforts, it remains very high, as it does for Sub-Saharan Africa at 232.1%.

In summary, two points can be highlighted in the current developing country debt problem. First, HIPC countries are heavily indebted relative to their ability to pay because of very weak economic performance. Second, despite heavy indebtedness, they need large net inflows of private capital if they are to develop, which is unlikely given their existing debt load. Expanded debt relief is seen as one answer to this "Catch-22" predicament, but there is disagreement on how to proceed. Comparing the 1990s HIPC debt problem with the 1980s Latin American debt crisis can provide valuable lessons for the policy debate.

Debt Problems in Latin America and Africa

Although sovereign debt is a normal part of any country's financial position, when it becomes excessive, it can expose, if not trigger, serious economic problems. This was the case of Mexico's dramatic default in 1982, which ushered in Latin America's debt crisis and subsequent decade of economic stagnation. What made this a crisis from the perspective of the developed world, particularly the United States, was the fact that much of the debt was owed to large U.S. money-center banks. Failure to keep developing country debt repayments current would mean huge writeoffs, and in the minds of many, risked the collapse of these banks, if not the international financial system. Although the African case differs in some respects, the policy dilemmas that Latin America faced are still instructive.

Latin America: Mismanaging Debt in a Hostile World

In August 1982, Mexico suspended payments on its foreign debt, becoming the harbinger of 1980s debt crisis. In short order, other Latin American countries needed

debt rescheduling including Argentina, Brazil, Chile, Costa Rica, Ecuador, Panama, Peru, Uruguay, and Venezuela. The sudden and massive appearance of the Latin American debt crisis can be seen in **Table 4**. From 1975 to 1981, net capital inflows to the region nearly tripled, easily covering the mounting debt obligation that can be seen in the growing net interest payments. This allowed the net transfer of financial resources to remain substantially positive. When the crisis hit in 1982, bank lending dried up, but interest obligations did not. As net capital inflows dropped suddenly (capital flight) and net interest payments remained high (high debt burden), the net transfer of financial resources went from a positive $11.3 billion in 1981 to a negative $18.7 billion in 1982, falling to negative $31.6 billion in 1983 (a $43 billion difference), pointing to the speed and magnitude of this financial crisis.

Table 4. Net Capital Resource Transfers to Latin America

($ billions)

Year	Net Capital Inflows	Net Interest Payments	Net Transfer of Resources
1975	14.3	5.6	8.7
1976	17.9	6.8	11.1
1977	17.2	8.2	9.0
1978	26.2	10.2	16.0
1979	29.1	13.7	15.4
1980	32.0	18.9	13.1
1981	39.8	28.5	11.3
1982	20.1	38.8	-18.7
1983	2.9	34.5	-31.6
1984	10.4	37.3	-26.9
1985	3.0	35.3	-32.3
1986	9.9	32.6	-22.7
1987	15.4	31.4	-16.0

Source: Sebastian Edwards. *Crisis and Reform in Latin America: From Despair to Hope*. Washington, D.C., The World Bank, 1995. p. 24.

The debt buildup in Latin America reflected a multitude of factors, conditions, and assumptions that went wrong. Although there are different schools of thought regarding the relative importance of these different causes, there is little disagreement that to varying degrees, domestic policy decisions, bank lending strategies, and external economic conditions collided to spark the crisis.

Debtor Country Policies. Brisk economic growth in most Latin American countries during the 1970s allowed a certain amount of complacency to creep into the policymaking processes, which were crafted in relatively closed economic systems. Debt accumulated quickly and often was not well managed, so when global economic conditions deteriorated, policy errors contributed to indebtedness becoming unsustainable.

Fiscal excess was a primary direct cause of the growing Latin American indebtedness in the 1980s, with some deficits pushing to 15%-20% of GDP. Given loose credit conditions in the global financial markets, countries could meet competing domestic needs by overspending and borrowing abroad at lower interest rates than at home, leading to large current account deficits. To a great extent, politics dictated borrowing strategy because stability could be bought over the short-term by spending on a variety of programs without raising taxes. Countries saved and invested less, but consumed more in public outlays through foreign borrowing.

Debt management exacerbated the debt buildup. As the amount of debt grew, it was serviced by additional borrowing, so many countries failed to meet even minimal interest payments with domestic resources. Combined with using debt for consumption rather than investment, the effect was to compound the debt service problem quickly. As one economist wrote, "Since accumulation of external debt was growing at a faster pace than the accumulation of productive investment, a debt crisis was just a question of time."[13] To make matters worse, many national governments assumed responsibility for private (corporate) debt after the crisis hit. This so-called "socialization of debt" added much to some country's overall indebtedness, a policy that has been highly criticized by many debt experts.[14]

Exchange rate policy and capital flight also contributed to the debt buildup. The use of fixed nominal exchange rates to control inflation led to real (adjusted for inflation) currency appreciation. Without some downward adjustment to the exchange rate, exports became more expensive relative to imports, driving up the trade and current account deficits. As speculation grew that exchange rates were overvalued, capital flight ensued. In effect, as the private sector in the developing countries began to protect its capital from an expected depreciation by investing abroad (U.S. bank accounts, bonds, stocks, real estate), the public sector covered the capital loss by borrowing abroad. Capital flight amounted to tens of billions of dollars for many Latin American countries, causing foreign reserves to dry up at an alarming rate and becoming a leading factor in the rising level of foreign debt.[15]

Economists emphasizing the domestic policy side of the debt issue argue that corrective measures could have been taken to reduce the impact including adjusting

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[13] Weisner, Eduardo. Latin American Debt: Lessons and Pending Issues. American Economics Association. *Papers and Proceedings of the Ninety-Seventh Annual Meeting of the AEA*. May 1995. pp. 191-95. See also: Sachs, Jeffrey D. Introduction. In Sachs, Jeffrey D., ed. *Developing Country Debt and the World Economy*. Chicago, University of Chicago Press, 1989. pp. 11-12.

