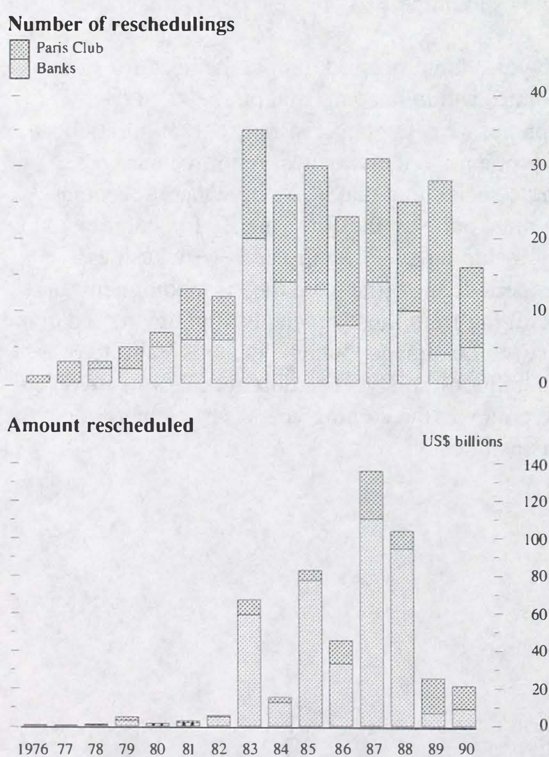
The LDC debt crisis

This article[1] examines the evolution of the less developed countries' (LDCs) debt problem over the past decade. It outlines the institutional framework for dealing with debt servicing difficulties; and describes the economic background to the problem and the different stages in the strategy. It is clear that the threat at one time posed to the international financial system has now receded. Recently, increasing emphasis has been given to debt reduction by both banks and official creditors as a catalyst for economic reform. The strategy of market-based debt reduction by banks appears to be having some success in some middle income countries and debt indicators have begun to improve. The plight of the poorest countries remains as serious as ever, however, and the main industrial countries have committed themselves to further debt relief.

The early approach to the debt problem

Public perception is that the beginning of the debt crisis is usually traced to Mexico's announcement on Friday, 13 August 1982 that it would be unable to meet its obligations. Individual developing countries such as Indonesia, Ghana, Turkey and Poland had encountered debt servicing difficulties before that date (and Argentina's first rescheduling of official bilateral claims dates back to 1956), but Mexico's problems—triggered by world recession and sharply higher interest rates and aggravated by capital flight—were shared by many other developing countries.

Chart 1
LDC debt rescheduling



Like Mexico they had allowed their external indebtedness to commercial banks to rise rapidly in the late 1970s and early 1980s. Many large banks had allowed their exposure to developing countries to grow to a significant portion of, or even to exceed, their capital. Thus the crisis was as much one for the lenders as for the borrowers, posing a systemic threat to the world's financial system.

Between August 1982 and the end of 1983 twenty-two multilateral rescheduling agreements with the commercial banks were negotiated. During the same period eighteen reschedulings with official creditors were agreed. Since then the annual number of reschedulings has remained high, though the number agreed with banks declined markedly in 1989 and has remained low since. The amount of debt rescheduled also increased sharply after 1982. Since then it has varied from year to year (see Chart 1).

Because of the potential systemic problem, reaction to Mexico's announcement was swift—within days the US administration had underlined its support by helping to arrange emergency financial support, while encouraging the maintenance of interest payments to the commercial banks. The steps taken to regularise Mexico's payments position illustrate a process that has generally been the model for subsequent cases. This process has the following features:

- If necessary, the provision of very short-term bridging finance by central banks (often arranged through the Bank for International Settlements) to assist the debtor with its immediate liquidity difficulties.
- Agreement on an IMF adjustment programme (the initial drawings under which often provide the funds to repay any initial bridging loan).

Approval of the IMF programme has, however, been contingent on adequate external financing being in place. In particular, the Fund looks to bank and official bilateral creditors to provide debt relief by agreeing to postpone

(1) Written by M J Dicks of the Bank's Developing World Division.

principal repayments and, if necessary, to refinance a portion of interest due. Concerted financing by bank and official creditors has usually taken place under the auspices of:

- Bank Advisory Committees (sometimes known as the London Club, although negotiations often take place in New York).
- The Paris Club—chaired by a senior official of the French Treasury and representing creditor governments or their agencies (such as the United Kingdom's Export Credit Guarantee Department).

Only when the Fund is assured that agreements with both sets of creditors are likely to fill projected financing gaps will the adjustment programme be approved (and drawings permitted). Approval of the Fund programme also unlocks:

- Adjustment lending by the World Bank and other multilateral development banks and in some cases further credits from bilateral official lenders.

This approach was based on the presumption that debtors had a liquidity problem that could be overcome by the adoption of appropriate domestic adjustment policies with external support from creditors, rather than an insolvency problem. It was expected that debtors would 'grow out of the problem' by the mid-1980s. There was no question of writing off claims—principal payments were postponed and interest was capitalised until the debtor could afford to pay.

A second important principle of the strategy adopted by creditors was to use a 'case-by-case' approach. Moreover, so as to discourage large numbers of debtors from claiming that they faced payment problems, it was made clear that rescheduling was not intended to be an easy option.

From the outset it was recognised that both debtor and creditors would benefit if creditors acted in concert. It was accepted that contributions to financing packages should be broadly in proportion to existing exposure. There was concern, however, to minimise free-riding[1] by lenders with relatively small exposures and this sometimes led to delay in finalising agreements. Free-riding has never been a serious problem among Paris Club creditors and the Club has adopted the practice of excluding *de minimis* creditors from the obligation to reschedule. More recently, however, the Club has been concerned that its members collectively have been required to provide a disproportionate share—relative to that of the banks and other creditors—of the financing requirements of countries with chronic debt problems. Such concerns were an important spur for the initiatives taken in the latter half of the 1980s (see below).

