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External debt and the reform of the international monetary system

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On the basis of an analysis oí the historical evolution of real international interest rates, the author asserts that the main factor which increased the external debt burden in the 1980s was the excessively and unexpectedly high levels reached by such rates. This increase, which took both bankers and debtor countries by surprise, so that they do not appear to bear major responsibility for this process, mainly originated in the economic policy followed by the United States Government. Through mechanisms which are analysed by the author, this policy increased the debt service burden and reduced the volumes and prices of commodity exports, giving rise to a transfer of resources from the debtor countries which exceeds 3% of their gross domestic product per year.

Lightening the debt burden necessarily calls for a reform of the international monetary system based on the co-ordinated intervention of the developed countries in the money markets, together with the economic expansion of those countries. The author considers that in recent years the macroeconomic policy of the central countries has led to a considerable distortion of some relative prices: the debtor countries should not commit the serious error of designing their economic policies in line with those prices (as for example by giving priority to the achievement of a big trade surplus), since when some degree of normality returns to the international macroeconomic scene, they will find that their hard-won "structural adjustments" have taken them along the wrong track.

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Introduction

The debt crisis, which has more than one antecedent in the not so distant past, exploded in 1982, threatening to bring down the international financial system and unleash a more generalized slump of the kind seen in the 1930s. Attitudes in the countries of the North quickly evolved from panic to near complacency only two years later, however. The rapid growth of the United States economy in 1984, affecting the whole world through the spill-over effect of its fast increasing trade deficit, seemed to announce the end of the debt problem. Yet at the same time the highly indebted countries were going through their worst crisis since the 1930s depression. Stagnation or reduction in per capita income, falls in real wages, and growth of unemployment have been widespread. Investment in new productive facilities has failed to keep up with the need for growth and fiscal accounts have been thrown dramatically out of balance as a consequence of the burden of foreign debt service on progressively tighter terms. Furthermore, the deceleration of the United States economy, the persistence of high real rates of interest, the impact of lower levels of economic activity and expenditure in industrialized countries, and the effect of the high dollar on commodity prices have all led to renewed concern about the debt crisis in the last twelve months in the creditor countries themselves.

The conventional solution to the debt problem —that of rescheduling maturities of the principal and mobilizing "fresh money" from commercial banks and IMF funds to cover interest service— is showing signs of exhaustion. By throwing the burden of adjustment almost completely onto the debtor countries it has entailed for too long a period sacrifices that could be only accepted if the situation were transitory. Worst of all, the conventional way to administer the debt problem has achieved very little improvement beyond keeping the banks' profits at a fairly high level and ensuring a rapid reduction in the exposure ratios of bank capital to developing country debt.

The implicit assumption in debt administration seems also to be fundamentally misplaced. The lion's share of the adjustment has had to be taken up by the indebted countries themselves. Little or nothing has been done to encourage better performance in the world economy apart from the United States' fiscally induced boom, which generated —because of its unilateralism and biased policy-mix— so many distortions as to preclude its generalization to the rest of the world economy. There has also been great reluctance to provide the necessarily vast amounts of finance required in the debt crisis in order to tide the indebted countries over the shock induced by the persistent deflationary forces at work in the world economy since 1979-

In fact, the debt problem, far from being mainly attributable to domestic developments in the indebted countries, may be much more fruitfully understood as part of two different but certainly strongly-linked forces at work in the world economy. The first force is what the World Bank has aptly called the rise and fall of commercial bank financing of the developing countries' balance of payments. Debt accumulation, at the abnormally high levels of interest rates of the last few years, has put an end to the *de fació* international monetary and development finance system of the 1970s, based on bank lending. The second force in recent years has been the strong commitment to fight inflation on the basis of demand restriction in a context of unilateral international policy making, which was made possible by the acceptance of floating exchange rates. The peculiar disinflation thus induced, with its high real rates of interest and low commodity prices, naturally created difficult problems for all debtors, whether in developing or in industrialized countries.

A solution to the debt problem, therefore, would require the replacement of commercial bank financing for developing countries by some new system which would probably entail a much larger role for public institutions. The solution would also demand policies for economic growth entailing close co-ordination among countries to overcome today's disequilibria with as little damage as possible to both industrialized and developing countries. For both these reasons a solution to the debt problem is intimately connected with the reform of the international monetary system. This paper is devoted to the development of this argument.

I

Commercial banking vis-à-vis public institutions in the provision of finance to the developing countries

At the beginning of the 1970s commercial bank lending represented only a small fraction of total borrowing by the developing countries. By 1971, the share of bank loans in the aggregate debt of these countries was slightly above 10%, whereas official bilateral and multilateral credits made up more than two-thirds of that same aggregate (UNCTAD, 1985, p.65). Only 15% of the total net resource receipts of developing countries in 1970 had been provided by commercial banks, but by 1981 this figure had risen to more than 27% (World Bank, 1985, table 2.3, p. 21). Rates of growth of such lending were at the level of 40 to 50% in the first half of the 1970s and almost 30% in the period 1975-1979. Lending from official sources, in the meantime, had declined to 55% of the developing countries' total medium and long-term debt by 1979 (UNCTAD, 1985, pp. 65-66).

The reasons for this explosion of commercial bank lending to the developing countries have been well explored. On the side of the borrowers the main reasons were the need to finance balance-of-payments deficits generated by the first oil shock and the easy access to a large volume of resources. On the lending side, banks seized the opportunity to develop a very profitable line of business on the basis of the ample funds deposited by the oil-exporting countries.

Some innovations introduced in loan contracts were also instrumental in the expansion of the market. Syndication of loans, with the incorporation of cross-default clauses, spread the risk among a multitude of lenders and placed the borrower in a position where the penalties for default on any specific loan had been clearly increased. Sovereign risk was, in any case, thought to be small. Even if it is more difficult to enforce loan contracts concluded with countries than with private domestic borrowers, the accepted wisdom held that countries do not go bankrupt. Even quite recently it has been argued that sovereign lending is less risky than domestic operations. In his well-known work on international debt, William Cline offers a calculation showing that domestic lending is more than two-and-a-half times as risky as country lending.[1]

The main innovation in bank lending to developing countries, however, was the floating interest rate loan. This enabled banks to effect the transformation of short-term liabilities into medium-term assets without assuming any interest rate risk. Floating interest rate loans now make up more than half of the public debt of major borrowers and almost 43% of that of all developing countries taken together (World Bank, 1985, table 2.4, p. 21).