[14] Sachs, ibid, pp.12-16. The East Asian countries, by contrast, borrowed to invest in projects with very high real rates of return and so were able to service their debts even when the world economy turned downward. See Krueger, Anne O. et. al. Developing Countries' Debt Problems and Efforts at Policy Reform. *Contemporary Policy Issues*, January 1990, pp. 2-4.

[15] On the importance of real exchange rate appreciation and capital flight, see: Sachs, Jeffrey D. Comments. *Brookings Papers on Economic Activity*, 2, 1984. pp. 397-98 and Cline, William R. *International Debt Reexamined*. Washington, D.C. Institute for International Economics, 1995. pp. 110-13 and Edwards, Sebastian. *Crisis and Reform in Latin America: From Despair to Hope*. Washington, D.C., The World Bank, 1995, p. 23.

interest rates, abandoning fixed exchange rates earlier, correcting large fiscal deficits, and limiting capital flows. For example, South Korea succeeded with just such a fiscal reform when debt became a problem in 1981 and Colombia avoided a large fiscal imbalance and so stands as an important exception to Latin American debt rescheduling in the 1980s.

Commercial Bank Lending Policies. Although debtor countries were responsible for much of their initial indebtedness, international banks also played a role in the crisis. Credit policy was clearly an issue. Banks weigh various risk factors when allocating loans, and conditions for lending to developing countries usually reflect the additional risk by requiring stricter terms such as a premium on the interest rate, a shorter maturity, or linking debt to short-term interest rates or a foreign currency. Historically, banks have done well lending to developing countries, including accounting for losses from default, which have occurred repeatedly over the past two centuries. The risk premiums reflect an expectation that at some point, not all loans will be repaid in full. In the case of the Latin American debt crisis, however, creditors appeared to act imprudently.

Loose credit standards beginning in the 1970s, many argue, ignored history and common sense, given that the stock of outstanding debt soon eclipsed all previous levels since the 1930s, when defaults also soared during the Great Depression.[16] Collectively, bank lending to developing countries amounted to nearly 300% of their capital base, with much of it occurring right before the debt crisis. As one study points out, bank lending to the major debtors in the time period immediately prior to Mexico's default (1980-81) doubled, with much of it financing capital flight even as the crisis unfurled.[17] Despite a history to the contrary, banks assumed that countries would not default (zero sovereign risk), and so lent to governments without adequate concern for "the economic feasibility of projects."[18] Developing country loans were also highly profitable right up until the crisis hit. It was not until after the crisis emerged that banks withdrew funds in a delayed response to risk.

Global liquidity was another key issue. With the surge in oil prices in 1973-74, oil exporting countries pumped massive amounts of dollars into the international economy through liquid investments in the United States and other industrial economies. These large bank reserves were "recycled" to developing countries in part because they could not be absorbed in developed economies and also because of the

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[16] For a short history of developing country defaults during the 19th and 20th centuries see: Lindert, Peter H. and Peter J. Morton. How Sovereign Debt Has Worked. In Sachs, Jeffrey D. *Developing Country Debt and the World Economy*. Chicago, University of Chicago Press, 1989. pp. 225-35.

[17] In the late 1970s, Mexico's public debt grew at an average annual rate of 15%. By 1981, the year before the crisis, it mushroomed by 57%, most of it to private lenders. See, Weintraub, Sidney. *A Marriage of Convenience: Relations Between Mexico and the United States*. New York, Oxford University Press, 1990. pp. 136-37. In fact, credit history was not a decision factor given that debtor countries tended to be "repeat offenders," with many of the countries that defaulted in the 1930s (and earlier) being central to the 1980s crisis. See ibid, pp. 230-32 and Sachs, Introduction in *Developing Country Debt*, p. 9.

[18] This is argued by Weisner, *Latin American Debt*, p. 193.

attractiveness of higher interest rates in developing economies. At the time, banks were encouraged to make direct loans rather than foreign direct investment because of the resistence to foreign ownership in many development countries.

Finally, *"Herd mentality"* fed the problem. Banks competed for potentially lucrative developing country loans, increasing their total exposure to levels deemed unwise. As with lending into a developing country, such "herd mentality" also led to panic withdrawal in the 1980s. The "free rider" problem soon arose in which the best interests of individual banks was to refuse further lending and hope for repayment (accelerating the panic), whereas the solution to a run on Latin American currencies was to have the collective bank community continue lending.[19]

Global Economic Shocks. Countries can over borrow, invest poorly, make other policy mistakes, and still avoid financial disaster if external economic conditions are supportive. Poor economic policy, however, is tested during times of economic turmoil, when so-called "external shocks" destabilize the normal workings of an economy. It is during these times that inherently weak situations are exposed and the 1982 debt crisis was no exception.

Global recession of the like not seen since the 1930s did much to undermine developing country economies in 1981-82. When the economic growth boom of the 1970s suddenly collapsed, there was no hope of supporting let alone "growing out" of the accumulated debt burden. The global contraction shut down Latin American export growth needed to service the debt and the regional depression of the 1980s eventually deflated the hope that the debt problem was one of illiquidity that would be resolved with the return of economic growth.

