



## Case Western Reserve Journal of International Law

---

Volume 19 | Issue 1

---

1987

# New Directions in Debt Management

Stephany Griffith-Jones

Lucy Nichols

Follow this and additional works at: <https://scholarlycommons.law.case.edu/jil>

 Part of the [International Law Commons](#)

---

### Recommended Citation

Stephany Griffith-Jones and Lucy Nichols, *New Directions in Debt Management*, 19 Case W. Res. J. Int'l L. 53 (1987)

Available at: <https://scholarlycommons.law.case.edu/jil/vol19/iss1/4>

This Article is brought to you for free and open access by the Student Journals at Case Western Reserve University School of Law Scholarly Commons. It has been accepted for inclusion in Case Western Reserve Journal of International Law by an authorized administrator of Case Western Reserve University School of Law Scholarly Commons.

# New Directions in Debt Management

by *Stephany Griffith-Jones\**  
and *Lucy Nichols\*\**

“The debt bomb of the newspaper headlines has turned out to be more like a debt cancer—less explosive, but every bit as traumatic and eventually destructive.”<sup>1</sup>

## I. INTRODUCTION

The widespread debt crises since 1982 have produced divergent views on the nature of debtors' financing problems and their solutions. Creditors have concentrated on the need to continue debt-service payments and have supported a multilateral negotiating framework. Debtors have been preoccupied with restoring growth and development in the face of increasing protectionism, low commodity prices and, most importantly, the dramatic erosion in the availability of external finance.

Between 1982 and 1985, Latin America has paid the United States \$100 billion more in debt service and profit remittances than it has received in net capital inflows. Financial flows to Sub-Saharan Africa remain positive, but have fallen from a peak of about \$2.8 billion in 1980 to \$0.8 billion in 1985.<sup>2</sup>

And since 1984, the developing countries as a whole have also been net exporters of capital. The United Nations Commission on Trade and Development (UNCTAD) estimates the net outflow from developing

---

\* Stephanie Griffith-Jones, Ph.D. Cambridge University, is a Fellow at the Institute of Development Studies at the University of Sussex where she is co-ordinating an international project on the impact of the debt crisis on various Latin American countries. Previously, Ms. Griffith-Jones was associated with the Central Bank of Chile and Barkleys Bank International, United Kingdom. She has also acted as a consultant to various international organizations including the World Bank, EC Commission, Commonwealth Secretariat, UNCTAD and UNICEF. Ms. Griffith-Jones has published a large number of articles and four books on macro economic issues and on external financial flows to Latin American countries. Her most recent book, co-authored with O. Sunkel, *THE CRISIS OF DEBT AND DEVELOPMENT IN LATIN AMERICA* is published by Oxford University Press.

\*\* Lucy Nichols, B.A. Colby College, M.A. University of Sussex, currently a Ph.D. candidate at the Institute for Development Studies, University of Sussex and a researcher at the Overseas Development Institute, London.

<sup>1</sup> S. Ramphal, Challenge and Opportunity for the World Bank, introductory remarks on the occasion of an address by Tom Clausen, President of the World Bank (London, Mar. 14, 1986).

<sup>2</sup> See Avramovic, *Transfer of Resources to Developing Countries*, Report to the Group of Twenty-Four (Jan. 20, 1986).

countries totalled \$16 billion in 1985<sup>3</sup> and more recent studies put the total at about \$25 billion for 1985.<sup>4</sup>

Furthermore, in the Latin American case, the net transfer of resources has had a profound and long-term impact on the region's development. For the whole 1973-1985 period, Latin America contributed an estimated \$15 billion to the international financial system.

---

Net Transfers to and from Latin America, (US billions)\*

---

1973-81	+ 91.8
1982-85	- 106.3
1973-85	- 14.5

---

Source: U.S. Economic Commission for Latin America (CEPAL), *BALANCE PRELIMINAR DE LA ECONOMIA LATINOAMERICANA*, 1985. \*Net financial transfers are defined as net capital inflows minus net payments of profits and interest. A positive sign implies a net inflow of resources.

Even though Latin America's debt grew spectacularly by at least \$200 billion from 1973 to 1985, the continent did not benefit for the period as a whole from the positive inflow, but actually made a net negative transfer. As can be seen above, Latin America received a positive net transfer of about \$10 billion per year from 1973-81, equivalent to 16% of the region's exports.<sup>5</sup> From 1982-1985, net capital inflows fell as interest payments skyrocketed. This prompted a net outflow of about \$25 billion per year, or about 25% of exports.<sup>6</sup>

The dramatic decline in the availability of external resources, increasing protection of export markets and low commodity prices, have caused growth, consumption and investment to fall. This has resulted in some debtor governments rethinking their debt-management strategies. In 1985, Latin America's gross domestic product (GDP) per capita was about 10% below its 1980 level, reversing 30 years of uninterrupted growth. In Africa, average GDP per capita fell 16% in the last six years from already low levels.<sup>7</sup>

Most debtor governments have accepted the need for often draconian economic adjustment to stay within the financing constraints imposed by the unfavorable world economic environment and the need to finance their debts despite these costs. But since 1985, a few debtor governments, especially in Latin America, have begun to perceive that massive and pervasive net transfers have strengthened their bargaining

---

<sup>3</sup> UNCTAD, *TRADE AND DEVELOPMENT REPORT* (1985)

<sup>4</sup> See Avramovic, *supra* note 2.

<sup>5</sup> U.N. CEPAL, Economic Comm. for Latin America and the Carribean, *Balance Preliminar de la Economia Latinoamericana* (1985).