With the arrival of the second oil shock, motives for balance-of-payments financing, if anything, increased for non-oil-exporting developing countries. With hindsight one can now see that the pace of bank lending, however, started to decline. While the annual rate of growth of the external assets of banks *vis-h-vis* developing countries was above 33% for the 1975-1977 triennium and almost 24% both for 1978 and 1979, in 1980 and 1981 —well before the 1982 crisis— it had declined to 20% and 15%, respectively (UNCTAD, 1985, table 20, p. 103).

The slowing down in the pace of bank lending to developing countries before the debt crisis seems to lend support to the hypothesis that the previous growth had been a once-for-all phenomenon associated with a phase of diversification of bank portfolios. Even without the debt crisis, the international financial and trade system would have been under pressure to accommodate such a decline in a major mechanism of the international financial system. The slowing down was particularly serious as it happened in a context of sharply increased interest rates due to a shift in economic policy in the United States. Thus, average interest rates on medium and long-term floating rate debt for all developing countries went up from 12.3% in 1979 to 17.4% in 1981 (UNCTAD, 1985, p. 71). Excess interest payments, it has been estimated, offset more than half of the net additional financing for several countries and the whole interest bill exceeded new lending for more than one country (UNCTAD, 1985, p. 81).

Impelled by the consequences of the post-1979 crisis, some debt indicators tended to deteriorate further. Particularly, the ratios of debt to GNP and interest service to GNP for all developing countries jumped between 1978 and 1981 from 21% to 22.4% and from 1.1% to 1.9%, respectively (World Bank, 1985, table 2.6, p. 24).

Not only the increase in interest rates but also a worsening of the terms of new lending caused pressure to be brought to bear from the financial side on the balance of payments of debtor countries. Spreads rose in 1980 and 1981 and average maturities lowered, with a significant accumulation of short-term debt (World Bank, 1985, table 8.6, pp. 118-119).

The above circumstances can be interpreted as additional evidence that banks were showing less interest, after 1979 and before the actual eruption of the debt crisis, in participating in the financing of developing countries' balance-of-payments needs. This trend was greatly strengthened by the debt-servicing difficulties of some major debtors as from 1982. To better understand the reaction of the commercial banks when confronted with those difficulties, it is important to keep in mind their own position.

By the end of 1982 the exposure of the United States banks' capital in the form of loans granted to non-capital-surplus developing countries and Eastern Europe was extremely high. For all the American banks together, lending to those countries stood at 182.8% of their capital. For the nine largest money centre banks the

[1]Cline shows that the average loss rate on country lending could be estimated as 0.28% of loan values per annum, while the corresponding rate for domestic loans —as applied to the nine largest banks— was 0.72% (Cline, 1983, pp. 100-101).

corresponding figure was 287% (Cline, 1983, pp. 32-33, and WFM, 1985a, p. 4). But other banks were also heavily exposed to potentially problem debtors. At the end of 1983, for instance, two of the largest British clearing banks —Lloyds and Midland— had a proportionately greater exposure to Latin American debt (leaving Mexico aside) than any of the nine United States money centre banks *(Financia/ Times,* 1984). Banks in the Federal Republic of Germany were also heavily exposed in Eastern Europe, where they held more than 60% of the Polish debt.

Capital-to-assets ratios had also been falling for banks in many of the industrialized countries during the late 1970s and early 1980s, presumably partly as a consequence of the fast pace of their international lending (World Bank, 1985, table 8.4). Moreover, in the changed international economic environment, the previous advantages of floating rate lending now turned against the creditors. With the high and volatile interest rates, generated by the new monetary policy followed by the United States, debtors' difficulties meant high transfer and commercial risk.

Although it is true that countries do not go bankrupt, historical experience confirms that both developing and developed countries may default on their international obligations. It is not at all surprising, therefore, that lending by banks to all developing countries grew by only 6.6% in 1983 (almost corresponding to a target of 7% suggested during IMF negotiations with some of the largest debtors) and by even less —2%— in 1984. Figures for the first half of 1985 were showing an even slower pace than that of the previous year (WFM, 1985a, p. 11 and BIS, 1985).

Moreover, a large part of the new lending that had taken place is the result of what the World Bank calls "concerted lending" arranged in conjunction with debt restructuring under the guidance of the IMF. In fact, out of US$ 30.2 billion and US$ 22.7 billion of syndicated Eurocurrency lending for the years 1983 and 1984, US$ 14.3 billion and US$ 11.3 billion could be attributed to "concerted lending" (World Bank, 1985, table 8.6, pp. 118-119).

As a result of this slow pace of growth for bank lending to developing countries, figures for capital exposure in such operations have fallen sharply for the nine largest United States banks, from the above-mentioned 287% in 1982 to 214% by the end of March 1985, "... lower than at any time since 1977" (WFM, 1985a). Capital ratios in relation to assets have also been improving at a fast pace for United States banks, from 5% at the end of 1982 to 6.27% at the end of 1984 for the 15 largest institutions. Such an improvement in bank ratios has been obtained through a fast increase in bank capital at a rate of about 9-10% per year (Bergsten *et d,* 1985, p. 31).[2]

In the performance and business strategies of banks it is difficult to separate the impact of regulatory activity from market-induced changes. In the matter of capital/assets ratios no doubt —at least in the United States— regulators have had a considerable influence. In fact, action on those ratios has been the main response to the threat to financial structures posed by the debt crisis in relation both to developing countries' debt and to domestic primary sectors, mainly agriculture and energy —the last one being responsible for the failure in 1984 of the Continental Illinois Bank, one of the ten largest in the country.