Rising real interest rates, led by U.S. Federal Reserve monetary tightening in response to inflation, were a major shock to the Latin American economies. The London Interbank Offer Rate (LIBOR), the leading measure of international short-term interest rates, rose in nominal terms from 5% in 1977 to 18% in 1981. The full implications of this trend were not immediately noticeable; interest rates in the 1970s had been below the growth rate of developing country exports, so countries could increase borrowing abroad to finance debt payments, but not increase the debt-to-export ratio, a signal of a worsening debt management situation. By 1981, interest rates had skyrocketed, export growth had plummeted, and the debt-to-export ratio took off seemingly overnight.[20] Recession combined with high interest rates shut down developing country economies and hiked the cost of debt. By one account, changes in interest rates alone caused 20% of the debt growth in the early 1980s.[21]

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[19] This was also seen more recently during the 1997-98 Asian financial crisis. For a textbook discussion on the role of banks, see: Lindert, Peter H. and Thomas A. Pugel. *International Economics, Tenth Edition*. Chicago, Irwin, 1996. pp. 570-72.

[20] Sachs, *Developing Country Debt and the World Economy*, pp. 7-9.

[21] Cline, William R. "International Debt: From Crisis to Recovery?" American Economics Association. *Proceedings of the Ninety-Seventh Annual Meeting*. May, 1985, p. 185.

Terms of trade (the purchasing power of a country's exports in terms of its imports) also deteriorated for most developing countries. Non-oil commodity prices had risen then fallen through the 1970s, eroding many country's export earnings. Although these prices more or less stabilized during the 1980-81 crisis, they were to plunge once again in 1984-86, hurting initial efforts to repay debt.[22] Oil importing countries were also hurt by the oil price spikes of 1973-74 and 1979-80.[23] Neither were oil exporters spared from the debt problem. High oil revenues encouraged heavy borrowing and when oil prices collapsed, Mexico and Venezuela found themselves in serious trouble as their terms of trade suddenly shifted negatively.

By the time a serious debt burden had been diagnosed, the story was already on a predictable path. As both foreign and domestic investors exited Latin America, demand for local currencies collapsed, forcing countries to devalue. This had a devastating effect on debt service because 1) dollar-denominated debt increased in value overnight, immediately raising debt servicing costs, and; 2) interest rates also rose in tandem, increasing the cost of interest-rate-linked debt and all short-term debt as soon as it was rolled over. The current account, no longer financed from abroad, had to correct from a large deficit (imports contracted) and because borrowing was no longer an option, fiscal tightening was necessary, leading to recession. In short order, the debt crisis spun into economic collapse for much of Latin America.

Sub-Saharan Africa: Debt with No Growth

Africa's debt grew dramatically in the post-colonial period (see **Table 5**), increasing from $6.1 billion to $46.6 billion or 664% in the 1970s (Latin American debt grew by 579%) and then tripling in the next decade. Unlike the middle-income Latin American countries, the current concern with African debt focuses on the plight of the world's poorest economies. The literature exploring Africa's slow growth and non-development point to a multitude of economic and political factors that have conspired to deter progress. Indebtedness is an important consideration and the African debt buildup can be traced to some similar issues with Latin America's problems including questionable domestic policy decisions and difficult international economic conditions.

Debtor Country Policies. As with the Latin American countries, the African governments played an important role in deciding to take on debt. Unlike Latin America, however, Africa debt was much smaller in dollar terms and might have been more manageable had many of the countries experienced faster economic growth, which was a basic assumption for incurring debt in the first place.

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[22] This issue is cited in many places, but tersely summarized in Dornbusch, Rudiger. Debt Problems and the World Macroeconomy in Sachs, Jeffrey D. *Developing Country Debt and the World Economy*, pp. 302-03.

[23] The per-barrel price of crude oil rose from $6.41 in 1973 to $36.47 in 1981.

Table 5. Latin American and Sub-Sahara African Debt, 1970-1998
($ billions)

	1970		1980		1990		1998	
	LA	SSA	LA	SSA	LA	SSA	LA	SSA
Total Debt*	27.6	6.1	187.3	46.6	379.7	149.9	586.1	176.0
Private	11.9	0.3	42.5	4.6	25.1	5.3	161.7	7.5
Public**	15.7	5.8	144.8	42.0	354.6	144.6	424.4	168.5
Multilateral	(2.9)	(3.3)	(14.1)	(7.6)	(60.0)	(38.3)	(77.2)	(56.3)
Bilateral	(5.2)	(0.9)	(30.8)	(18.1)	(86.0)	(70.9)	(86.7)	(78.1)
Private guaranteed	(7.6)	(1.6)	(99.8)	(16.3)	(208.6)	(35.3)	(260.5)	(34.1)

* Average total long-term debt.
** Includes all public and publicly guaranteed private debt.
SSA = Sub-Saharan Africa; LA = Latin America
Source: The World Bank. *Global Development Finance, 1999: Analysis and Summary Tables*. pp. 167 and 173.

Fiscal and monetary policies led to much of Africa's growing indebtedness and stemmed from decisions to finance development projects, focusing mostly on domestic industry and infrastructure (not expressly for export promotion). It was assumed that economic growth and higher commodity export prices would provide the earnings to meet expected higher debt service obligations. Policy, however, failed to respond to changing realities. The oil price shocks of the 1970s caused imports and debt to grow precipitously. In addition, government spending rose with the trend in primary commodity prices, but remained high even as prices went into steep decline in the 1980s, greatly reducing government revenue.[24]

In addition, many African countries had expansionary monetary policies in place to support growing aggregate demand, resulting in inflation. Because many exchange rates were fixed, they became overvalued on a real basis, raising African export prices relative to imports. These decisions, combined with heavy subsidies for key imports and capital flight, meant that there was effectively a policy bias against exporting, forcing the resulting trade deficits to be financed from borrowing and creating a rising debt and debt burden situation.[25]

Poor debt management and governance increased financial problems in many countries. Low investment rates in human and physical capital underlie not only Africa's stunted economic performance, but also its poor use of the debt, in both the private and public sectors. Government policies contributed to this problem by

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[24] Greene, Joshua. External Debt Problem of sub-Saharan Africa. In: Frenkel, Jacob A. Michael P. Dooley, and Peter Wickham, eds. *Analytical Issues in Debt*. Washington, D.C. International Monetary Fund. 1989. pp. 47-54.