<sup>6</sup> *Id.*

<sup>7</sup> UNICEF, *RECESSION, ADJUSTMENT AND HUMAN WELFARE IN THE FIRST HALF OF THE 1980s: AN OVERVIEW* 23 (1986).

position and have re-defined the minimum debt-rescheduling deals acceptable to them.<sup>8</sup> That is, governments have shifted toward the view that it is the international financial system that has to adjust to their pressing growth and development needs, and that if it does not do so sufficiently, debtor nations will be forced to take unilateral action and lighten the burden of negative net transfers.

Debtor governments taking this new approach have some sympathy and support from those concerned with the plight of the poor in developing countries, those who believe that stagnation of slow growth in the developing economies contributes to lower world economic growth and those who benefit directly from growth such as industrial-country exporters and investors.<sup>9</sup>

A new strategy to deal with the crises of debt and development in the 1980s needs to significantly increase the flow of external resources to developing countries. Also, debt negotiations must widen their scope beyond multi-year rescheduling and reductions of fees and spreads. This is because such measures lead only to marginal changes in the availability of resources.

Although these criteria require fairly radical changes in debt-crises management and international financial intermediation, this is by no means radical in itself. Practically all schools of economic thought assume that the normal direction of flows of financial resources should be from relatively richer, capital-abundant industrial economies to the relatively poorer, capital-scarce developing economies, and certainly not in the opposite direction.<sup>10</sup>

A drastic reduction or cessation of negative net transfers is a condition for restoring growth in developing countries to pre-crises levels and would hopefully be a first step towards restoring positive transfers of resources. The Commonwealth Secretariat's report on the debt crisis emphasized this point as follows:

It is a matter of urgency to put an end to the premature outflows of resources from developing countries.<sup>11</sup>

This paper will first review debt crises management to date, arguing that most developing countries are no nearer to a long-term solution to their financing problems and that current strategy will not work as long as external trends continue to contravene its underlying assumptions. Second, a discussion of how the management strategy has changed since

---

<sup>8</sup> Authors inference from many sources.

<sup>9</sup> E.G. JOINT ECONOMIC COMMITTEE, *THE IMPACT OF THE LATIN AMERICAN DEBT CRISIS ON THE U.S. ECONOMY*, 99th CONG., 2d SESS. (Comm. Print 1986).

<sup>10</sup> *The Debt Crisis and the World Economy* in COMMONWEALTH SECRETARIAT (1984). (Report by the Commonwealth Group of Experts).

<sup>11</sup> *Id.*

the Baker Initiative and the Mexican rescue package. And third, suggestions on the essential ingredients of a debt management strategy that could begin to solve the debt crises.

## II. DEBT CRISES ORIGINS AND SIZE

The debt buildup had its roots in the emergence of transnational banking and Euro-currency lending in the 1960s. It greatly accelerated as commercial banks recycled surplus savings by lending to developing countries whose external accounts began to deteriorate rapidly after the rise in oil prices in 1973-74 and the slowdown in industrial countries' growth.<sup>12</sup> Industrial country governments approved of this recycling by commercial banks as it represented a "market" solution rather than a "governmental" solution to the problem.

Private borrowing seemed in the interest of all the actors involved. Debtors paid low nominal interest rates and often negative real interest rates to finance a slower adjustment to an external shock.

Historical precedent suggested that capital transfers were essential to development, and many governments were in the midst of major public-sector investment programs that required imported capital goods.<sup>13</sup> The United States, after all, had enjoyed large capital inflows in the 19th Century. Dell notes the United States often suspended interest payments when a recession in Great Britain depressed the demand and prices of its exports, or when high interest rates in Europe severely constricted capital flows. This pattern bears a resemblance to debtors' experience today.<sup>14</sup>

For those who had access to it, bank lending looked like a good way to finally get away from the conditionality of the International Monetary Fund (IMF). Commercial bank loans were relatively quick to arrange and had few strings attached. Official development assistance was stagnating and direct foreign investment was seen to create dependency. Governments found commercial bank loans an ample and better substitute for their traditional finance. Lending made sense as well. Recession dampened the demand for commercial credit at home at a time when deposits from oil producers and others were growing quickly. Furthermore, the loans to developing countries were profitable. Increasing competition in the Euromarkets prompted commercial banks to diversify their risk geographically and to begin lending to countries they had become familiar with through their lending to multinational clients. High

---

<sup>12</sup> S. GRIFFITH-JONES, *INTERNATIONAL FINANCE AND LATIN AMERICA*. (1982).

<sup>13</sup> Well-known fact. Vast literature on import-substituting industrialisation.

<sup>14</sup> Dell, *The World Debt Problem: A Diagnosis* in REPORT TO THE GROUP OF TWENTY-FOUR (Jan. 1986) citing Solomon, *The United States as Debtor in the 19th Century* in BROOKINGS DISCUSSION PAPERS IN INTERNATIONAL ECONOMICS 19 (May 1985).

commodity prices in the 1970s, which bolstered the usual creditworthiness measures and the prevalent idea amongst bankers that countries could not go bankrupt, further, encouraged commercial lending.

Mexico's declaration of a temporary moratorium on debt service on August 20, 1982 created crises headlines, but the underlying trends had been deteriorating since the late 1970s. The increase in the price of oil during 1978-79—and more importantly, the rise of monetarism with its consequent increase in interest rates in the 1980s—and the recession in the developed countries which reduced the demand for debtors' exports contributed to debt-servicing problems. The commercial banks' cutback of new lending after the Mexican moratorium tended to further undermine their clients' creditworthiness.