Capital/assets ratio requirements were first of all raised in 1983 to 5%. After the Continental Illinois Bank crisis they were further increased to 5.5% and in April 1985 to 6%. Currently a new regulation is being discussed which might again raise required capital ratios and would also incorporate within the requirements some off-balance-sheet operations like letters of credit outstanding. The proposal includes a new concept, i.e., that of differentiated requirements for different kinds of assets. Third world debts would be placed, of course, at the top of the scale (Nach, 1986).

Increased capitai/assets requirements engender quite a contradiction for bank strategies. As a consequence of the debt crisis, bank shares have lost value, so that they no longer represent a means to raise capital. Therefore,

^Henry Terrell (1984), Chief, International Banking Division of the Federal Reserve System, estimates that United States banks' capital will increase, in the coming years, at about 9'/i per annum.

capital requirements have to be met through earnings at the very moment when some profitable activities are being discouraged as too risky. Banks have preferred not to employ their own capital and to emphasize so-called off-balance-sheet operations, some of them carrying high risks. We shall see later how such a phenomenon becomes linked to what has been called the "securitization" of financial markets. The fact remains that in the eyes of regulators, and of more than a few bankers, capital ratios have to be re-established at higher levels, compatible with historical notions of prudential management.

As a consequence of the debt crisis, regulators have also tightened up rules on loan classification and setting up of reserves. In the United States, loans for which no interest has been collected in the previous 90 days have to be classified as "non-performing" and interest accrued on them deducted from the quarterly reported earnings. This rule was in fact tightened up in June 1984, at the time of conflict about the Argentine debt, in order to avoid what under the previous practice had been recurrent end-of-quarter crises, since the rule used to be applied only at those points in time.

Continuation of interest arrears for six or more months is one of the important factors that could cause a country to be classified as "substandard" or "value impaired". In this case, banks have to set up reserves at a level specified as a percentage of the face value of the loans. Five countries were placed in this last category at the end of 1983, and a new one —Peru— has reportedly been added to the list in 1985. Provisioning for bad loans has been restricted, therefore, to very few cases in the United States, although it is understood to be an extended practice in continental Europe, aided by very flexible and generous tax treatment of such reserves.

On the other hand, it is important to note that neither regulations nor accounting practice require banks to write down the value of troubled loans in their balance sheets unless they change hands or the nature of the contract is altered. Consequently, loans to developing countries are carried at face value even if they are traded on a rather marginal secondary market with discounts of 15 to 75%.[3]

More important, however, than regulatory pressure to discourage bank lending to developing countries is the influence of some developments in financial markets and structures, as well as the behaviour of the world economy. After a prolonged period in which commercial banks stressed growth —lending to developing countries being one attractive avenue for such strategy— increased awareness of risk has in more recent years encouraged more concern about profit levels and capital adequacy (OECD, 1983 and 1985a). Risk, in turn, has its origins in a much more volatile economic environment: e.g., greater variability of interest and exchange rates and, of course, the problems of highly indebted countries.

Consequently banks have been searching for new activities or placing new emphasis on old ones that would allow them to build up profits —the safest basis for generating capital increases in a context of lessened Stock Exchange confidence in the industry— without committing new capital. Off-balance-sheet operations implying contingent liabilities but no initial commitment of funds or sheer intermediation of third-party paper have generated sizable increases in fee-income and profits without making demands on their own capital and reserves. Ways have also been found to increase capital through other instruments than placement of shares, such as the issue of floating-rate notes whose results are admissible as part of the banks' own capital.

The whole process had led to what has been labelled the "securitization" of financial markets. Estimations published by the Bank for International Settlements (BIS) show that, while in 1981 out of a total of net international finance —both loans and bonds— of US$ 190 billion

'See Montagnon (1986). It has been also estimated that the Stock Market, in 1983, implicitly valued —through bank share prices— loans to major debtors at **79ÇÏ** of their face value. (See Bergsten *et al* (1985), p. 28.) Another regulation and/or accounting standard impinging on treatment of loans to developing countries is the requirement for public disclosure of so-called "Troubled debt restructurings", i.e., loan renegotiations involving concessions not originally envisaged. It need not apply, however, to a weakening of lending terms as long as new-terms are still within market practice.

almost 87% was in the form of bank loans, this proportion fell to around 65% for the period 1982-1984 and in the first half of 1985 it was down to only 42% (Bank for International Settlements, 1985, table IV, p. 24).

That shift in international financial markets is not only connected to banks' strategies but it also reflects basic changes in ultimate lenders and borrowers. The syndicated Euroloan reigned at the time when funds originated in OPEC countries —with a preference, at least initially, for bank deposits— and were lent to developing countries with little access to security markets. Now funds originate mainly in some industrialized countries —Japan foremost among them— and have an important outlet in the financing —through bond purchases— of United States Federal Government deficits.

The market has also witnessed the development of 'hybrid' instruments like "note issuance facilities" or "transferable loans", which have blurred the distinctions between loans and bonds while giving commercial banks a chance to do business without long-run commitments of their resources.

The rapid development of new instruments for financial intermediation is only very recently being incorporated into banking regulations. The pursuit of off-balance-sheet operations carrying important risks has led —in the case of the Bank of England— to requirements for up to 50% capital coverage for note issuance facilities and the top of the ratio's scale for letters of credit in the above-mentioned new regulations under discussion by banking authorities in the United States.

The consequence for developing countries, at any rate, is that —as the BIS has analysed— the international financial market has become a highly segmented one. For countries with debt problems, there is the "concerted" or "involuntary" lending market based on the need felt by big banks to look after their huge loan portfolios in those countries. This has represented about half of the syndicated Eurocurrency loan market in 1983-1984, which stood at about 50% of its peak pre-1982 level. For some other developing countries there is still a reduced access to syndicated loans from international banks but lately recourse has been had to the floating rate note market and other forms of securities which entail lower costs. In fact, a great deal of activity in this sector is related to cancellation of earlier loans and refinancing through new instruments. As with lending in the late 1970s, bank activity in negotiable paper and off-balance-sheet operations is taking place at very reduced margins and with increased accumulation of risks (Bank for International Settlements, 1985, pp. 25-26).