[25] Ibid, pp. 53-54.

hindering competitive forces that might have improved enterprise behavior, including debt and investment management. These policies included: high barriers to trade; cumbersome exchange rate regimes; excessive taxes; large budget deficits; over-regulated domestic markets; and inadequate protection of private property. Poor use of debt contributed to low productivity in such critical export sectors as agriculture, which affected the ability of many countries to service external debt.[26]

Public sector expenditures often have had little social and economic payback, in part, because of costs associated with social conflict, as well as inefficient and corrupt governance in some cases. "Ethnic fractionalization," cross border warfare, civil war, and general unrest in many countries deterred investment and development. Related military expenditures, which are poor substitutes for more productive uses of public resources such as improving health, education, and infrastructure, have undermined attempts to reduce large fiscal deficits and increased the need to borrow abroad. Although military expenditures in Africa have actually fallen in the 1990s from over 3.4% of GDP to 2.3% in 1998, they remain relatively high compared to Asia (1.6%) and Latin America (1.3%), and are a detriment to growth and development. In the worst cases, where economic elites have pilfered their own economies, sent the proceeds abroad, and chosen economic policies that benefitted only the few, economic progress has been stifled.[27]

Creditor Policies. Unlike the Latin American case in the 1980s, Africa has not been enticed to over borrow in the private markets. In fact, the dearth of capital has long been the a major problem for the region. Because much of Africa has an excessively risky investment environment, it has not been able to attract private capital and, as noted above, has experienced much greater capital flight than other developing regions, particularly if measured as a percent of private wealth. Except for capital flight, Africa has not been well integrated into the world financial markets as seen by private financing trends in **Table 5**.[28]

The lack of private investment meant Africa had to borrow from official creditors, including multilateral institutions such as the World Bank and IMF, and developed country loan and aid programs. The prudence of lending to countries that may have had poor prospects for repaying can be questioned, but unlike the private

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[26] Many have chronicled Africa's economic setbacks. See: Sachs, Jeffrey. Growth in Africa: It Can Be Done. *The Economist*, June 29, 1996. pp. 19-21; Ihonvbere, Julius O. Between Debt and Disaster: The Politics of Africa's Debt Crisis. *In Depth*, Winter 1994, pp. 111-118; and Wright, Stephen. Oil, Energy, and Debt: The Emergence of Africa's Economic Crisis, *Journal of the Third World Spectrum*, Spring 1995. Also discussed is geographical determinism given many African countries are landlocked. This is judged generally less significant than fundamental economic and political factors and in any case is not easily remedied by public policy.

[27] IMF, *World Economic Outlook,* October 1999, p. 105, Freeman, Richard B. and David L. Lindauer. *Why Not Africa?* NBER Working Paper No. 6942, February 1999, and Easterly, William and Ross Levine. Africa's Growth Tragedy: Policies, Collier and Gunning, *Explaining African Economic Performance*, p. 100 and 105 and Ethnic Divisions, *The Quarterly Journal of Economics*, November 1997, pp. 1203-50.

[28] Ibid, pp. 92-93.

banks in Latin America, the multilateral development banks are expected to operate where the private sector will not. In theory, official lending should have had some positive effect on development through the policy conditions attached to it. Dependence on foreign financing grew without broad reform, however, leaving much of Africa deeper in debt and struggling with archaic, elitist incentive systems that fostered social discontent, underdevelopment, and high risk investment environments. Without broad social and economic change, private sector lending is unlikely to materialize and economic growth and development will continue to lag. It is still unclear if the latest HIPC initiative and its requisite policy changes will serve as a greater force for change.[29]

Global Economic Shocks. Africa has been susceptible to the same external shocks as Latin America. Heavy dependence on commodity exports often has resulted in volatile terms of trade and unpredictable periods of slack demand, causing large trade deficits. African balance of payments problems swelled with the oil shocks of the 1970s and 1980s, as debt and aid were used increasingly to finance basic fuel import needs. The 1981-82 global recession and concurrent rise in interest rates had similarly compounding effects on Africa's debt as they did in Latin America, leading to over 100 debt rescheduling cases in the mid-1980s.[30]

Africa's many problems have led to slow economic growth and an inability to service even relatively small amounts of foreign debt. For example, at one extreme, East Asia was able to sidestep the debt crisis in part because of annual GDP growth rates that averaged 7.5% in the 1980s and 9.4% in the 1990s. By contrast, Africa could muster growth economic growth of only 1.8% and 2.0%, respectively, over the same time periods. A closer look at these figures reveals significant discrepancy among countries; the top nine grew at an average annual rate of 3.1% over the past three decades, whereas the bottom nine contracted by 2.0%.[31] Overall, however, African economies have lagged badly, even by developing country standards, almost guaranteeing that at some point debt would become a serious problem.[32]

The poorest African countries that qualify as part of the HIPC group find themselves in the very difficult position of not being able to cover their debt obligations and having little investment to show for their indebtedness. As with Latin America in the 1980s, this is a recipe for stagnation and one that requires major

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[29] Ibid, p. 105 and Schaefer, Brett D. and Denise H. Froning. *How Congress Should Relieve Poor-Country Debt*. The Heritage Foundation, Washington, D.C., June 29, 1999. pp. 3-4.