Internally, some debtors had added to the problem by using borrowed money in ways that did not create debt-servicing capability, i.e., arms purchases, capital flight, or imports of consumption goods. From 1979-1983, capital flight was an important part of the increase in external debt in Mexico and Argentina.<sup>15</sup> Other debtors, like South Korea, invested the funds in industries that generated foreign exchange to service the loans.<sup>16</sup>

Much ink has been lavished in the debate over the external versus the internal causes of the debt crises, a distinction that tends to be overdrawn, but it is important to the moral arguments about debt relief. The debtors' current account deficits were not *prima facie* evidence of fiscal irresponsibility, but "to a large extent, a passive rather than an active source of internal disequilibrium."<sup>17</sup> Capital flight, on the other hand, clearly played a negative role. An IMF study of how 20 middle-income countries used borrowed funds in the 1970s showed that, on the whole, "increases in indebtedness . . . have reflected primarily an exchange of debt instruments for additional physical capital."<sup>18</sup>

The sheer number of developing countries that simultaneously ran into debt-servicing difficulty argues strongly that common external shocks played a primary role. The number of formal reschedulings climbed from an average of four per year in the late 1970s to 13 in 1981, 31 in 1983 and 21 in 1984.<sup>19</sup>

Debtors reacted differently to the economic shocks—internal and

---

<sup>15</sup> MORGAN GUARANTY TRUST COMPANY OF NEW YORK, *WORLD FINANCIAL MARKETS* (March and April 1986); INTER-AMERICAN DEVELOPMENT BANK, *FUGA DE CAPITALES EN AMERICA LATINA, 1970-1985*. (Dep't of Econ. and Social Research, Working Paper).

<sup>16</sup> Dell, *supra* note 14 (citing International Monetary Fund study).

<sup>17</sup> INT'L MONETARY FUND, *WORLD ECONOMIC OUTLOOK* at 140-44 (1983) (cited by Dell *supra* note 14).

<sup>18</sup> *Id.*

<sup>19</sup> INT'L MONETARY FUND, *Recent Developments in External Debt Restructuring*, 40 OCCASIONAL PAPER (Oct. 1985).

external—which emphasizes their heterogeneity, even though they share common problems posed by the unfavorable external environment. The size of the debt varies tremendously by region. The IMF estimates Africa's debt totalled \$128.5 billion in 1985, less than half the Western Hemisphere's (Latin America) estimated \$368 billion.<sup>20</sup> Asia owed an estimated \$230 billion, Europe, \$88 billion and the non-oil Middle East, \$74 billion.<sup>21</sup> Sub-Saharan Africa's (SSA's) debt is estimated at between \$81 billion and \$125 billion at the end of 1985.<sup>22</sup>

In Latin America the main lenders were banks which have held more than half of the external public debt since 1978. This is an unusually large proportion measured against an average of 16.4% in the 1960s and 19.5% in the 1970s.<sup>23</sup> Commercial bank rescheduling packages, with IMF sanction, have been the primary "solution" to debt-servicing problems thus far, as opposed to increased aid, new lending, or debt relief.

African debtors in general, had far less access to financial markets and show a greater diversity of lender and type of debt. Low income SSA countries tend to owe the bulk of their debt to official creditors and sometimes as arrears, (forms of debt that traditionally have not been eligible for rescheduling). As a result, African "solutions" have focused on increasing concessional, bilateral and aid flows, except for a handful of countries that borrowed from the banks.<sup>24</sup>

Latin American debt, held chiefly by the banks, is relatively more sensitive to interest rate changes; African debt-servicing problems stem more from falling commodity prices and declining terms of trade. Oil exporters in both regions face similar debt-servicing problems.

### III. DEBT MANAGEMENT TO DATE

The question—have the debt crises been managed toward a long-term solution?—begs the fundamental issue of what constitutes progress, a point debtors and creditors have not agreed on.

Is it meant that debtors have reduced their current account imbalances to the point where they can finance them in the medium term given external constraints and are therefore liquid? Or is it that the debtors' economies have adapted structurally to the external environment? If so

---

<sup>20</sup> INT'L MONETARY FUND, *WORLD ECONOMIC OUTLOOK*, (Apr. 1986).

<sup>21</sup> *Id.*

<sup>22</sup> Brau, *African Debt: Facts and Figures on the Current Situation*, and Green, *Comments*, in *AFRICAN DEBT AND FINANCING*, (Special Report No. 5, May 1986).

<sup>23</sup> INTER-AMERICAN DEVELOPMENT BANK, *ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA: 1986 ANNUAL REPORT*, (WASH., DC 1987).

<sup>24</sup> Chiefly, Congo, Gabon, Ivory Coast, and Nigeria.

how far do the indicators have to move before a debtor has adjusted enough or "solved" the problem?

Or can a solution mean a lifting of the external financing constraint and the restoration of growth and development of the debtors' economies? In this case, should not the international financial system have to adjust to the debtors? If so, are falling real interest rates, rising commodity prices, faster growth of world output and trade, or the revival of lending to be the key indicators of progress?

Despite the diversity of debtors, "management" through 1985 took the first approach based on the argument, put forth by William Cline and others, that the debtors were illiquid, not insolvent, and therefore warranted new lending and rescheduling to tide them over until creditworthiness and new financial flows were restored.<sup>25</sup>

Dell, identifies six assumptions underpinning the "management" strategy: that OECD growth would be 3% or slightly less per year and that the income elasticity of demand for imports from developing countries would revert to the favorable levels of the 1960s and 1970s, that commodity markets would revive, that commercial bank exposure would increase by 6% to 7% per year, that nominal and real interest rates would fall, that developing countries would maintain access to creditors' markets and finally, that "debtor countries would continue to accept strong compression of consumption, investment and imports as well as the postponement of any significant recovery of living standards to the 1990s or even (in the case of African countries) beyond."<sup>26</sup>

Forecasting the balancing of payments to estimate when countries would be liquid again became in Carlos Diaz-Alejandro's words "major indoor sport."<sup>27</sup> Cline's optimistic forecasts were broadly supported by the IMF and World Bank scenarios from 1983 to 1985, reinforcing the view that the crises were temporary and that short, sharp current account adjustments would restore debtors' creditworthiness and external financial flows.<sup>28</sup>

These conjunctural forecasts, weakened by all the usual prediction problems and the increasing volatility of the external environment, proved a thin peg on which to hang an international debt strategy. Most debtors have not begun to solve their financing problems as measured by the "standard" creditworthiness measure, the debt-to-export ratio, and

---

<sup>25</sup> W. CLINE, *INTERNATIONAL DEBT: SYSTEMATIC RISK AND POLICY RESPONSE* (1984).