For debt-ridden developing countries the prospects could not be gloomier in this respect. Their low creditworthiness —as gauged by the financial markets— excludes them from sources of international private finance other than "involuntary" or optimistically —if adjustment were successful— "voluntary" bank lending. This will certainly grow, if at all, at an extremely slow pace in the coming years as a consequence of banks' having outgrown their capital base —a process which will take quite a long time to redress.[4] According to the most optimistic projections of the results of the present "adjustment" process of the highly indebted countries, the archetypal risk indicator —i.e., the debt/exports ratio— will for most countries take a long time to get down to a safe level of between 150% and 200%. In fact, for the ten major debtors the average ratio has actually increased from 257% to 308% between 1982 and 1985 (WFM, 1985a, table 6, p. 4).

Simultaneously, banks would be caught in a process of building up their small capital base —the obverse side, one could say, of the high debt ratios of the developing countries— by avoiding committing their own resources to *any* lending, let alone to highly-indebted countries to which their exposure is still extremely high in terms precisely of their capital. The paradox is compounded by the fact that as bank debt is the largest part of the foreign debt of those same countries —almost two-thirds for the 15 Baker Plan countries— debtors are being forced to

^Lessard and Williamson (1985, p. 17) estimate the future growth of bank lending to developing countries in the near future at 3% per year, the bulk being trade finance. Exposure to the ten major debtors increased at a rate of 2% per year from end-1982 to March 1985: a figure that may have improved lately after implementation of the fresh-money provision in the Argentine programme beginning in July 1985 (see WFM, 1985a, p. 4 and also comments by a senior banker —Mr. Lawrence S. Brainard— of Bankers Trust Co. (1984)).

make up for the increased real interest burden (which ends up in commercial bank coffers) by having recourse to other international financial sources or by the generation of big trade surpluses entailing a negative resource transfer to industrialized countries.

The building up of debt to bank creditors, although an expedient instrument of development finance and liquidity creation during the 1970s, seems to have come to an end. A new system will have to be set up unless the balance-of-payments position of developing countries is fundamentally transformed in the immediate future. Trends at work before the debt crisis, which were only reinforced by later developments, exclude commercial banks as a major force for the coming years in the financing of debtor countries. What are the prospects for other sources of finance?

Let us first dispose of one source that has been mentioned with insistence, namely, foreign direct investment. The main objection to foreign direct investment is that, for the ten major debtors, at its peak annual average of US$ 6 303 million (in 1981/1982), it would still represent no more than 15% of those countries' annual interest payments. In fact, foreign direct investment has come down rather abruptly, rather as a natural consequence of the discouragement caused by the economic crisis brought about by the debt problems than because of any alleged irrational antipathies held by governments or public opinion in developing countries. For all its possible advantages in bringing in marketing or technical/managerial knowledge, foreign direct investment would not be a force of any significant weight in balance-of-payments terms.

Somehow connected with foreign direct investment is the question of capital flight. Even in the period 1983-1984 capital outflows from highly-indebted countries —the ten major ones— represented more than half of the newly accumulated debt (WFM, 1985a, table 5). Such a flow is decisively influenced both by long-run trends and by more recent developments. From a long-run point of view, capital flight from debtor countries is just one more instance of a world-wide phenomenon of portfolio diversification by investors taking advantage of the internationalization of financial markets. In more recent times such a trend has been encouraged by the high rates of return that can be obtained in financial placements as a consequence of high real rates of interest plus institutional changes such as the elimination of withholding taxes. For debtor countries it is difficult to compete against such high rates of return —a problem that is compounded by the recessionary consequences of debt renegotiation plans. There seems to be little chance of any significant return of capital outflows, although sound macroeconomic policies on the part of debtor countries could, by offering better prospects for private investment, increase such a reflux within limits. Domestic tax treatment of this issue is of course highly contentious, particularly in countries where schemes for subsidization of private external debt —intimately connected through back-to-back operations where deposits abroad operated as collateral for borrowing from foreign banks— were introduced during the debt crisis.

We are therefore left only with official or officially-guaranteed sources of funds. Let us first take up the bilateral sources. Due to the increased role of bank lending in balance-of-payments financing for the developing countries, official export credits were losing part of their share throughout the 1970s. As a percentage of developing countries' total receipts, export credits went down from 15% at the beginning of the 1970s to 12% in 1981. Thereafter, they dropped further to only 8% in 1983 (World Bank, 1985, table 7.2, pp. 96-97). To a great extent such a fall is only an expression of the fall in imports by developing countries and, more specifically, of capital-goods imports. There are, however, supply-side reasons to explain the reduction in export credits. Although interest rates charged on export credits have been rising since the April 1978 agreement among OECD countries, the sharp rise of market rates since late 1979 had increased the bill for interest subsidies from US S 2 billion in 1978 to US$ 5.5 billion in 1981. Export credit agencies recovered US$ 1 billion in 1982 and US$ 2.5 billion in 1: i.e., less than outgoings at the very moment when fiscal austerity throughout OECD countries was placing demands on the agencies to be self-sustaining (UNCTAD, 1985, pp. 114-115).

As a consequence of the above, export credit agencies have been criticized for displaying "herd-like behaviour" to a greater extent than have the commercial banks —i.e., their behaviour has been pro-cyclical. Terms of lending have been progressively tightened and, worst of all, cover has been suspended for countries entering debt renegotiations with the Paris Club. Only with great delay has such cover been reinstated after the successful negotiations. As a result, for the ten major debtors —out of which eight have gone to the Paris Club— net official export credits from OECD countries went down from an annual average of US$ 3.7 billion in 1979-1981 to US$ 2.74 billion in 1982-1984. For five out of the ten countries net flows were actually negative (WFM, 1985a, table 18, p. 11).