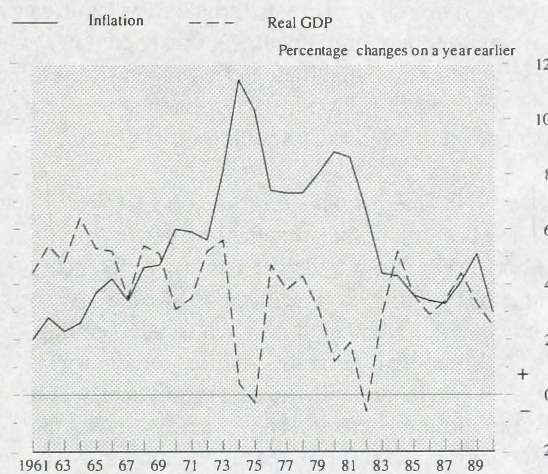
Developments during the first half of the 1980s

(i) The debtors' performance

Many non-oil-exporting LDCs had increased their borrowing sharply in the second half of the 1970s. The two oil price shocks had left the banks flush with deposits as those oil exporting countries which continued to run large trade surpluses chose to bank much of their increased revenues. Recycling of these funds was not discouraged by governments in the industrial countries, who were also anxious to boost exports to stimulate domestic industrial recovery and provided export credits and/or guarantees on generous terms. Some oil exporting LDCs, such as Mexico, Nigeria and Venezuela, chose to borrow against their perceived oil wealth in order to pursue expansionary policies.

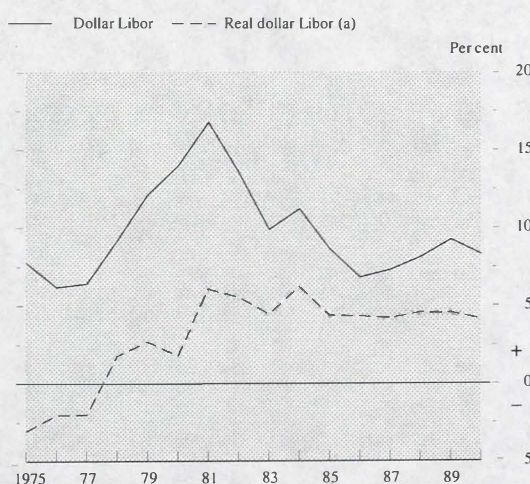
By choosing to borrow, many LDC governments delayed adjustment. Foreign borrowing was politically a more attractive option than raising taxes or reducing expenditure. The fact that at some later date such adjustment would be needed was largely disregarded. By the time debts fell due it was confidently expected that economic growth in the interim would have provided sufficient resources to meet obligations without resort to painful measures. There were also other incentives for LDCs to borrow and for banks to lend. Interest

Chart 2
Real GDP growth and inflation



Total OECD countries.

Chart 3
Real and nominal US dollar interest rates



(a) Real dollar Libor allows for consumer price inflation in the industrial countries.

(1) This occurred since, although there was an incentive for lenders as a whole to provide new loans to debtors in difficulty, no individual bank wanted to provide the new money.

rates were low or even negative in real terms; and the banks appeared to be able to earn much higher spreads on their lending to LDCs than they could obtain elsewhere. Both debtors and creditors appeared to gain from the process. With hindsight it is evident that both seriously underestimated the risks.

The late 1970s and the early 1980s witnessed a sharp slowdown in growth in the developed economies accompanied by an upsurge in inflation (see Chart 2). To reduce inflationary pressures policies were tightened in the industrial countries, resulting in higher nominal and real interest rates (see Chart 3).

As a consequence, the external trade position of LDCs deteriorated sharply while their interest payments rose significantly. In the short run, non-oil exporters' difficulties were countered by increased bank lending—total bank debt of the major debtors nearly doubled between 1979 and 1981. This permitted higher imports despite the poorer export performance as demand for developing countries' products fell. Countries which were to experience debt-servicing difficulties (in the sense of incurring external payment arrears or entering official or commercial bank debt rescheduling agreements) saw their combined trade deficit increase from $2.5 billion in 1980 to $21 billion in 1981. Interest payments rose from $15 billion in 1978 to $58 billion in 1982.

During the late 1970s interest payments due on LDCs' external debt had been more than matched by new borrowing, allowing the borrowers to run trade deficits and to finance large resident capital outflows. The onset of Mexico's difficulties, however, brought an abrupt halt to new lending by the banks. Net lending by private creditors to countries encountering debt servicing difficulties fell from nearly $60 billion in 1981 to virtually zero in 1983. Table A shows the consequential changes in external debt of developing countries, split between those with and those without debt-servicing difficulties. Developments in the external financing of net debtor countries are shown in Chart 4.