<sup>26</sup> Dell, *supra* note 14.

<sup>27</sup> C. Diaz-Alejandro, *Latin American Debt: I Don't Think We Are in Kansas Anymore*, 2 BROOKINGS PAPERS ON ECONOMIC ACTIVITY, (1984).

<sup>28</sup> The World Bank and I.M.F. scenarios are printed annually in INT'L MONETARY FUND. WORLD ECONOMIC OUTLOOK 1986 and WORLD BANK, WORLD DEVELOPMENT REPORT 1986. That these reports reinforced the view that the debt crisis was temporary is our inference from academic papers, meetings and the press.



crises headlines that persist when debtors cannot find enough external resources to finance their greatly reduced, current account deficits.

The IMF reports that developing countries decreased their current account deficits from \$91 billion in 1982 to \$34 billion in 1985, largely through a sharp contraction in imports.<sup>29</sup> Latin America cut its current account deficit from \$41 billion in 1982 to \$4 billion in 1985. The external debt of the 10 major debtors continues to rise, albeit much more slowly than before 1982. The debt incurred since 1982 has been used to service old debts, creating no new productive capacity or debt-servicing ability. As the Table below shows, most of their debt-to-export ratios continue to worsen as export revenues decline on the back of low commodity prices. The ratios for Ecuador, Mexico, Peru, Venezuela, and Nigeria deteriorated greatly in 1986 as oil revenues fell. Scheduled interest payment's share of export earnings has not fallen much since 1982 for most of the major debtors, despite falling nominal interest rates, forcing them to live without imports that could be invested in export industries that would help service the debt.

Debt-to-exports and interest payments to exports\*

	Debt-to-Exports			Interest-to-Exports		
	1982	1984	1985	1982	1984	1985
Argentina	405	473	483	50	56	52
Brazil	339	322	368	54	38	41
Chile	333	402	442	44	44	46
Ecuador	240	250	254	30	30	24
Mexico	299	293	322	44	37	33
Peru	251	330	370	25	33	31
Venezuela	169	177	201	18	16	18
Nigeria	85	165	180	8	11	13
Philippines	270	312	342	24	29	28
Yugoslavia	167	166	160	18	16	15
Average	257	279	308	34	31	31

Source: Morgan Guaranty, *WORLD FINANCIAL MARKETS*, Sept/Oct. 1985, p.3. \*Countries listed comprise 10 major debtors. Debt-to-export ratio is calculated as the average of gross external debt at the beginning and end of year as percent of exports of goods and services. Interest payments to export ratio is scheduled interest payments as percent of exports of goods and services.

For low-income Africa, the World Bank estimates that the debt ratio doubled from 1978 to 1983, hitting 393%, nearly double the 200% level previously considered creditworthy.<sup>30</sup> For SSA as a whole, the debt ratio has increased from 200% in 1982 to 240% in 1985, an average that

<sup>29</sup> INT'L MONETARY FUND, *WORLD ECONOMIC OUTLOOK*, (April 1985).

<sup>30</sup> WORLD BANK, EXTERNAL DEBT DIVISION, *WORLD DEBT TABLES, 1985-86* (1987).

conceals great variation.<sup>31</sup> In 1985, debt ratios within SSA ranged from over 1000% in Mozambique, Sudan and Guinea-Bissau to less than 50% in Gabon, Botswana and Lesotho.<sup>32</sup> According to the IMF, interest payments to exports increased from 9% of exports in 1982 to 14% in 1985, but as for the debt ratio, the average conceals enormous variation from less than 5% in seven countries to more than 68% in Mozambique and Sudan.<sup>33</sup> Thus, Hope and Larkum of the World Bank conclude that in 1985:

[E]ven for most of those problem debtor countries steadfastly pursuing efforts to strengthen their economies, the restoration of creditworthiness came no closer; for many others, it receded. Confidence in these countries' economic prospects, an essential component of their return to financial health, can no longer be expected to recover rapidly.<sup>34</sup>

Furthermore, the short-term strategy is not likely to succeed in the future given external trends that violate the six underlying assumptions identified earlier, calling the strategy's premise, as well as its performance, into question. World output and trade are growing slowly despite falling oil prices. Real interest rates remain high, while commodity prices remain low, and external finance shows few signs of returning to troubled debtors. Each point will be considered in turn.

First, growth has slowed more than expected in the industrial countries to 2.75% in 1985 and an estimated 2.8% in 1986 despite falling oil prices. The Organization for Economic Cooperation and Development (OECD) expects growth to reach about 3% in 1987.<sup>35</sup>

Second, some developing countries are having difficulty maintaining access to developed country markets and competing with subsidised United States and European Community agricultural exports. The volume of world trade grew only 3.5% in 1985, less than half the 1984 rate of 8.5% and by most forecasts is not expected to increase greatly in 1986 and 1987. This situation reduces debtors' opportunities to increase market share.<sup>36</sup>

Third, the World Bank estimates that the dollar value of commodity prices (excluding oil) fell 11% in 1985, after improving in 1983 and 1984, leaving prices 26% below their 1980 level. This decline has sent the Bank's non-oil commodity price index to its lowest point in its 27-year

---

<sup>31</sup> INT'L MONETARY FUND, *WORLD ECONOMIC OUTLOOK*, (April 1986).