There is a clear need for the role of official export credit agencies to be stepped up both in the long run and in the context of the debt crisis. In fact, some of the plans to sort out the debt problem revolve around radically increased funds from such agencies. Cover is also needed not only for capital goods but for current inputs, as was envisaged in Eximbank operations for Brazil in 1983. But their role is intimately linked with monetary and fiscal policy-making by the OECD countries, and in the present deflationary phase this has conspired against the enhancement of their role.

As for the multilateral institutions, the World Bank stepped up its disbursements to indebted countries, managing a total of almost US$ 5 billion in the period from end-1982 to June 1985 for the ten major ones. In terms of rate of increase, however, this amount is not very far above the interest rate prevailing in those same years. Criticism of the World Bank's procedures has been prominent in relation with the initiative of the United States Secretary of the Treasury 'Mr. James Baker) on the debt problem. Opposition by the United States Government to an increase in the resources of the World Bank remains, thus preventing greater mobilization of funds to the debtor countries in the medium term. In the meantime a greater stumbling block to the role of the World Bank is the additional conditionality and cross-conditionality with IMF that it is trying to impose on its quick-disbursement lending. Debtor countries operating under IMF plans also encounter budget constraints in trying to fulfil the local counterpart requirements of World Bank loans. But it is above all the attempt to promote an overall ideological viewpoint through loan conditionality which, besides not fully respecting the Bank's statutes, is deterring debtor countries from using more fully their access to such resources.

The role of IMF in the direct provision of resources cannot be denied in the context of the debt crisis. Nearly US$ 10 billion were lent by it from end-1982 to mid-1985 to the ten major debtor countries (WFM, 1985a, tables 8 and 9, p. 5). For the 15 debtor countries envisaged in the Baker initiative over the period 1982-1984, the Fund provided close to 20% of the external financing.

Apart from disputes about conditionality, the real trouble about continuing this role, lies ahead. Access to IMF resources has been tightened and no initiative seems to be in progress to replenish funds for the enlarged access policy that has superseded the Supplementary Financing Facility. In fact, in spite of the small potential for expansion of private credit to developing countries in the near future, it seems that the policy of the main industrialized countries is to keep the IMF as a lender of last resort and to encourage stabilization and adjustment rather than facilitating extra finance. Consequently, the IMF might very soon become a net recipient of funds. Repayments are climbing very fast as the post-1982 plans unwind, and countries looking for support from the Fund may find that drawings will barely match repayments (WFM, 1985a, table 15, p. 9)-

If present policies are followed, therefore, there seems to be very little chance for official institutions to step in again to take up the role being abandoned by commercial banks in providing liquidity and development finance for developing countries. More serious even in the short run is the fact that the net drain of resources occasioned by the rather wide gap between interest payments to banks and "fresh money" provided by them is forcibly being filled by debtor countries through accumulation of positive trade balances entailing a negative real transfer of resources, from the developing to the industrialized countries. In the case of Latin America, for instance, the accumulated net negative transfer of real resources, in the period 1982-

1984, has been above USjf 106 billion (leaving aside terms-of-trade effects), i.e., on average about 3-2% of the aggregate national income of the region (ECLAC, 1985).

The burden of external debt service has brought to an end an era of easy financing through commercial bank credit, whose terms anyway were never wholly adequate for developing countries. A new financial system is needed to stop the negative transfer of resources from becoming chronic as a consequence of the great debt overhang. Estimates provided by, for instance, UNCTAD point however to the fact that, at present interest rate levels, it is very difficult to imagine any other source of borrowing that would be sufficient to fill the gap; and even if it were available on concessional terms, the whole process could very soon end up with the accumulation of an even more serious debt problem (UNCTAD, 1985, pp. 107-110).

No reform of the international system of liquidity creation and development finance, then, seems to be satisfactory. But, in fact, interest rates are not natural events. Would it be conceivable for interest rates to be low enough to ease substantially the debt burden on developing countries? And what would be the connection between such a possibility and the reform of the international monetary system? To such questions the next section is devoted.

II

Economic policy co-ordination among countries, the reform of the international monetary system and the fundamental solution to the external debt problem

Since the beginning of the debt crisis an acrimonious debate has raged over who —bankers or debtor governments— was responsible for the accumulation of debt levels considered to be too high. Some other commentators tend to blame the governments of industrialized countries for having actively encouraged the process as a way to recycle the oil surpluses through private markets. But is it true that debt levels are too high? The burden of debt service (given the "voluntary" or "involuntary" willingness of creditors to roll-over amortization) boils down to the burden of interest service. In turn, interest service depends not only on the size of the principal but also on the rate of interest.

Now, beginning in the last quarter of 1979, nominal interest rates shot up owing to the new monetary policy introduced by the UnitedStates Federal Reserve. Emphasis on monetary targets added to the stringency an element of great volatility in nominal and real interest rates. After that date a great deal of debt accumulation was due to the need to refinance excess interest payments. Consequently a Ponzi system of finance was started, under which the situation, partially at least, escaped control of debtors (and creditors also). New loans are granted simply in order to finance interest payments on the existing debt. Were debt levels up to 1979 excessive? Had debtors and creditors gone irretrievably beyond reasonable debt levels on the basis of historical experience?

On the contrary. Historical experience on interest rates is quite clear. Taking United States prime rate as the nominal interest rate and the index of wholesale prices —now renamed producer's prices— in that country as the indicator for inflation, the average *real* interest rate for the 60-year period 1920-1979 was only slightly above 1 % per year. If we do not go so far back in time, and take the 20-year period 1960-1979, the average *real* interest rate would have been 1.3%-

Of course for the 1970s the average real interest rate was slightly negative. But this is not the point, because a prudent debtor country government or banker would not have relied on it staying there.