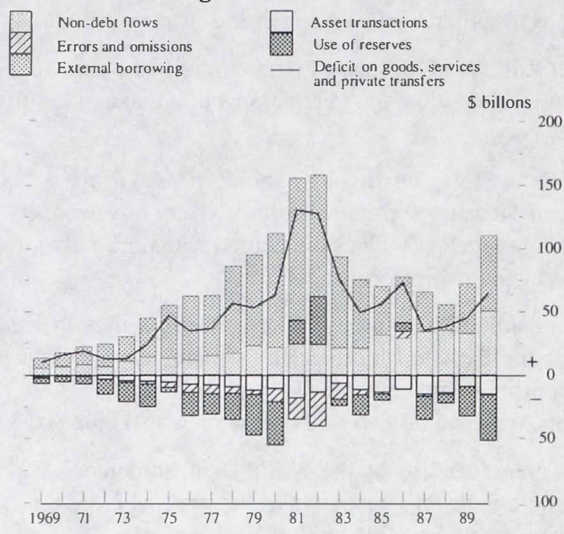
Table A
External debt, 1980–1990

$ billions, *percentages in italics*

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
All LDCs	636	752	836	889	930	1,005	1,096	1,216	1,224	1,234	1,306
By maturity:											
Short term	136	161	184	179	174	172	176	197	206	203	225
Long term	500	591	652	710	756	833	920	1,019	1,017	1,031	1,082
By creditor:											
Official	191	219	250	280	304	354	409	489	497	526	576
Banks	..	na	428	462	472	487	507	545	532	516	518
Other private	..	na	158	148	155	164	180	182	195	192	213
By criteria:											
Net creditors	..	49	55	57	51	51	54	61	62	57	55
Net debtors	..	703	781	832	879	954	1,043	1,155	1,162	1,177	1,251
Debtors with difficulties	..	478	536	564	589	622	670	740	733	739	771
As a percentage of total	..	*68*	*69*	*68*	*67*	*65*	*64*	*64*	*63*	*63*	*62*
Debtors without difficulties	..	227	245	269	290	332	373	414	429	437	480
As a percentage of total	..	*32*	*31*	*32*	*33*	*35*	*36*	*36*	*37*	*37*	*38*

Source: IMF.

Chart 4
External financing of net debtor countries



Although the markets for developing country exports recovered quite vigorously after 1982 and interest rates were significantly lower than the peak in 1981, the scarcity of external financing forced heavily-indebted LDCs to adjust. Their trade positions moved back into surplus as fiscal deficits were reduced and exchange rates were made more realistic. This adjustment was, however, achieved at considerable cost in terms of lower output and a sharp reduction in the share of output devoted to investment. The growth performance of debtors before and after the crisis is shown in Table B. The marked changes in current and capital account developments of LDCs with payment problems are shown in Table C.

(ii) The commercial banks

One of the clear successes of the debt strategy adopted during the first half of the 1980s was the avoidance of widespread failures in the banking system. Although the banks were forced to reschedule their medium-term claims and to freeze short-term facilities or convert them into medium-term claims, they were able to contain most calls for new lending to quite modest sums in relation to their exposure. (They

Table B
Growth performance, pre and post-crisis

Average annual growth rates (per cent)

	1972-1981	1982	1983	1984-89
Developed countries	3.0	-0.3	2.7	3.7
All developing countries	5.0	2.1	2.2	3.8
of which:				
Countries with debt-servicing difficulties	*4.4*	*0.1*	*-1.8*	*2.5*
Countries without debt-servicing difficulties	*5.3*	*5.3*	*7.1*	*6.6*

Ratios

	1982-89 over 1972-81	1984-89 over 1972-81
Developed countries	1.00	1.23
Developing countries	0.68	0.76
of which:		
Countries with debt-servicing difficulties	*0.38*	*0.57*
Countries without debt-serving difficulties	*1.22*	*1.25*

Source: IMF.

Table C
Current account developments and external financing of countries with debt-servicing difficulties

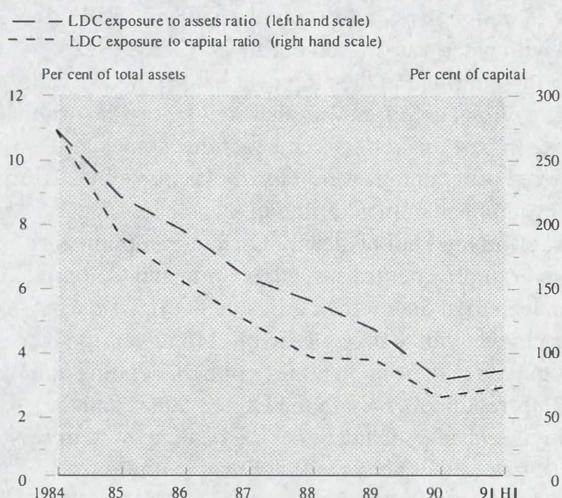
$ billions

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Trade balance	-3.6	-29.3	-15.9	17.0	34.4	34.9	9.3	21.1	23.7	29.0	23.0
Services, net	-46.5	-66.5	-76.8	-61.8	-63.1	-60.5	-60.8	-55.6	-63.5	-65.7	-70.3
Transfers	7.8	11.9	9.4	13.4	14.3	15.5	16.9	17.9	20.0	19.9	28.3
Current account balance	**-42.3**	**-83.9**	**-83.3**	**-31.4**	**-14.4**	**-10.1**	**-34.6**	**-16.6**	**-19.8**	**-16.8**	**-19.1**
Deficit on goods, services and private transfers	46.2	90.0	89.2	38.6	21.4	18.0	42.6	25.1	28.6	25.9	34.0
Non-debt-creating flows, net	9.1	13.1	13.9	11.1	12.5	13.9	12.5	15.4	17.3	15.8	23.3
Asset transactions, net	-3.8	-12.9	-12.1	-2.8	-4.4	-5.9	-2.9	-4.4	-5.9	-3.7	-9.7
Errors and omissions, net	-11.7	-15.7	-18.0	-10.0	-2.7	-0.6	1.3	-2.0	-0.5	2.8	3.3
Use of reserves	-7.8	23.5	41.6	1.6	-13.4	-1.3	8.7	-7.1	5.4	-8.6	-16.2
Net external borrowing	60.4	81.9	63.8	38.7	29.3	11.9	23.0	23.3	12.3	19.6	33.3
Memorandum item											
Borrowing from:											
Official creditors	15.0	14.5	22.2	34.6	28.0	21.6	23.9	25.2	16.5	22.7	30.4
Commercial banks	43.2(a)	71.2	49.9	21.6	13.1	-8.4	-6.4	-1.3	-11.7	-6.4	6.5

Source: IMF.

(a) Estimate.

Chart 5
Large British banks' capital, assets and exposure to LDCs



Notes: LDC exposure is exposure to countries covered by the Bank's provisioning matrix. Total capital comprises share capital plus reserves plus minority interest.

were also helped by the fact that they did not set aside provisions on a large scale until 1987.) Overall, bank claims on LDCs with debt servicing problems grew only modestly after 1983 and exposure fell both as a percentage of total assets and relative to capital (Chart 5).