<sup>32</sup> Brau, *supra* note 22, at 39 (Table 218).

<sup>33</sup> The seven include Cameroon, Guinea, Gabon, Botswana, Rwanda, Swaziland, and Djibouti.

<sup>34</sup> Hope & Larkum, *Development and Debt Service: Dilemma of the 1980s*, WORKING PAPER No. 1986-1, (World Bank, External Debt Division, January 1986).

<sup>35</sup> ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, *OECD ECONOMIC OUTLOOK* (1986).

<sup>36</sup> Consensus of projections done by June of 1986 including: INT'L MONETARY FUND *WORLD ECONOMIC OUTLOOK*, (April 1986); OECD *ECONOMIC OUTLOOK*, (May 1986).

history.<sup>37</sup> With the possible exceptions of sugar, coffee, maize and cotton, commodity prices are not expected to recover in the medium term.

Fourth, commercial banks have not increased their exposure to developing countries by the 6% to 7% per annum originally envisaged by the debt management strategy, but have reduced their lending to Latin America and Africa to \$2.1 billion and \$0.7 billion in 1985.<sup>38</sup> As the Table below shows, lending to all non-oil developing countries in 1985 recovered to about 1983 levels, but the bulk went to Asian countries without debt problems.

New net flows from private banks, 1980-85 (\$US billions)

	1980	1981	1982	1983	1984	1985
Latin America	27.3	30.5	12.2	8.1	3.6	2.1
Africa	2.0	2.0	1.7	0.3	0.2	0.7
Asia, Middle East	9.7	7.4	5.9	3.5	5.0	8.5
Total*	39.0	39.9	29.8	11.9	8.8	11.3

Quarterly new net flows from private banks, 1985-1986.I (\$US billions)

	1985.I	1985.II	1985.III	1985.IV	1986.I	1986.II	1986.III
Latin America	0.0	0.5	-0.3	1.9	-2.2	-0.1	-0.8
Africa	0.0	0.3	-0.1	0.5	-0.2	-0.3	0.3
Asia, Middle East	-0.7	2.6	3.2	3.4	-2.3	0.3	0.7
Total	-0.7	3.4	2.8	5.8	-5.2	-0.1	0.2

Source: Bank for International Settlements (BIS), INTERNATIONAL BANKING DEVELOPMENTS, January 1987. \*Total includes non-Opec developing countries.

The Baker Initiative, unveiled at the 1985 IMF/World Bank Annual Meeting in Seoul, has not restored bank lending to promised levels. The plan called on commercial banks to increase their exposure by slightly more than 2% per year and lend \$20 billion in new money to the heavily indebted, middle-income countries over the next three years; on the multilateral institutions to increase their lending by about 50% above recent levels and the World Bank to make more policy loans; and on the IMF Trust Fund to aid low-income debtors.<sup>39</sup>

As the Table shows, the commercial banks have withdrawn \$1.1 billion from Latin America since the Baker Initiative was announced in the

<sup>37</sup> Hope & Larkum, *supra* note 34.

<sup>38</sup> BANK FOR INTERNATIONAL SETTLEMENTS, INTERNATIONAL BANKING DEVELOPMENTS AND FINANCIAL MARKETS, (various issues).

<sup>39</sup> The Baker Initiative would raise \$40 billion over three years for 15 countries that owe about \$430 billion and which pay about \$40 billion in interest per year. It excludes the Paris Club and governments and only offers debtors one-third of their interest payments on average, implying debtors must maintain permanent, large trade surpluses.

third quarter of 1985 and contributed only \$0.2 billion to Africa. The decline in commercial lending to developing countries is linked to three trends. First, the flow of surplus Japanese, West German, and other capital into the United States diverts savings that developing countries could potentially borrow.<sup>40</sup> Second, lenders increasingly use securities markets where different, and more restrictive, creditworthiness standards apply.<sup>41</sup> Third, and most importantly, bankers as a group view developing countries as unsafe and simply are not willing to lend any more new money than is strictly necessary to safeguard previous loans. Hope and Larkum of the World Bank argue that:

After 1982, creditors became much more conservative in their view of the economic possibilities of the developing countries, as real interest rates increased, the terms of trade worsened and export prospects deteriorated. The debt indicators themselves worsened and creditors' reading of them both moved adversely for developing countries . . . Against this background, the recent weakness of private lending to the developing countries cannot be seen as an aberration, likely to correct itself in the near term.<sup>42</sup>

Furthermore, the IMF is in danger of receiving more in repayments on past loans than it dispenses as loans made in the early years of the debt crises fall due.<sup>43</sup> The net repayment will depend on future loans and therefore cannot be estimated precisely. The World Bank has increased its lending, particularly the fast-disbursing policy loans, but may also receive net repayments in 1986.<sup>44</sup>

The fifth trend to work against the debt management strategy is the persistence of high real interest rates even though nominal interest rates have fallen. The World Bank estimates that real interest rates adjusted for developing countries' export prices were 10% for oil importers, down from 12.7% in 1984, but still high by historical standards and measured against returns to investment. For oil exporters, real interest rates increased to 12.5% in 1985, from 1984's 12.1%.<sup>45</sup>

Finally, debtors are growing increasingly less willing to accept falling levels of consumption, investment, and imports and to postpone the

---

<sup>40</sup> WORLD BANK, WORLD DEVELOPMENT REPORT (1986).