After 1978, nominal rates of interest kept pace with inflation for about two years, in 1979 and 1980. But with inflation subsiding by 1981, nominal rates (although they declined after 1981, and especially after the mid-1982 debt crisis) have been kept at a level that generates real rates of interest for the four-year period 1981-1984 of around 10% per year. In 1985, there was some reduction in nominal rates, down from the peak 13% of the third quarter of 1984 to 9.5% in the second half of 1985. But real rates have still been in the range of 6 to 7% per year.

Nothing in the pre-1979 experience could have told a decision-taker at the end of the 1970s that real interest rates could reach and stay at so high a level. The only other instances of real rates above 10% per year were the first three years of the 1930s depression and the year 1921, also a crisis year after the post-First World War inflation.[5] Moreover, dispersion around those long-run averages was quite low, with a post-war peak at 4.6% in 1967.

The point, then, is not that decision-makers projected to the future negative real rates of interest (granted a rather exotic circumstance only persistently seen in the 1940s). The point is that, on the basis of historical experience, interest service on external debt could have been quite easily achieved, even without refinancing, through fresh loans, with very little adjustment effort.

Even in 1985, with all the newly accumulated debt and the impact on export proceeds of the lowest export prices seen in the post-war period, current account balances for the 15 problem indebted countries envisaged in the Baker initiative would have been in sizable surplus at historical levels of the real rate of interest. In fact, with inflation as measured by the wholesale price index of the United States only slightly above 2% plus (to be generous) a 1.5% real rate of interest, plus, say, a spread of 1 point, nominal rates of interest would stand below 5% for a developing country borrower, whereas instead they are actually above 10% at present.

At a nominal interest rate of 5% on an accumulated debt, for those 15 countries at the end of 1984, of US$ 427 billion, interest service would thus have stood at no more than USJt 21 billion. But in 1985 the combined trade balances of those 15 countries was above US$ 39 billion, with increases in reserves and other minor items detracting only some US$ 5 billion from the trade balance. A surplus of about US$ 14 billion would thus remain, allowing for extra imports or even a cushion of more than 3 points against increases in real rates of interest.[6]

Of course, no surplus on the trade balance of those countries was available in 1982. But had not the interest rates reached those extraordinary and persistent levels beginning in 1981, a much weaker adjustment on the part of debtors would have allowed a current account equilibrium and hence, with the ensuing better creditworthiness, a continuation —although at lower levels— of private market finance.

Argument about responsibility for the accumulation of debt is therefore misplaced. Both bankers and the debtor countries' governments have been taken by surprise by the absolutely unforeseeable and extraordinary level of real rates of interest. Bankers, by increasing spreads, have only to a minor degree compounded a phenomenon which was not of their own making and which in fact resulted in a situation in which a large proportion of their portfolios, both international and domestic, looked rather shaky.

We have already seen that, at present levels of interest rates, it is inconceivable that other sources could replace commercial banks in generating a sufficient stream of finance to achieve current account balance. We have now seen that it is the extraordinary level of real interest rates that generated the debt crisis and is responsible, to some extent, for the retreat of commercial

[5] For series of prime rate and of the wholesale (later producers') price index going back to 1920, see United States Department of Commerce (1975). For more recent data, see the same source, 1984.

[6] For figures on debt and external financing of the 15 Baker Plan countries, see Institute of International Finance, 1985.

banks from the financing of developing countries. The debt crisis, in fine, originates in the high level of interest rates. In fact, it is just one expression of a disinflation process, as it was at the beginning of the 1930s or in 1921.

The impact on the debtor countries of the deflationary forces put into action in industrialized countries goes beyond their effect on interest rates. Export volumes as well as export prices have also been seriously affected, and this in turn has worsened the balance-of-payments situation of debtor countries. The UNCTAD secretariat has estimated that the cumulative loss of export proceeds over the period 1980-1983 due to commodity price declines reached US$ 28 billion for a group of 48 developing countries. In 1984, non-oil commodity prices picked up with the recovery of the word economy, but by the third quarter decline had again set in and continued throughout 1985, getting even worse in 1986. The World Bank index for prices of basic products stood in 1985 at its lowest level (81, compared with an average of 100 in the three-year period 1979-1981) since the series was started in the late 1940s (UNCTAD, 1985, p. 78).

As overvaluation of the United States dollar has also been a consequence of the deflationary policies followed after 1979, there is little point in discussing which factor —the OECD level of economic activity or the high dollar— has been responsible for the low prices of basic products. Of course, there are more long-run forces at work having to do with technical substitution of some materials, like copper, which can hardly be subject to policy action. But certainly declines in prices of cereals, beef or sugar are, to a large extent, a direct consequence of subsidy schemes in industrialized countries.

The combination of excessive real interest rates and low commodity prices engendered by the economic policies of the industrialized countries, therefore, has induced a reverse real transfer of resources —i.e., from developing to developed countries— of gigantic proportions. In Latin America, for instance, the loss of income on account of the fall in the terms of trade and the excessive real rates of interest could be in the region of US$ 30 billion per year, which is more than 3 % of the region's gross domestic product.[7] The need, however, to cut imports so as to make room for such a transfer of resources has led to a cut in the developing countries' purchases abroad which the UNCTAD secretariat estimates has entailed the loss of close to 7 million man-years of employment in Europe and close to 1 million man-years in the United States and Canada during 1982-1984 (UNCTAD, 1985, p. 119 and table 26, p. 120.

Thus, the deflationary policies applied in the industrialized countries have induced a crisis in the developing countries which, in turn, reacts back as a further deflationary force on levels of output and employment in the industrialized countries, notwithstanding any benefit that might have accrued to them in terms of transfer of resources from developing countries.