(iii) Official creditors

Official creditors comprise two main groups—the international financial institutions (IFIs)[1] and the Paris Club.

As regards the former, the IMF found its policy advice and financial resources being called upon more frequently as more countries adopted adjustment programmes in the face of debt servicing difficulties. Fund drawings outstanding rose from a little over SDR 2.5 billion at the end of April 1979 to over SDR 25 billion by end-April 1983. Most of these loans were to deal with what were still perceived as relatively short-term balance of payments disequilibria. In many cases, however, successor programmes were required following initial policy failures and/or to support further multi-year debt restructurings. Increasing use was made of the Extended Fund Facility, established in 1974 to provide medium-term support for structural adjustment. Furthermore, in 1986 the Structural Adjustment Facility was introduced to provide concessional financial assistance to low-income members facing protracted balance of payments problems. This was enhanced the following year, in order to provide additional resources in support of stronger adjustment programmes.

Despite the evolution of IMF facilities, the fact that most Fund credit has to be fairly short-term resulted in net credit extended by the Fund quickly falling back from its peak. Thus, although LDCs as a whole made net drawings of $11 billion in 1983, these had fallen to zero by 1985 and were negative each year for the rest of the 1980s, before turning positive again in 1990.

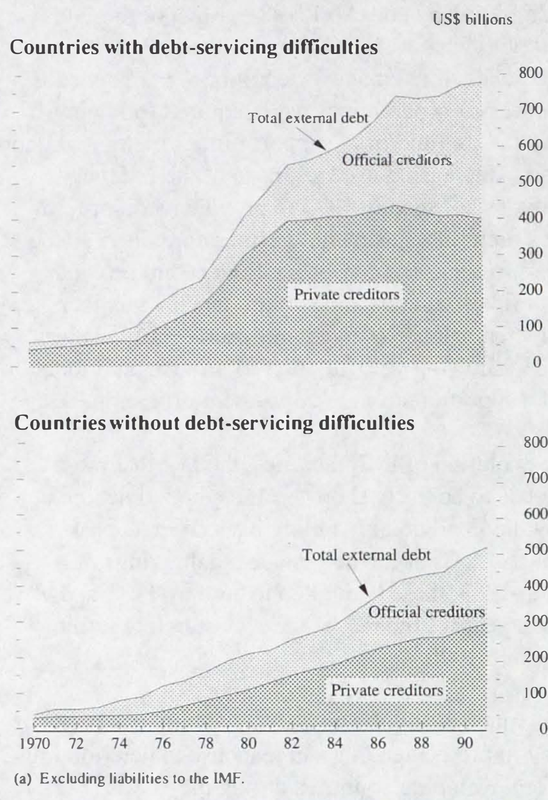
Historically, much of the World Bank's activity has been concentrated in project lending. In response to deteriorating prospects for developing countries during the 1980s, however, the Bank inaugurated a programme of lending in support of structural adjustment and sectoral reform. The total amount of loans approved rose gradually from $5 billion per annum in the mid-1970s to a little over $10 billion by 1982. Thereafter the rate of increase of approvals slowed slightly, although the growth of actual disbursements fell only negligibly.

Overall, the Bank's response was constrained by the willingness of its government shareholders to increase its capital and by market factors—unlike the IMF, the Bank relies upon the international capital market as its main source of funds. It was therefore necessary to avoid perceptions of excessive exposure to the most heavily indebted middle-income LDCs which might have adversely affected the Bank's credit rating, and hence the terms under which it was able to lend to (often poorer) client countries which had avoided debt difficulties by the adoption of cautious policies. The number of operations the Bank could undertake was also constrained by policy failures or bottle-necks in the recipient countries themselves.

Given the reluctance of the commercial banks to provide new loans and the relatively small amounts made available by the IMF and the World Bank, it was left to the Paris Club to take up the slack. The share of debt owed by debtors with debt-servicing difficulties to Paris Club creditors rose sharply—from under one quarter in 1982 to close to one third by 1985 (Chart 6). This trend reflected the way the Paris

(1) The IFIs comprise the IMF, the International Bank for Reconstruction and Development (which with the International Development Association (IDA), the International Finance Corporation (IFC) and the Multilateral Investment Guarantee Agency (MIGA) comprises the World Bank Group), the European Bank for Reconstruction and Development and the various regional development banks.

Chart 6
External debt: breakdown by creditor [(a)]



(a) Excluding liabilities to the IMF.

Club dealt with debtors that found it necessary to reschedule payments to official creditors. Unlike the banks, which tended increasingly to reschedule principal repayments due on the whole or at least a large part of the stock of their medium-term and long-term claims, but provided relatively little new money to refinance interest payments, the Paris Club generally agreed to reschedule both interest and principal falling due over a fairly short 'consolidation' period coinciding with the debtor's IMF programme. A series of comprehensive reschedulings involving the partial capitalisation of interest thus led to a significant rise in official exposure. This exposure was sometimes supplemented by new export credits or guarantees.

Developments since 1985

(i) The Baker Plan

By the time of the IMF/IBRD Annual Meetings in 1985 it was becoming clear that initial claims that the debt problems of LDCs would be resolved reasonably quickly were unrealistic. After a sharp upturn in world trade in 1984, growth slowed and commodity prices weakened; a series of only partially successful IMF programmes indicated that 'adjustment-fatigue' appeared to be setting in among a number of debtors.

At the Annual Meetings the then US Treasury Secretary James Baker launched an initiative intended to revitalise domestic adjustment and structural reform while at the same time providing greater external financial support for countries willing to adopt reforms. The initiative called on the commercial banks to extend new loans of $20 billion over a three-year period to fifteen of the most highly indebted countries, with a similar amount being made available by the multilateral development banks.

The Baker Plan, as the initiative came to be known, envisaged that the extra new money was necessary if debtor countries were to be successful in their efforts at structural reform. These reforms would entail both trade liberalisation and a reduction in the role of the public sector. The Plan reinforced the shift in the focus of policy-makers from short-term adjustment to medium-term issues while giving renewed emphasis to the promotion of economic growth and, in particular, the contribution of the private sector.