<sup>41</sup> *Id.*

<sup>42</sup> Hope & Larkum, *supra* note 34.

<sup>43</sup> United Nations. Committee for Development Planning. *Doubling Finance for Development: Meeting a Global Challenge*, April 1986. Report to July 1986 session of the Economic and Social Council. See also, D. Lessard & J. Williamson, *Financial Intermediation Beyond the Debt Crisis*, 12 POLICY ANALYSES IN INTERNATIONAL ECONOMICS, (Sept. 12, 1985); I.M.F., WORLD ECONOMIC OUTLOOK Table A40 (1986); UNCTAD, *Trade and Development Report* Table 22 (1986).

<sup>44</sup> Fleming, *World Bank on brink of taking in more funds than go in aid*, FINANCIAL TIMES, June 23, 1986.

<sup>45</sup> Hope & Larkum, *supra* note 34, at 21.

recovery of living standards. As Mexico's former finance minister Silva-Herzog told a conference in London in January 1986, "The limit of the responsibility to our creditors is the responsibility to our people."<sup>46</sup>

As Dell points out, it is the political willingness of debtors to accept sacrifices that is the most sensitive link in the debt strategy.<sup>47</sup> Debtors' impatience seemed to shift to a higher plane in mid-1985 when Fidel Castro urged Latin America's leaders not to pay the close to \$400 billion due and Peru's President Alan Garcia announced at his July 28 inauguration that the country would pay a maximum of 10% of exports annually to service its \$14 billion debt.<sup>48</sup>

The Reagan Administration reassessed its debt strategy in mid-1985 and introduced the Baker Initiative in response to the poor external economic trends and debtors' increasing impatience. The Baker Initiative accepts for the first time a point long made by the debtors—that adjustment would have to be accompanied by growth to succeed.

The debtors called the Baker Initiative a first step forward and welcomed its increased flexibility and growth emphasis, but argued that the plan did not mobilize enough external finance to allow them to restore growth and service their debts regularly.<sup>49</sup> As we have seen, the plan has not even delivered the levels of finance criticized at the outset by debtors as too low.

The \$12 billion Mexican rescue package agreed to by the IMF in July could be another such step forward if the commercial banks disbursed the promised \$6 billion and extend the agreement to other debtors. The package allows for automatic increases in lending if the oil price falls below \$9 per barrel or if Mexico's GDP growth does not recover to 3-4% by the end of the first quarter of 1987.<sup>50</sup> The level of lending will fall by a like amount if the oil price climbs above \$14 per barrel.

<sup>46</sup> Address by J. Silva-Herzog entitled *The Evolution and Prospects of the Latin American Debt Problem*, delivered to a conference sponsored by the International Herald Tribune *reprinted in* INTER-AMERICAN DEVELOPMENT BANK, *BEYOND THE DEBT CRISIS—THE LATIN AMERICA: THE NEXT TEN YEARS*, (January 1986).

<sup>47</sup> Dell, *supra* note 14.

<sup>48</sup> Interview with Fidel Castro, *How and Why the Unpayable Foreign Debt of Latin America and the Third World must be Cancelled and the Urgent Need for a New International Economic Order*, GRANMA WEEKLY REVIEW,; Reid, *Garcia taking a firm line on Peru's \$14 billion debt burden*, GUARDIAN, August 13, 1985; Martin, *Castro presses his case for repudiation of foreign debts*, GUARDIAN, July 30, 1985; *Rumblings in Latin America*, FINANCIAL TIMES, August 6, 1986.

<sup>49</sup> See, Navarrete, *Foreign Policy and International Financial Negotiations: The External Debt and the Cartagena Consensus*, 27CEPAL REVIEW, (Dec. 1985); Tussie, *The Coordination of the Latin American Debtors*, in *DEBT CRISES OF THE EIGHTIES AND THEIR IMPACT*, (S. Griffith-Jones ed. forthcoming 1987).

<sup>50</sup> Mexican Government, *Mexico's Economic Program of Growth-Oriented Adjustment and Structural Reform: 1986-1987*; see also Mexican Gov't *Commercial Bank Financing Package for Mexico*, (October 1986).

The Mexican package, with its explicit commitment to financing for growth, marks the first time the IMF has agreed to a non-deflationary adjustment plan and follows in the spirit of the Baker Initiative. If the banks agree to it, they are sure to stress that Mexico's status as an oil exporter makes it a special case. If other debtors can negotiate similar deals, the Mexican blueprint could prove a flexible-enough management strategy to relieve some debtors' financing problems.

Thus, the debt management to date has not made great progress towards a long-run solution to developing countries' financing problems as measured against its own creditworthiness yardsticks. Nor is it likely to work given the probable persistence of unfavorable external trends. The Baker Initiative and Mexican package, with their emphasis on growth and flexibility, are steps in the right direction.

Indeed, the excessive reliance on short-run, current account correction at all costs may have prevented movement towards a long-term solution by squeezing out investment needed in export and import-substituting sectors to generate the foreign exchange which could be used to service the debt. But the strategy has worked to the advantage of commercial banks, agencies and creditor governments by allocating most of the costs of adjusting to these trends to debtors.

From the bankers' viewpoint, the strategy has prevented a major crash and write-offs, and safeguarded the precedent of repayment for future use. Banks' depositors have not been asked to absorb the costs of their imprudent lending. The 24 largest United States banks have reduced their exposure to developing country debtors from 200% of capital in 1982 to 148% in 1985.<sup>51</sup>

From an institutional point of view, the debt crises have strengthened the hand of the IMF, which had taken a back seat to the large private financial flows of the 1970s, and may well increase the influence of the World Bank and the other multilateral banks.