A growing consensus of opinion among professional economists blames the specific economic policy mix applied by the United States in this period for the high interest rates, and also lays blame on the high dollar, with its effects on commodity prices. Tight money has been followed by fiscal expansion. Starting with the tax reductions and the enhanced rearmament programme of the Reagan Administration, the United States Government has increased its fiscal deficit to the level of almost 5% of GDP. Since there is a rather low domestic savings ratio, the deficit is spilling over the rest of the world as the Administration seeks funds to fill the gap. From 1982 to 1984, the United States capital account experienced a positive swing of around US$ 90 billion. Within the OECD area Japan accounted for the major part of this increase of net capital flows into the United States. The gap of about US$ 30 billion which was left was covered by countries outside the OECD area, "notably by a reduction in net capital flows to non-oil developing countries as they reduced their current deficits by some US$ 40 billion".[8] In fact, the United

'See ECLAC (1985) for figures on the 16.5% fall in the terms of trade since 1980 (table 9), which, applied to aggregate exports —at 1985 prices— of USJ 91.93 billion (table 12), would mean a loss of some USÏ 15 billion. On the other hand, 4-5 points of excess interest rates as applied to a global debt of US$ 360 billion (table 15) means another loss of USS 15 billion; the sum of both items relative to aggregate tiDP for the region (US$ 890 billion) gives 3.3%.

[8]See OECD (1985b) and the analysis of the reorientation of capital flows given there.

States Government has taken the place of the developing countries in this new phase of international financial "recycling", with japan and some other countries, like the Federal Republic of Germany, now playing the former role of the OPEC countries at the time of the original 1970s "recycling". The wealthiest country is thus absorbing resources from the rest of the world by financing abroad a large proportion of a fiscal deficit which is the consequence of an expanded rearmament programme and tax cuts.

The problem with the United States policy mix to fight inflation through a revaluation of the dollar is that it is essentially asymmetrical. Not all countries can manage to revalue their own currencies, although in a world of non-fixed exchange rates an attempt could be made to do so through a process of competitive revaluations (instead of the classic beggar-my-neighbour policy of competitive devaluations that Bretton Woods was supposed to avoid). Under the influence of the alleged advantages of the floating exchange rate system in granting complete autonomy to the economic policy of each nation, the traditional attempts to co-ordinate international economic policy were abandoned in favour of the presumed work of an "invisible hand" as applied to the community of nations, just as Adam Smith envisaged if for national economies. Thus, in the last few years we have witnessed extreme divergence in economic policy stances, leading to extreme values in some of the market-determined variables such as exchange or interest rates.

This whole attitude has been, in some instances, elevated to the level of dogma. Thus we see Mr. Henry R. Naun—a former official of the United States National Security Council in charge of international economic affairs— lending support for "... an assertive use of U.S. economic power in the marketplace... and a relatively passive U.S. economic diplomacy", a "combination that could work because the U.S. power in the international marketplace... remains much greater than its power at the bargaining table" (Bergsten, 1985 and Naun, 1984-1985). However, the wide disequilibria that the world economy is experiencing —of which the debt problem is one more aspect— and some further academic work on optimum policies in an international economy tend to indicate that it is high time for "unilateralism" to be replaced by a co-ordinated approach. Protectionist pressures in the United States, unleashed by the high dollar, seem to have convinced the United States Administration of the need to start modifying its previous point of view and to accept the idea both of intervening in exchange markets and of doing so in a co-ordinated way, at least in the context of the Western summit countries (Group of Five).[9]

The debt problem will only find a permanent, fundamental solution in a context of world economic growth with reasonable levels of commodity prices and real interest rates. Disputes about the exact magnitude of the elasticities of developing countries' exports to OECD growth rates cannot alter the fact that this growth is needed if exports from debtor countries are to expand so as to be able both to serve the accumulated external debt and to finance a higher and growing level of imports.[10]

Even more important, there is no doubt that a reduction of real rates of interest to historical levels would basically dispose of the debt problem. But for rates of interest to fall, co-ordinated action among the United States, Europe and Japan is needed so that the United States fiscal deficit may continue to be financed. Thus the debt problem is intimately connected with a path towards reform of the international monetary system that would increase mechanisms of surveillance for avoiding "unilateralist" policies and introduce, perhaps through a new exchange rate system, forces making for such co-ordination. The fundamental, long-run solution to the debt crisis would also call for ¡nsr**" :'>"o1 reform of the international monetary system in order to generate enough liquidity and development finance to replace the role played by commercial banks in the 1970s.

'For work on how an unco-ordinared set of economic policies is likely not to be efficient, see Oudiz and Sachs (1984). See also Marris (1985).

[10]See Cline (1983), chapter 3. Dornbusch and Fisher (1984) also give alternative estimates of the same elasticities. For the notion that growth of the world economy is absolutely indispensable for the solution of the debt problem, see the speech by James Baker, U.S. Secretary of the Treasury, at the Annual Meeting of the IMF/IBRD ¡n Seoul, in October 1985- See also WFM (1985b).

III

The adjustment process in highly-indebted countries, conditionality and the debt problem in the transition to a growing world economy

It will certainly take time to bring back growth with price stability and reduced real interest rates as well as more reasonable levels of commodity prices. Let us hope that it will not involve a "crash landing" for the value of the debtor, in view of the negative consequences this could have for all countries. In the meantime, there is an urgent need to alleviate the debt burden, which has not only brought stagnation and crisis to the developing countries but has proved to be an additional deflationary force in the world economy and is posing a serious threat to the stability of the international financial system.

The measures to be taken should address the fundamental causes of the problem. It is not realistic to imply that the debt problem was brought about by a simultaneous failure of prudent economic management on the part of ail the countries in trouble, in view of the differences in their economic policies and their political regimes. After three years of adjustment and of a drastic swing in trade and current account balances, what remains of the debt problem is surely only external to the debtor countries. The debt problem, as it now stands, must be seen for what it is, i.e., an external shock generated by the economic policies followed in the industrialized countries which shifted the values of key economic variables to abnormal levels which there is no reason to believe will not be rectified. It is thus a reversible external shock which, to avoid introducing gratuitous deflation of the world economy, should be treated by the provision of finance to avoid cutbacks in demand. Moreover, a reversible external shock should not induce adjustment in allocation of resources that could afterwards be difficult to undo. That is to say, if present levels of interest rates imply the need for high trade surpluses, there would be little point in inducing accelerated export sector promotion and/or import substitution investment that will not be required once those rates return to a normal range, in terms of market signals, present-day prices (levels of exchange and interest rates) are not proper guidance for long-run investment decisions, as they are far removed from any conceivable long-run equilibrium.