A deterioration in the international economy proved to be a serious obstacle to the Baker Plan's aims. Many developing countries experienced even slower growth during 1986–88 than in 1984–85. In particular, non-oil commodity prices weakened further and oil prices collapsed, seriously affecting the prospects for such debtors as Algeria, Mexico, Venezuela and Nigeria.

In the face of this further threat to creditworthiness, new lending by the banks was not forthcoming on the scale envisaged, although they did offer longer grace periods compared with what was offered during 1982–83. Net lending by the multilateral development banks, the IMF and the bilateral official creditors was also well below the original projections. In part this reflected the fact that some IMF-approved programmes were blown off course by adverse external developments. In addition, in many cases adjustment efforts ran out of steam. On a more optimistic note, however, those countries, such as Chile and Colombia, which managed to maintain their adjustment efforts during 1986–88, achieved fairly strong growth. Moreover, the banks continued to reduce their vulnerability to LDC lending and by the late 1980s regulators in both the United States and the United Kingdom had concluded that the banking system was no longer at risk (although some individual institutions remained heavily exposed).

During 1987 a number of US banks increased substantially provisions against their LDC exposure, starting with Citibank's announcement in May that it was to set aside $3 billion. These announcements were generally well received by the market, with the individual banks' stock prices often rising in the short term. Investors interpreted the move as demonstrating the banks' ability to absorb losses and as a sign that management resources could be reallocated from damage limitation to other areas of business. Rising stock prices also enabled the banks to meet stricter capital requirements more cheaply. Bank regulators had been exerting pressure on banks to increase their loan loss provisions. By end-1987 most large US banks had loan loss reserves equal to one fifth or more of total exposure. In the United Kingdom, the Bank of England developed a scoring system (the 'matrix') as a guide to assist banks in the determination of country debt provisions. This led UK

banks to raise their average provisions first to around one third and subsequently to around one half of their LDC exposure.[1]

Higher provisions also gave banks greater flexibility in the management of their LDC loan portfolios. They made increasing use of a rapidly growing secondary market in LDC debt to swap loans and in some cases to make outright sales to third party investors. The latter could then use the claim to acquire the currency of the debtor at, in effect, a favourable exchange rate in order to finance local investment ('debt-equity swaps'). Existing provisions would wholly or largely absorb the losses which the banks would otherwise have made by selling at a discount.

According to the World Bank, by 1985 secondary market trading volume had risen to only $4 billion. During the next three years it increased sharply. Provisional estimates for 1990 suggest a trading volume of $65 billion. Even this figure, however, represents a fairly small proportion (around 20%) of outstanding commercial banks' claims on countries experiencing debt-service difficulties.

(ii) The Brady Plan

By the end of the three-year period covered by the Baker Plan it was evident that while the banks' position had generally strengthened, many debtors continued to face difficulties. In aggregate, LDCs with debt-servicing difficulties had a higher debt-export ratio in 1988 than in 1982 and a debt-service ratio only one percentage point lower. For the severely indebted low-income and moderately indebted country groups the deterioration was particularly marked. Arrears, in total, topped $40 billion in 1987 and reached $52 billion by December 1988. Only one or two countries (for example, Chile) looked to be near the point of regaining access to international capital markets. Adjustment efforts were rarely being sustained. This lack of success was reflected in secondary market prices—the weighted average of prices of the major debtors fell from around 70 cents in the dollar in early 1986 to 35 cents by early 1989.

There was increasing concern among official creditors that they were being asked to take on a disproportionate share of LDCs' financing needs—their share of total long-term debt having risen from 36% in 1982 to 46% by 1988.

In a speech to the Bretton Woods Committee Conference in March 1989, the US Treasury Secretary Nicholas Brady proposed a strengthening of the strategy for resolving the problem of middle-income LDC debt. The main elements of the proposal were:

- The IMF and the World Bank should make funds available to those debtor countries that were prepared to adopt and sustain adjustment and reform policies in support of voluntary market-based debt reduction by banks.
- In order to speed up the process of debt restructurings (and implicitly to put pressure on banks to reach agreement with debtors) it was proposed that IFIs should be willing in certain circumstances to make disbursements before all elements of the financing package were in place.
- Creditor governments should examine accounting and regulatory requirements to ensure that these would not impede debt reduction by the banks.

The underlying proposition being made to the banks was clear. Official creditors expected them to put up their fair share of new financing as before. If the banks felt unable to provide new loans they would have the option of (effectively) selling their claims back to the debtor at a discount consistent with prevailing secondary market prices. The existence of arrears to the banks would no longer necessarily hold up approval of an adjustment programme by the IMF and subsequent initial disbursements by the Fund and other IFIs or by bilateral official creditors.

In May 1989 the IMF and the World Bank adopted guidelines for lending to support debt and debt-service (ie interest rate) reduction. The two institutions expected to provide around $20 billion of such lending between them. Japan indicated that it would support the initiative with $10 billion in co-financing. In October 1990 the Inter-American Development Bank also approved plans for lending in support of debt and debt-service reduction.

Although 'Brady' deals have taken longer than was originally envisaged to put in place (partly because of their complexity), three such agreements—for Mexico, the Philippines and Costa Rica—were agreed in 1989 with a further two—for Venezuela and Uruguay[2]—in 1990. In 1991 Niger was the first beneficiary of a World Bank facility whereby $100 million of the IBRD's net income was provided to the IDA to finance buy-backs of bank claims on the poorest countries. Nigeria has also reached agreement with its banks on a deal with par bond and buy-back features. Morocco too has agreed a debt-service reduction package contingent on a three-year IMF programme with its banks. Negotiations are continuing with, *inter alia*, Argentina, Brazil, Côte D'Ivoire, Honduras, Jordan, Paraguay and Poland.