[30] These points are developed in: Wright, Stephen. Oil, Energy, and Debt: The Emergence of Africa's Economic Crisis. *Journal of the Third World Spectrum*, Spring 1995, pp. 47-61.

[31] World Bank, *World Development Indicators 1999*, p. 190 and International Monetary Fund, *World Economic Outlook*, October 1999, p. 17.

[32] South Korea was the fourth largest debtor country in 1981, but by pursuing very different policies than Africa or Latin America (fiscal restraint, a competitive exchange rate and persistently high levels of investment) its fast economic growth provided for debt service and reduction. Collins, Susan M. and Won-Am Park. External debt and Macroeconomic Performance in South Korea in Sachs, Jeffrey D. *Developing Country Debt and the World Economy*. Chicago, University of Chicago Press, 1989.

changes in economic policy to correct. Part of the answer may lie with debt relief proposals, particularly if accompanied with policy reform, because these countries appear incapable of growing out of their debt.

In summary, Latin America and Africa can point to some similar trends that have caused serious debt problems. Africa differs, however, in having specific problems particular to many countries in the region that have compounded their debt burden. These include having much poorer initial conditions, highly fractionalized societies, weaker links to the international economic community, and political systems and institutions that are extremely elitist, if not corrupt. Collectively, these characteristics contribute to a highly risky and otherwise, unappealing investment environment.

A Retrospective on Debt Policy

Despite the need for broad social and political change, investment in physical capital is still among the most important factors for economic development.[33] Domestically, HIPC countries must find a way to save and invest more in themselves. Externally, they require large amounts of foreign financing beyond that available in the form of aid. Part of the solution may be greater use of HIPC debt relief, but there is considerable debate over how to proceed. This is not unusual; controversy and divisiveness are central themes in the history of debt relief policy.

Whereas discussions on reducing the actual debt obligations of poor countries is now commonplace, it has been a long, difficult journey from the time debt relief was considered a precedent-setting option to becoming accepted policy. When the 1980s debt crisis erupted, debt reduction was not a possibility. Policy options focused on finding ways to keep debtor countries current in their obligations without reducing their debt load. In time this changed, but it was a arduous process.

Private Debt Rescheduling and "Concerted Lending"

The first stab at debt relief policy in the 1980s was known as "concerted lending," in which commercial banks were collectively "encouraged" or forced to reschedule debt, extending loan agreements and incorporating lapsed interest payments. Individual banks were reluctant to sign on and the IMF was unwilling to extend credit without a firm private sector commitment. Nonetheless, the prevailing viewpoint was that all interests would be served best by preventing massive default, so the IMF took the lead role in coordinating a response with clear obligations for all three parties. The private banks would reschedule loans and provide new financing, the IMF would bring various multilateral institutions to the table and insist on policy

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[33] This point is clearly made in a recent paper that focuses on political stability and securing protection of private property as two top issues. See: Freeman and Lindauer, *Why Not Africa?*, pp. 9,16, and 20.

reform, and the debtor countries would agree to structural reforms as a condition for debt rescheduling.[34]

The thinking behind this strategy proved faulty, however, because it rested on the dubious assumption that most debtor countries faced a problem of liquidity rather than insolvency and that in time, they would be able to "grow out" of their debt.[35] In hindsight, it is clear that this did not happen; in fact, developing country debt actually worsened. Because the dollar value of new bank lending was less than the repayments debtor countries made to the banks this strategy bought time for the commercial banks to build up loan loss reserves, but could not reduce total debt.[36]

As discussions moved toward the possibility of debt forgiveness, the United States reacted negatively to proposals to cancel any debt obligations. The policy was formalized as the Baker Plan (named for the former U.S. Treasury Secretary) unveiled in 1985, in which the World Bank and commercial lenders continued to lend to indebted countries, with the lead role ideally left to the bankers, but ultimately assumed by official lenders. The Baker Plan, which may be viewed as little more than an extension of the private sector "concerted lending" approach, proved short-lived and succeeded only in lengthening debt maturities and transferring debt from commercial to official lenders. It too failed to alleviate overall indebtedness.

Market-Based Debt Relief

At about the same time that the Baker Plan surfaced, market solutions emerged in the private sector in which various types of debt conversion mechanisms were crafted, on a case-by-case basis, in a strategy dubbed the "menu approach." One common option, the debt-equity swap, allowed debt to be written down and exchanged for direct investment in the country. It had limited success, but with other options, became the seed for market-based debt relief and opened the door for a secondary market mechanism to trade what was essentially bad debt.[37]

Other related developments pushed policy makers toward market-based solutions. First, commodity prices had begun falling again in 1984, with oil tumbling in 1986, deepening the debt crisis and dampening any remaining hope that Latin America could grow out of its debt. Second, Brazil, one of the most deeply indebted countries, declared a debt moratorium in 1987, which was viewed by most as a

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[34] MacMillian, Rory. The Next Sovereign Debt Crisis. *Stanford Journal of International Law*. Summer 1995. pp. 318-20 and Cline, *International Debt Reexamined*, p. 205-06.

[35] As one noted economist reflected: "...a country that was demonstrably solvent would not be illiquid; it would be able to borrow from confident creditors. Thus, a debt problem is prima facie evidence of at least a significant risk that the country is indeed insolvent." Krugman, Paul. LDC Debt Policy. In Feldstein, Martin, ed. *American Economic Policy in the 1980s*. Chicago, University of Chicago Press, 1994. p. 706.