The Reagan administration, likewise, has avoided a financial crash. The cost of direct intervention has largely preserved precedents, and has suffered no great foreign policy defeats on the debt front. As a bonus, debt management has allowed the administration to export its free-market philosophies such as liberalization of trade, foreign investment rules and privatization of public companies as part of IMF packages.

The debtors, on the other hand, have contended with diminishing and negative financial flows, negative per capita growth rates, increasing political instability and severe reductions in the saving and investment needed to fuel growth and development. That they have continued to service their debt more or less faithfully without the restoration of

---

<sup>51</sup> Hope & Larkum, *supra* note 34, at 22 (citing United States Federal Financial Institute Examination Council).

creditworthiness and financial flows on which the debt strategy was premised is remarkable (it is not surprising that the debtors are now demanding—individually and collectively—a better deal).

#### IV. A NEW MANAGEMENT STRATEGY

The net negative transfers and the uncertainty of long-run adjustment without adequate investment have compelled debtors to seek a better deal from the international financial system by cashing in on their improved bargaining hand.

As we have seen, debtors are just beginning to capitalize on their bargaining strengths as their perceptions of their options and their willingness to resort to unilateral action change with the calculus of the costs and benefits of not servicing their debts as agreed. In the past, analysts have seen debtors' options in black-and-white terms—default or cooperate with a market solution. Increasingly debtors are moving into a grey area of conciliatory default or flexible market solutions where debt servicing obligations in the long-run are adhered to, but short-run costs are reallocated.

In this section, the approach will be first to review the new elements of the management strategy that has evolved since 1982 and argue that it has favored the creditors, and second, to show how debtors' assessment of the costs and benefits of their options are changing. The magnitude of the debt crises that emerged after 1982 overwhelmed traditional methods of resolving sovereign debtors' financing problems and led to six innovations, each of which affects debtors' bargaining strengths.

First, financial interests, institutions, and criteria have dominated debt management to the disadvantage of debtors and non-financial interests in the developed countries like exporters. UNCTAD estimates that falling OECD exports to developing countries have cost a cumulative loss of close to seven million man-years of employment in Europe and close to one million in the United States and Canada from 1982 through 1984.<sup>52</sup>

Both the Reagan Administration and Congress worried about the growing United States trade deficit, have realized in recent months that United States manufacturers and exporters suffer when Latin American debtors are forced to run huge trade surpluses to service their debts. This perception may have contributed to the new flexible market approach to debt management.<sup>53</sup>

This financial slant has also reinforced the short-term nature of remedies, particularly the one-year rescheduling packages. Under this

---

<sup>52</sup> Dell, *supra* note 14, at 45.

<sup>53</sup> Joint Economic Committee *supra* note 9.

“short-leash” approach, debtors and creditors negotiated nearly continuously, creating innumerable opportunities for brinkmanship and heightening uncertainty. Several debtors have recently won multi-year rescheduling agreements. This change is bound to benefit all parties.<sup>54</sup>

Finally, financial interests required financial measures of progress. Thus, debt-to-export ratios and new flows have predominated rather than unemployment, real wages and growth—which are measures of the real economy—and are couching the debate in terms unfavorable to debtors.

Second, the international agencies have returned to center stage to orchestrate rescue packages that include restructuring of maturing debt and new bank finance in exchange for tight policy conditions. The IMF stepped into the breach early on. Thus the World Bank may play a more important role in the new more flexible packages.

Third, commercial banks have lent “involuntarily” under IMF pressure preventing an even greater fall in net new lending than the markets would have provided after 1982.<sup>55</sup>

Fourth, the banks have set up steering committees to negotiate with debtors on behalf of hundreds of banks ensuring a united bargaining front that greatly strengthened the bankers’ bargaining hand.

Fifth, debtors have bargained on a case-by-case basis with creditors in contrast to the creditors’ relative unity. The early vision of the debt crises as a short-run problem accepted each case as different, preempting a search for more global solutions like a debtors’ cartel, and forcing debtors to negotiate singlehandedly with the banks as a group.

Sixth, debtors and creditors have opted for multilaterally agreed action negotiated between the commercial banks, international agencies and debtor governments. In the 1930s, negotiation followed unilateral action, often resulting default. However, since 1982, negotiation has preceded action.

The debt management strategy that evolved after 1982 led most debtors to weigh the costs of default more heavily than the benefits based on four prevalent ideas: creditors could recover their losses; well-behaved debtors would get new loans; default would irreparably tarnish a debtors’ creditworthiness and postpone the restoration of external lending; and for Brazil and Mexico, default would bring down the international financial system. We will consider each argument in turn.

Anatole Kaletsky argues that the costs of default are much lower than generally supposed.<sup>56</sup> The laws safeguarding sovereign nations’

---

<sup>54</sup> The durability of the agreements is questionable, as Mexico has already been forced to renegotiate its agreement just months into its three-year term.

<sup>55</sup> Without I.M.F. packages, the banks would have lent nothing.

<sup>56</sup> A. KALETSKY, *THE COST OF DEFAULT* (1985).



rights ensure that private creditors have few means of recovering their assets after a default. Creditor governments have more options but have shown little inclination to use them in the cases of Peru and Nigeria and will give first priority to shoring up their domestic banking systems.

Kaletsy argues that debtors can minimize the remaining costs of default by taking a conciliatory approach i.e. servicing debts owed to suppliers and multilateral banks and not those to lenders who will not loan more in the short term in any case.<sup>57</sup> Debtors, well-behaved and otherwise, have been repaying banks more than they have been lent, especially in Latin America, eroding the perceived benefits of servicing debt. Banks are reluctant to lend to most debtors, creditworthy or not.