Up to now, however, the administration of the debt problem has taken a completely different course to the above. Debtor countries have been forced to cut domestic expenditure levels, causing a drastic fall in imports. And the only promise these countries have been offered is that there will be a solution to their predicament in export-led growth, with the corresponding reallocation of resources. Now it is one thing to justify misconceived action on the grounds that credit rationing to developing countries makes it non-viable to choose any other way than the one the debtor countries are being asked to follows, but it is quite another to wrongly ascribe the debt problem mainly to domestic over-expenditure and misallocation of resources which in turn, would imply that the burden should be thrown on the shoulders of the indebted countries. The debt problem calls for external finance accompanied by the little adjustment needed to put an end to over-expenditure —to the extent that it existed— and to induce the trend adjustments and the structural reforms that were needed anyway before the crisis struck in 1982.

The international monetary system must find ways to accommodate such a transition to a more normal growth path. The Group of 24 and the Cartagena Consensus have repeatedly put forward reasoned proposals for action (mainly by the International Monetary Fund) to cope with the immediate aspects of the debt problem. Once the debt crisis is regarded as an external, reversible shock on the balance of payments, the possible solutions become clear enough.

The International Monetary Fund has long accepted the difference between temporary and fundamental disequilibria. For the first kind, facilities like the Compensatory Financing Facility were devised. On very low-conditionality terms, it provides funds to make up for an exogenous decline in export values or, in recent years, an increase in cereal import prices. During the mid-1970s also, the Oil Facility came into operation, lending —even to some developed countries— on low-conditionality terms to avoid deflationary cuts in spending as a consequence of balance-of-payments deficits generated by the oil price increases. As a few authors have argued, there is no reason why the Compensatory Financing Facility could not be extended to cover other exogenous shocks on the balance of payments of a borrowing country. In particular, William Cline (1981) and Sidney Dell (Dell and Lawrence, 1980) have argued for a compensatory financing facility that could absorb the impact of increases in interest rates. The Group of 24 (1979) has also discussed the possibility of setting up a medium-term facility with repayment periods adequate for the necessary structural reallocation of resources.

Of course, the question arises of the sources of financing for such facilities. There is no question that, except for the United States, the fiscal policies of the industrialized countries are still extremely restrictive. New funds will be difficult to come by. However, countries in surplus —as some oil exporters were a decade ago— could make special contributions and themselves fund some of these facilities. Sometimes too much is made of the effort necessary to increase quotas in IMF. After all, of any increase in quotas only 25 % has to be made effective, and on the other 75% interest is earned. The financial cost of a quota increase is therefore much less than the apparent one. In fact, it boils down to the cost of differential interest between the market rates and those applying to 75% of the contribution, which is 0.85 of the SDR rate plus the 25% in Special Drawing Rights or designated foreign exchange. IMF quotas, anyway, have fallen radically in relation to world trade or, worse still, even in relation to current account imbalances.

There are other sources already available that could be applied to alleviate the burden of high interest rates in the transition to an improved world economic environment. The first one is the 19 billion SDRs in the kitty of the General Agreement to Borrow. At least part of this sum is intended to avoid prospective crises in the international financial system, which certainly would be the case if there are any major interruptions of debt service. Last but no least, there is always the possibility of a major issue of SDRs. Explicit objections to such issues have been based in the last few years on the fear of feeding inflation. With significant unused capacity in all industrialized countries, with full employment adjusted surpluses in fiscal accounts for most countries, with high unemployment rates and a slackening in earnings growth and labour costs, it seems that the time has come to shed concern for inflation and to embrace unhesitatingly the cause of world economic reactivation.[11]

Mobilization of other official institutions would be complementary to the setting up of adequate facilities under the International Monetary Fund.

There is no question that the World Bank's resources and procedures must be improved so that a larger volume of development finance is made available, now that the commercial banks have retreated from the role they played in the 1970s. But it would be wrong to make the World Bank —for lack of adequate resources and procedures under the International Monetary Fund— a balance-of-payments support institution. Such an attempt, which is partially incorporated in the Baker initiative, is doomed to failure as the speed at least, if not the direction, of the structural reforms that the World Bank should encourage bear little relation to the external debt shock of the developing countries.

"See WFM (1985b) for figures on adjusted fiscal balances and, more in general, for the argument that expansion is now decisively needed to avoid stronger protectionism and a renewed debt crisis.

IV

Concluding comments

The above analysis points to a consensus-seeking, tow-tier strategy to tackle the external debt problem at the world level.

i) Fundamental reform of the international monetary system has to be introduced and an immediate process of co-ordination of economic policies is required to achieve non-inflationary growth with reduced real interest rates and reasonable levels of commodity prices.

ii) Action is urgently needed to provide finance on adequate terms to see the developing countries through the transition period towards the achievement of that growth. Such finance would have to come mainly from official institutions, and the multilateral financial institutions are —after the necessary reforms— the best candidates to replace commercial bank lending. In particular, conditionality should be low, as befits the external, reversible shock character of the balance-of-payments disequilibrium during this period. In this way, no extra deflationary forces would be introduced in the world economy and no erroneous adjustment to an unsustainable pattern of external balances and relative prices would be induced.

If such measures and reforms are not introduced for lack of political will, due to misconceived self-interest or the failure of political leaders to assemble the various parties in a fruitful dialogue to agree on solutions, the prospects for major disruption in the world financial system are high. Debtor countries would reluctantly —after all the sacrifices made and the utmost responsibility shown in recent years— be forced into unilateral action. In the words of the recent Declaration of Montevideo, issued by the Cartagena Consensus in December 1985: "Should the proposed set of measures not be adopted, the region will face a very serious situation which would necessarily force it to limit its net transfers of resources to avoid greater social and political instability which could reverse the process of consolidating democracy" (Cartagena Consensus, 1985).

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