[36] MacMillian, *The Next Sovereign Debt Crisis*, p. 327 and Cline, *International Debt Reexamined*, 213-15.

[37] Krugman, Paul, *LDC Debt Policy*, p. 698 and the World Bank, *World Bank Tables, Volume I: 1992-93*, pp. 87-88.

change that flagged an "unwillingness" rather an "inability" to pay. Third, interest arrears were growing, suggesting that continued debt rescheduling was increasing rather than reducing the debt burden.

The reality of the debt situation triggered a major decision by Citicorp in 1987 to set aside $3 billion to cover Latin American debt losses and other major banks followed suit. The provisioning for loan losses ushered in a new period in which market solutions, explicitly incorporating debt write-offs, were now feasible. This action forced the secondary market value of developing country debt to plummet, which caused one debt expert to opine that, "Without the low secondary market prices, the market-oriented debt conversion of the Brady Plan would have been impossible."[38]

The United States came around to supporting a commercial debt reduction strategy in early 1989 following a change in Administration, continued prodding from various interest groups, and a growing sense that the debt problem no longer could cause a major financial collapse. The new approach, dubbed the Brady Plan for then-U.S. Secretary of the Treasury Nicholas Brady, promoted some level of debt and/or debt service reduction, including "debt buybacks," combined with repackaging of remaining bank loans into various types of bonds that could then be traded on the securities markets. In most cases, Brady deals included coordinated lending from multilateral institutions and requisite policy reforms by debtor governments.

This new strategy was essentially a voluntary, cooperative process that targeted each deal to the particular needs of the debtor country and the lender. Given that banks had provisioned against loan losses and that the new bonds were collateralized and transferable, they had two strong incentives to join in, even if it meant taking a write-off. First, they could strengthen their balance sheets by replacing basically worthless loans with higher grade bond debt. Second, they could exit from any remaining developing country debt obligation by trading the bonds in the secondary market.[39]

The debt crisis begun in 1982 eventually subsided in the mid-1990s, in part, because of Brady debt relief, which helped restore confidence in debtor country finances sufficient for capital to return.[40] Policy reforms, very much a reaction to the debt crisis, were equally important, providing environments more conducive to private investment, while also directly reducing the debt burden. Financial sector reform, for example, was critical for encouraging capital to return. Privatization of state enterprises resulted in private equity replacing public debt, reducing government debt levels. More efficiently operated firms helped improve economic growth, productivity, and other fundamentals that enhanced debt service capabilities. Falling barriers to trade and capital also improved export earnings and made for a quick

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[38] Cline, *International Debt Reexamined*, p. 214.

[39] MacMillian, *The Next Sovereign Debt Crisis*, p. 314-15 and Cline, *International Debt Reexamined,* p. 262.

[40] Cline, *International Debt Reexamined*, p. 248-49.

turnaround in capital inflows in the 1990s. In general, those countries that moved quickly to reform emerged faster from their debt crisis.[41]

Bilateral Debt Relief

The poorest countries, however, were in a different situation and faced a parallel process involving official rather than private creditors. Because private banks were not heavily involved in HIPC countries, the problem of "unsustainable debt"was treated with less urgency and debt rollover was a political, rather than financial decision. Consequently, Africa did not face the sudden withdrawal of capital that sparked the Latin American crisis.

Nonetheless, official bilateral creditors (developed countries) eventually had to face the prospect of debt relief for the African nations, which was done through an informal group of creditor countries known as the Paris Club.[42] Until 1988, it too avoided debt reduction, relying on debt rescheduling. According to the IMF, between 1976 and 1988, 81 Paris club loan agreements were rescheduled, delaying some $23 billion in debt for 27 HIPC countries. Like the private-sector "concerted lending" approach, official creditor debt rescheduling under the Paris Club reduced poor country cash flow obligations, but worsened overall indebtedness.[43]

Also like the private-sector experience, Paris Club countries soon determined that debt relief would have to move beyond rescheduling to forgiveness if poor countries were ever to reduce the debt burden to "sustainable" levels. At the 1988 G-7 summit in Toronto a menu approach was adopted allowing for three debt rescheduling options (listed in order of most relief): 1) reduction of debt principal coming due by up to one-third on a present value basis; 2) rescheduling all debt at below-market rates; or 3) rescheduling at market rates, but with an extended grace (no payment) period. Most countries chose not to give the most relief under option one, and so although the so-called Toronto terms offered the first round of true debt relief from Paris Club countries, its impact was limited.[44]

It soon became evident that the initial level of Paris Club debt relief was not going to significantly alleviate debt burdens and so it was expanded. The terms were enhanced in 1991, for example, allowing for lengthened maturities while the present value debt reduction was increased to 50% (London terms). In 1994 debt relief was raised to a ceiling of 67% (Naples terms) of debt on a present value basis. A total of

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[41] Latin America's reform efforts are detailed in: Edwards, Sebastian. *Crisis and Reform in Latin America: From Despair to Hope*. Washington, D.C., World Bank, 1995.

[42] The Paris Club includes Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, Switzerland, the United Kingdom, and the United States.

[43] Daseking, Christina and Robert Powell. *From Toronto Terms to the HIPC Initiative: A Brief History of Debt Relief for Low-Income Countries*. IMF, Working Paper 99/142, October 1999. p. 5.

[44] Ibid, p. 10 and Cline, *International Debt Reexamined*, p. 385.