Has the Brady Plan succeeded? Mexico's experience

The agreement with Mexico has been by far the largest Brady package to date and involved the retirement of more than $20 billion (in net present value (NPV) terms) in debt service. The banks were offered a menu of debt/debt service reduction and new money options. They could swap old Mexican debt for new 'discount' bonds carrying a market rate at an exchange ratio of $100 of old debt for $65 of new or one-for-one for 'par' bonds carrying a fixed reduced interest rate of 6¼ %. The new bonds were partly collateralised with US Treasury paper—Mexico used part of

(1) For a description of the matrix see the *Bank of England Banking Act Reports* for 1987/88 and 1989/90.
(2) In addition, Chile and its bank creditors agreed to amend previous rescheduling agreements permitting Chile to engage in debt buy-backs.

its IMF and World Bank loans to buy zero-coupon bonds to guarantee principal payments in full. Sufficient collateral was also purchased to provide an eighteen-month rolling interest guarantee. A 'value recovery' clause, whereby bondholders would receive higher payments in the event that Mexico's oil revenues exceeded a threshold, was also included. Finally, the new bonds were enhanced further by being transferable, non-reschedulable and exempt from calls for new money.

A third option required banks to provide new 15-year loans. Another feature of the package was the resumption of a debt-equity swaps programme amounting to $1 billion a year for three years.

The willingness of a debtor to buy back its debt and of a creditor to sell it are dependent on the price. It will only be in the interest of the former to buy if its perception of the NPV of the debt service it might otherwise have expected to pay per dollar of debt exceeds the price. The converse is true for the banks: they will look for a price higher than the NPV of expected cash flows as they perceive it. If (as seems likely in practice) perceptions are different (and/or discount rates differ) both creditors and debtors can gain from a Brady deal. If, however, perceptions and discount rates are identical, then a buy-back simply serves to bring forward debt service payments which both parties were expecting to see made. Of course, there may still be benefits from this—banks will save in management time and will be able to declare balance sheets unsullied by problem loans, while debtors will gain from the reduction in uncertainty regarding future payments obligations. Indeed, the psychological impact on confidence might be one of the most important benefits from such a deal.

The complexity of the Mexican Brady deal and the uncertainties regarding future prospects for both Mexico and the world economy make it difficult to judge the effects of the agreement at all precisely. Taking into account the actual mix of choices made by the banks, the total debt relief provided by the package has been calculated at between $12 billion and $13 billion—a little over one quarter of the $49 billion of debt which was restructured. The cost to Mexico of providing security for the new bonds was around $7 billion, to which needs to be added the cost of any 'value recovery' payments.

Since the deal, however, Mexico's IMF programme has remained on course and the secondary market price of its debt has risen sharply. There are indications that flight capital is returning and, though no new medium-term bank loans have been arranged, Mexico has managed to raise money in the international bond and equity markets. Against a background of solid policy performance, the Brady deal has almost certainly helped to catalyse a marked improvement in domestic and foreign investor confidence. Nevertheless, the Mexican economy will remain vulnerable to external shocks and its impressive adjustment and structural reform efforts will have to be sustained.

Developments in the Paris Club

(i) The poorest countries

The Brady Plan did *not* call for debt reduction by official bilateral creditors, who were assumed to continue to reschedule and to capitalise payments where necessary on a case-by-case basis. Nevertheless, before the Brady Plan was announced, official creditors had recognised that some of the poorest debtors—whose debts are predominantly to official creditors—faced more than a liquidity problem after nearly a decade of deteriorating terms of trade, low investment and declining per capita income. It was acknowledged that some countries were, in effect, insolvent and that the traditional remedy of rescheduling/refinancing would lead only to an explosive increase in their debt.

In April 1987 the then UK Chancellor, Nigel Lawson, had proposed that payments due from the poorest, most heavily indebted countries (those with a GNP per capita less than $600 and a debt service ratio of 25% or more) which undertook to make strong adjustment efforts should be rescheduled by the Paris Club at concessional interest rates (thereby reducing the NPV of the debt). At the Toronto Economic Summit in June 1988, the G7 endorsed a package of debt relief the details of which had been formulated in the Paris Club (following encouragement from Ministers attending the IMF/IBRD Spring meetings that year). Official creditors would choose from a menu of rescheduling options, two of which would involve an element of debt write-off. In October, Mali became the first debtor to benefit from the new 'Toronto' terms (see the note on page 505 for details).

Negotiation of the package had been protracted and one of the menu options involved no debt forgiveness (in NPV terms), at least as applied to commercial rate credits. Some members of the Paris Club remained reluctant to write off claims or had no legal powers to do so.

Since the adoption of so-called Toronto terms 20 countries have benefited from debt relief (all of them African countries with the exceptions of Bolivia and Guyana). Nevertheless, it is recognised that the application of Toronto terms will have a rather limited impact. At any given negotiation with the Club only debt service falling due during the consolidation period is restructured on concessional terms and at most one third of debt service obligations is written off. It will require repeated reschedulings before the whole debt has been subject to concessional treatment.

The World Bank has estimated that even if OPEC countries and other non-Paris Club bilateral official creditors were to grant equivalent terms, total savings during the 1990s would add up to less than 5% of total debt-service payments. The Bank also estimates that so far only about 10% of bilateral official claims has been subject to Toronto treatment. Recognising that Toronto terms were only a first step towards a long-term solution to the debt problem of the poorest, the United Kingdom has proposed a package of relief which addresses the whole stock of debt and provides a much greater element of forgiveness. The proposal (see the note on

Toronto and Trinidad terms

Toronto terms (first proposed in 1987 and used from 1988 onwards to reduce the debt of the poorest countries) allow creditors to choose from three options in dealing with debt service falling due during a consolidation period (usually of 18 months, co-terminous with an IMF programme):

Option A: Partial write-offs—creditors forgive one third of debt service falling due and reschedule the remainder at market rates over 14 years with 8 years' grace;

Option B: Longer maturity periods—creditors reschedule debt service at market rates over 25 years with 14 years' grace;

Option C: Concessional interest rates—creditors reschedule debt service at reduced interest rates (either 3.5 percentage points below or one half of market rates, whichever is the smaller concession) over 14 years with 8 years' grace.