26 agreements were rescheduled under London terms and another 34 under Naples terms, affecting some $25 billion in debt payments.[45]

These increasingly concessional debt relief efforts, although slow in coming, have helped the HIPC countries reduce the present value of their debt and their debt service payments, particularly in dealing with interest arrears. The significant reduction in debt burden for HIPC countries is evident in the decline in the average paid debt service ratio of over 30% in 1986 to 17% in 1997. Importantly, debt forgiveness combined with aid and other official transfers, has allowed for a positive flow of resources to continue into these countries, avoiding the large negative outflow that occurred in Latin America during the mid-1980s. Nonetheless, debt has remained a nagging issue in some cases, suggesting a need for greater relief.[46]

The HIPC Initiative

Multilateral institutions were brought into the debt relief mix with the HIPC initiative, which was adopted by the World Bank and IMF in September 1996. Much as private banks and the Paris Club initially hesitated to forgive debt in the 1980s, multilateral lenders also have been reluctant to reduce debt until alternatives appeared exhausted, waiting nearly a decade longer than other international lenders. With the HIPC initiative, multilateral debt relief builds on existing efforts by the Paris Club to reduce claims on those poor countries struggling with unsustainable debt levels. Multilateral debt forgiveness is financed from the IMF, World Bank, regional development banks, and developed countries.[47]

As initially conceived, a country qualifies for HIPC debt relief by demonstrating through a lengthy and complicated process that it: 1) is eligible only for concessional assistance from the IMF and World Bank; 2) has an unsustainable debt burden even after traditional debt relief mechanisms have been applied; and 3) has established a "track record" of reform policies through programs supported by the IMF and the World Bank. These three conditions are met through a two-stage process. At the "entry point" of the process, the first stage begins, which relies essentially on existing standard debt relief mechanisms: Naples terms for bilateral debt relief coupled with adopting structural reform programs (see above).

After three years, the debtor country arrives at the "decision point," where its debt situation is reevaluated. Countries either have reduced debt to a sustainable level and exit the program, or graduate to stage two. At stage two, they are eligible for enhanced relief from the Paris Club of up to 90% of non-concessional debt on a present value basis. Non-Paris Club countries and private lenders are encouraged to increase debt relief in like manner. If after a second period of approximately one year, on average, debt remains unsustainable, the so-called "completion point" is reached and the debtor country is fully HIPC qualified, or eligible to receive additional debt

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[45] Ibid, p. 10.

[46] Ibid, pp. 12-13.

[47] For details, see: Nowels, Larry. *Debt Reduction: Initiatives for the Most Heavily Indebted Poor Countries*. CRS Report RL30214, updated periodically.

reduction from the international financial institutions to a point that brings the country's total debt-to-export ratio down to 150%.[48]

In part because of slow progress in implementing debt forgiveness, the HIPC initiative has been criticized for providing insufficient debt relief under excessively stringent guidelines that do not adequately address poverty reduction goals. Alternative proposals for amending HIPC range from slightly altering current guidelines to providing immediate 100% debt cancellation (over $200 billion) with no conditions attached. Following an extensive review process, the IMF and World Bank responded with an "enhanced framework" for the program intended to facilitate "faster, deeper, and broader debt relief," including: 1) lowering the target debt sustainability ratios (e.g. debt-to-export ratio reduced from 200-250% to 150%); 2) moving the decision point forward on a case-by-case basis; 3) front loading debt relief to free up resources earlier; and 4) formally linking debt relief to social spending/poverty reduction programs as specifically defined by the debtor country.[49]

Reflecting these changing policy priorities, the IMF renamed the facility used to extend concessional financing to poor countries, including those falling under HIPC, from the Enhanced Structural Adjustment Facility (ESAF) to the Poverty Reduction and Growth Facility (PRGF). The Paris Club increased debt forgiveness to 90%, with the United States and United Kingdom agreeing to 100% on a net present value basis. The enhanced framework, which will make more countries eligible for increased debt relief, will more than double the program's estimated cost from $12.5 billion to over $28 billion. Obtaining commitments from developed countries to finance the enhanced HIPC is the next major challenge. As of the February 2000, actual HIPC debt relief commitments have been made to eight countries totaling $5.5 billion in net present value terms, assistance that will reduce future debt service payments by $10.5 billion.[50]

A Policy Perspective on Debt and Debt Relief

The HIPC initiative is the primary focus of the current debt relief debate. Total HIPC country external debt amounts to $206 billion (**Table 3**) and current HIPC proposals anticipate total debt reduction costs for all creditors in 1999 net present value terms to be $28.2 billion, both relatively small amounts by developed country or global standards, yet still largely unfunded. The United States has not committed funds to the HIPC Trust Fund to help finance the reduction of multilateral debt, but Congress appropriated $110 million for bilateral debt relief under HIPC terms in

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[48] Other thresholds apply in certain cases.

[49] IMF, *Overview: Transforming the Enhanced Structural Adjustment Facility (ESAF) and the Debt Initiative for the Heavily Indebted Poor Countries (HIPCs)*. February 9, 2000.

[50] The World Bank. *Progress Through February 2000*. World Bank web page: [http://www.worldbank.org] and International Monetary Fund. *Heavily Indebted Poor Countries (HIPC) Initiative – Update on Costing the Enhanced HIPC Initiative*. December 7, 1999. p. 7. On IMF web site: [http://www.imf.org].

FY2000.[51] In addition, President Clinton has requested $847 million in appropriations to support HIPC debt reduction for fiscal years 2000-2003. This includes a total of $210 million for additional U.S. bilateral debt forgiveness and $600 million to finance multilateral debt reduction.