Only options A and C actually involve debt forgiveness, in terms of a reduction in the NPV of the debt.

Trinidad terms (proposed by the United Kingdom last year as a means of granting further relief to these countries) have four main features:

- the whole stock of eligible Paris Club debt should be written down;
- the level of concessionality should be increased (a figure of two thirds has been suggested);
- the repayment profile should be related to ability to pay;
- debt relief should only be granted to those debtors who are genuinely insolvent and only if they continue to follow strong adjustment programmes.

The relative impact of Trinidad and Toronto terms on debt-service payments and the stock of debt is shown in the accompanying charts. The calculations assume that a country initially has $600 of debt repayable in 6 equal tranches of $100 falling due in years 1 to 6. The debt carries an interest rate of 10%. Under present arrangements (Toronto terms) there would be 6 successive annual Toronto reschedulings. Capitalisation of interest in the early years leads to a substantial rise in the stock of debt outstanding except in the case of option A where the one-third cancellation of principal has an offsetting effect. Debt service obligations rise rapidly under options A and C on expiry of the grace period.

The effect of Trinidad terms is both to reduce the stock of debt substantially and to smooth out the debt-service profile, allowing for the fact that the availability of cash to service the remaining debt will probably grow over time. The lowest dotted line in the first chart shows the effect of a two-thirds cancellation of the debt stock with the remainder rescheduled over 25 years with 15 years' grace (ie the same maturity as Toronto option B). Debt service is constant until year 16 when principal starts to become due and it then jumps sharply.

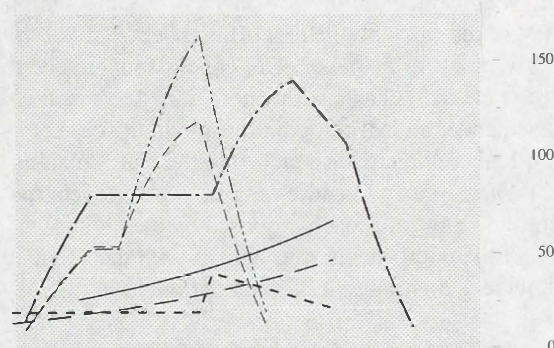
In order to smooth out the profile and to allow for the fact that the debtor's cash flow difficulties are likely to be most severe in the early years, the assumption might be made that total payments be permitted to grow at a given percentage rate (5% in the example) throughout the life of the debt (see lower dashed line in charts). This necessitates some capitalisation of interest in the early years (which accounts for the slow rise in the stock of debt until year 11).

While this procedure further reduces payments in the initial years, at the outset they still exceed those due under some of the Toronto options. By introducing an interest holiday (over which interest is capitalised), the debtor is excused any payment (see lower solid line in charts). From year 6 payments are again assumed to grow at a constant rate. By that time interest capitalisation over the holiday has led to a rise in the debt stock, necessitating a higher schedule of payments than in the case of a steady growth in payments with no holiday.

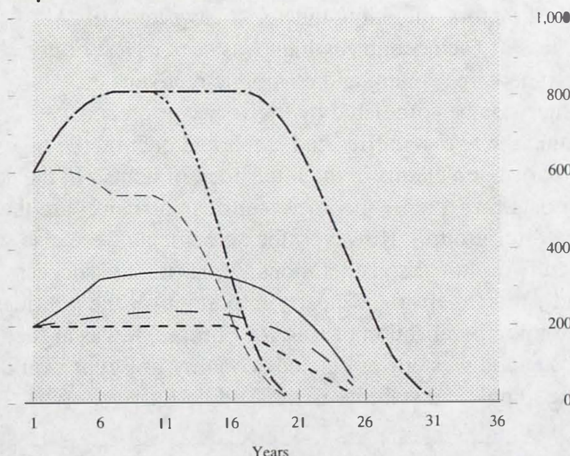
'Trinidad' proposal

Toronto 'A' — Toronto 'B' — Toronto 'C'
Trinidad 25/15 — Trinidad growth at 5% and 5 year holiday
Trinidad payments growth at 5%, no holiday

Impact on debt service



Impact on debt stocks



page 505), outlined by John Major, then Chancellor, at the Commonwealth Finance Ministers' Meeting in Trinidad in September 1990, has been the catalyst for discussions within the Paris Club over the last year. At the London Summit in July the G7 agreed on the need for prompt implementation of measures, on a case-by-case basis, going well beyond the relief already granted under Toronto terms. At the Commonwealth Summit in Harare in October the Prime Minister stated that, 'if agreement cannot be reached at the Paris Club in the very near future, the United Kingdom, acting in concert with as many of our Paris Club colleagues as possible, will implement Trinidad terms'.

(ii) Lower middle income countries (LMICs)

Following agreement at the Houston Economic Summit last year, the Paris Club has also eased the terms under which it is prepared to reschedule payments due from lower middle income debtors (LMICs) with a significant share of their debt owed to the Club.[1] The LMIC package includes a longer rescheduling period and provision for creditors to swap a proportion of their debt into claims denominated in local currency (for example to support environmental initiatives, or debt-equity conversions). The latter provision is partly intended to allow creditors with small exposures to exit from the rescheduling process. LMIC reschedulings do not, however, involve debt reduction or any additional cash flow relief in the short term.

(iii) Poland and Egypt

In the spring of this year the Paris Club signed comprehensive debt-reduction agreements with Poland and Egypt. Each agreement involves a staged 50% cancellation of the NPV of the *stock* of bilateral official debt. Creditors will either write off principal or offer concessional interest rates on their claims. Each agreement is linked to satisfactory performance under an IMF programme and in the case of Poland particular emphasis is attached to the banks making equivalent concessions. In addressing the stock of debt the agreements adopt the approach proposed by the United Kingdom for the poorest countries and, as with the Trinidad proposal, there is no non-concessional option.