If greater emphasis on debt relief is desired to help poor countries develop, it should be pursued with the experiences of the past clearly in mind. A key point to consider is that most developing countries are not overly indebted and international debt markets can support their development goals. For the HIPC countries, however, debt may be a drag on economic growth and so debt forgiveness may afford an opportunity to boost the development process. The HIPC "enhanced framework," which has increased the potential speed and quantity of debt relief, reflects a broad perspective that more has to be done to help the poorest countries improve their chances for development. Efforts have so far stopped short of embracing unconditional debt relief, which experience suggests may be counterproductive because it does not have the supporting leverage to encourage broader economic, political, and social reform.

One oft-repeated lesson of the debt relief history is that if the goal of debt reduction is to support growth and development, it must become part of a long-term investment strategy. Other broadly suggested components of such a strategy include: increasing domestic saving rates; avoiding large fiscal deficits; and re-engaging the global private capital markets (encouraging foreign direct investment and technology transfer), while minimizing the risk of major financial imbalances (avoiding large sudden movements of short-term capital). This argues for incorporating debt relief into a broader reform package, with many players and policies having mutually supportive roles.

Debt Relief Management. On the creditor side, experience suggests that debt reduction be comprehensive, or sufficiently large and involving all major creditors. Rescheduling or postponing assistance appears to compound the problem by delaying growth and development. This point became evident with the pitfalls of the private sector concerted lending schemes, including the Baker Plan, and the well-intentioned Paris Club concessional refinancing schemes. Recent changes to the HIPC initiative reflect this viewpoint. A question that remains for some is whether these recent changes go far enough in helping poor countries overcome, and prevent the recurrence of, unsustainable debt. On the debtor side, good country debt management policies support relief by helping direct new financial resources to productive purposes in both the public and private sectors, which will promote development and reduce the possibility of relapsing into heavy indebtedness.

Debt Relief and Poverty Reduction. This goal is receiving increased attention, particularly under the HIPC initiative, yet debt relief is no guarantee that poverty or social conditions will improve. First, debt does not cause poverty, so more than debt relief is needed to reduce it. Second, because financial resources are largely fungible within government budgets, debt relief is no guarantee that social program spending will grow. Many countries have competing demands for financial resources, some

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[51] Consolidated Appropriations Act of 1999 (P.L. 106-113).

with powerful constituencies such as the military, therefore social spending will only grow with debt relief to the extent that specific policy goals are adopted and enforced. Third, increased social spending will not necessarily improve social conditions. Social programs need to be targeted, well crafted, and ably administered.

HIPC Country Reforms. Developing countries themselves have a responsibility for enacting policy and institutional reform to help create an environment conducive to investment and growth. The 1980s reforms in Latin America were critical components of renewed growth and were a product of domestic commitments, spurred by necessity and assisted by the Brady debt restructuring program. By contrast, in many African countries where civil stability and reform are lacking, the failure to develop is equally evident. Good policies also help a country survive when the external environment becomes adverse (falling terms of trade, rising interest rates, global recession), arguing for policy reform as a condition of debt forgiveness.

Private Sector Participation. HIPC countries are in need of private capital. Just as private capital flows were a major factor improving the debt situation in Latin America, so too must they be in Africa. Without private investment, the debt relief efforts of the multilateral organizations will be too small relative to the financial needs of the poorest countries. History has shown that private lenders often fail to respond to individual debtor histories, so many countries are punished because they are grouped with other developing countries even though they may have markedly different credit histories. The private sector will need encouragement to return to the poorest countries, but will likely hesitate unless conditions and reforms create a more conducive investment climate.

Developed Country Response. If the HIPCs are to succeed, developed countries (and international financial institutions) will need to cooperate and support them as they attempt to reform and adapt to changing international economic trends. Solutions that prolong excessive indebtedness delay development, as the Latin American debt crisis clearly demonstrated. This point supports the decision to adopt the "enhanced framework" of the HIPC initiative. Additionally, foreign aid has proven helpful at the margin and may best be used to pursue immediate social needs, but is not adequate to affect long-term development and is not a substitute for debt forgiveness. To the extent that foreign aid means more debt, it could also compound the problem. Nor will debt reduction provide the needed impetus to grow if developed countries pursue policies that inhibit imports from developing countries. If developing economies are to grow, they will need the widest possible access to foreign markets.[52]

Greater Assistance. Finally, a call has gone out for a much larger transfer of resources from the developed to the developing world, with the implicit understanding that the HIPC debt relief initiative is probably too small to make a significant difference by itself. Resources are required in the poorest countries for the

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[52] Non-tariff barriers to trade (antidumping and countervailing duties) are a major concern for developing countries, and many experts believe it is counterproductive to pursue debt relief while blocking the exports of developing countries.

construction of infrastructure, health care facilities, technology investment, and other vital and immediate needs at levels beyond those envisioned for debt forgiveness. These needs raise a large, and likely controversial, public policy issue for the developed world.[53]

Heavy indebtedness of the poorest countries is a serious problem, but only one that they face in the context of broader economic and social development. Reducing HIPC debt burdens can be most effective if it is thought of as part of an opportunity for structural change in countries that may lead them back to the growth path. The HIPC countries are no different than other developing nations in this respect. The benefit of debt reduction may be limited, however, because it is not capable of overcoming many of the other obstacles to development that need to be addressed directly. Without broader change and a generous response by developed countries, the benefits of debt forgiveness may well prove short-lived, or simply inadequate.

[53] In addition to many church and other voluntary groups, this point was expressly made in: Sachs, Jeffrey. "Helping the World's Poorest." *The Economist*, August 14, 1999, p. 20.

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