The two agreements are regarded by the Club as exceptional. The willingness of the Club to extend such conditions reflects a number of factors, including the very heavy level of indebtedness of each country, which was seen as a serious obstacle to new investment and economic recovery that would otherwise be stimulated by the very comprehensive reforms that the two countries had embarked on, and the high share of Paris Club claims in the total stock of debt. (In the case of most other middle income countries, the banks are the largest creditor group.) However, the agreements were also influenced by political considerations. Ensuring the success of Poland's reform efforts is clearly important for the political and economic liberalisation of Eastern Europe. It was argued that a strong and western-orientated economy in Egypt would contribute to political stability in the Middle East.

Prospects for the rest of the 1990s

Most developing countries now appreciate the need for economic liberalisation and reform and a smaller role for the public sector. Many are in the process of abandoning the inward-looking trade policies which were at one time considered a key element of their development strategy. LDCs also expect creditor countries to open up their markets so as to provide the means of servicing the debt: a successful outcome to the current GATT round would be an important contribution to resolving debt problems.

In many countries foreign investment is being encouraged and financial sector reforms put in place which are intended to raise locally generated savings. After years of low, and in some cases negative, net investment, the potential returns on domestic capital formation are probably very high. Excessive fiscal deficits are being tackled by reforms to the taxation structure and by cuts in wasteful spending. Lower deficits and reduced dependency on finance from the banking system are helping to bring down inflation. Most debtors have eschewed a confrontational approach in dealing with their creditors. Peru is the latest example of a country seeking accommodation with its creditors after a prolonged moratorium.

These trends have contributed to a general recovery of secondary market debt prices. The break-up of the eastern bloc has, however, exposed the strains in the external financing position of the USSR and of other countries in Eastern Europe. India has also emerged recently as having a difficult external payments problem and is adopting stringent adjustment measures and structural reforms. Moreover, despite progress with economic reform in some of the most heavily indebted countries in Latin America, there continue to be problems of policy implementation in many countries. This is especially true in Africa where a combination of external economic pressures (most notably weak commodity prices and drought), political instability, problems such as those brought about by the spread of AIDS, and poor domestic policies have led to a sharp fall in living standards. There is little prospect of the poorest countries' debts being serviced in full and this has been recognised by official creditors.

The experience of Mexico and other beneficiaries of debt reduction has demonstrated that debt reduction can play a part in resolving the economic problems of developing countries as part of an overall recovery strategy emphasising comprehensive reform. Lower debt service obligations can contribute directly to a resolution of the problem of excessive fiscal deficits, reducing the need to levy higher taxes (or to make cuts in essential infrastructural spending) that might otherwise undermine the incentives for new investment. Debt relief can be a catalyst for a virtuous circle of higher investment and growth.

Nevertheless, debt forgiveness will never be a step taken lightly by creditors. Respect for the sanctity of contracts is

(1) Countries with per capita income greater than $580 but less than $1,140. Eligibility is also subject to various criteria related to the degree of indebtedness.

fundamental for the viability of trade and financial relationships. There is a very real risk that debt forgiveness undermines the incentive of other debtors to pay. It is important to ensure that only countries that are making a determined effort to reform their economies are allowed to benefit.

In terms of cash flow received, creditors ought to benefit from the elimination of excessive debt burdens if the effect is to generate a higher capacity to pay. While their nominal claims on the debtor are reduced, actual payments should be higher. It is also clear, however, that one group of creditors cannot be expected to make sacrifices without a comparable effort by others. Creditors may differ in their judgement of an individual debtor's capacity to pay or on the wider impact of debt relief. Those that are unwilling to reduce their claims should nevertheless be willing to provide a fair share of new financing. Otherwise the threat of free-riding will lead to a stalemate and neither creditors nor the debtor will benefit. It is important that the different creditor groups achieve a consensus regarding measures that constitute equal sacrifice. Judging what constitutes equal sacrifice can, however, be difficult and not only because of technical considerations—banks are likely to argue, for example, that official creditors have political objectives for which they must be prepared to pay.

The debt write-offs granted to Poland and Egypt are likely to result in pressure for similar concessions to LMICs with lower per capita incomes and even higher levels of debt. Indeed, the Managing Director of the IMF has recently called on the Paris Club to extend relief to other countries. There is as yet, however, no prospect of agreement.

The IFIs will continue to play an important role in facilitating debt restructurings as well as supporting them financially. Given this role, other creditors have been prepared to accept the implicit seniority of IFI claims and, with a small number of exceptions, most debtors have attached high priority to meeting their IFI obligations. Nevertheless, if the IFIs are to maintain their financial integrity, and hence their developmental role, they will have to continue to guard against taking on an excessive exposure to the most heavily indebted countries.

The major success of the response to the debt crisis has been the avoidance of a collapse of the international financial system. Banks are unlikely to want again to provide balance of payments financing on the scale or on the terms that led to such an explosive growth of lending in the late 1970s and early 1980s. Effective regulatory structures are also now in place which should prevent banks from assuming such disproportionate exposures. The banks' future role will probably put more emphasis on the provision of trade and project finance, the latter perhaps mainly in association with the multilateral development institutions such as the World Bank. In addition, the banks will contribute through the services they provide to those of their corporate clients undertaking direct investment in LDCs and by their local banking operations in those countries.

Those developing countries that have maintained or are beginning to recover access to international capital markets seem likely to rely much more heavily on bond and equity financing (the latter facilitating better risk-sharing between creditors and debtors than direct borrowing) than was the case in the 1970s and 1980s. The costs of borrowing will inevitably appear to be high, partly as a result of the debt problem. However, capital will only be allocated efficiently if the returns adequately reflect the risks. The poorest countries are likely to remain largely dependent on non-market sources of funds, whether from official donors or non-government organisations. Nevertheless, by creating a domestic policy environment attractive to foreign investment even they should be able to attract direct investment.