Finally, debtors have realized that the banks are stronger than they were in 1982 and default would not, in Kaletsy's words, "result in worldwide economic armageddon."<sup>58</sup> Wall Street estimates that a total loss of interest payments from Mexico would reduce the earnings of the leading U.S. banks, which hold about a third of the total debt, by about 20 percent. Major banks in other countries would be affected less.<sup>59</sup> A 20% loss would badly hurt fragile banks, but could probably be contained. The real question is who pays: stockholders, taxpayers or depositors? Thus, in 1986, debtors perceive the costs of default and the benefits of faithful debt servicing to be lower than in 1982. They are increasingly willing to take unilateral action as the traditional debt strategy fails to work and austerity increases political instability.

Several countries have applied this newly perceived bargaining advantage. Nigeria, Peru, South Africa, Costa Rica and Bolivia have taken some sort of unilateral action.<sup>60</sup> Mexico has negotiated a new, more flex-

---

<sup>57</sup> *Id.*

<sup>58</sup> Kaletsy, *Crying Wolf in Mexico*, FINANCIAL TIMES, July 1, 1986 (Lombard column).

<sup>59</sup> War on Want's Working Party on Debt calculates that Latin American income represents about 5.5% of the annual interest income of the British banks and that even a total cessation of payments of interest and profit would still leave the banks in net profit before tax except Midland's which would lose 140 million pounds.

<sup>60</sup> Costa Rica quietly stopped servicing its debt in the autumn of 1986 when its creditors refused to reschedule \$1.4 billion in external debt over 25 years at below-market rates. Costa Rica argued that it should never pay more than 1.5% of its GDP in debt-service and that interest charges should be fixed at 4% until 1988, rising in stages to 6% in 1993. P. Montagnon, *Costa Rica asks for 'cut-prices' rescheduling*, FINANCIAL TIMES, Oct. 27, 1986; Bolivia halted interest payments to creditor banks in 1984 and in late 1986 owed over \$200 million in arrears. In 1986, the Bolivian government entered negotiations with the Paris Club to reschedule about half of its external debt, after a dramatic domestic adjustment program, but announced in January 1987 that it would ask creditor governments to cancel all or part of their loans to Bolivia. FINANCIAL TIMES, Jan. 24, 1987. Peru's President Alan Garcia announced in his inauguration speech in July 1985 that debt-service payments would be limited to 10% of exports, the first major public debt-service cap by a debtor, but an improvement on what the country had been paying. The cap was later extended to private sector debt and the profits and royalties of foreign companies. The I.M.F. declared Peru ineligible for new loans in August 1986. The country continues to receive trade credits, largely from European banks,

ible deal with its bankers that will serve its interests. Brazil has steered clear of the IMF and still agreed on a rescheduled agreement with the Paris Club.<sup>61</sup>

The majority of debtors, especially those in SSA, will continue to adjust their economies and service their debt within the multilateral

---

and the World Bank and IDB have disbursed previously agreed loans. No new loans are likely from either multilateral agencies, governments or banks. Peru sought negotiations with its commercial bankers in September 1986 on rescheduling of \$6 billion of its \$14 billion debt, but an agreement is unlikely without an I.M.F. package, which President Garcia continues to resist. Peru grew an estimated 8.5% in 1986, more than any other country in Latin America except Brazil, and is expected to grow about 6% in 1987. *ECONOMIST*, Aug. 3, 1985, Sept. 21, 1985, Mar. 29, 1986, Aug. 23, 1986, Jan. 10, 1987; *Peru puts its Creditors' Patience to the Test* *FINANCIAL TIMES*, July 30, 1986; *Peru President Defies I.M.F. Credit Freeze*, *FINANCIAL TIMES*, July 30, 1986, *Peru prepares to go it alone*, *FINANCIAL TIMES*, Aug. 15, 1986; *Garcia Stays on Path to Growth*, *FINANCIAL TIMES*, Jan. 13, 1987. African countries have also taken unilateral action, often quietly letting arrears pile up, but occasionally by publicly limiting debt-servicing. The Sudan, like Peru, was declared ineligible for further I.M.F. loans in February 1986 because of long-standing interest arrears on its I.M.F. loans. The country owes an estimated \$13 billion to multilateral agencies, banks and governments. Sudan still suffers the after-effects of famine and from civil war. *I.M.F. Talks with Sudan Fail*, *FINANCIAL TIMES*, Oct. 3, 1985, *Sudanese Officials Begin I.M.F. Loan Talks*, *FINANCIAL TIMES*, Oct. 17, 1985, *Sudan and I.M.F. in Deal on Policy Reforms*, *FINANCIAL TIMES* Nov. 14, 1985, *I.M.F. Bans New Loans to Sudan*, *FINANCIAL TIMES* Feb. 5, 1986, *Sudan Performs an Uncertain Balancing Act*, *FINANCIAL TIMES*, Jan. 16, 1987. The Nigerian government announced in January 1986 that it would pay no more than 30% of export earnings to service its \$7 billion debt in 1986. In March, the government asked its creditors for a 90-day moratorium on principal repayments on medium and long-term debt, after oil prices collapsed. The government continues to limit debt-servicing to 30% of exports, but has negotiated rescheduling agreements with bank and government creditors on much of its \$22 billion debt. The government has agreed to policies supported by the I.M.F., including a controversial exchange rate auction, but refuses to take an unpopular I.M.F. loan. *Nigerians Reluctant to Take I.M.F.'s Bitter Remedy*, *FINANCIAL TIMES* Sept. 20, 1985, *Nigeria Likely to Begin \$7bn Rescheduling Talks Soon*, *FINANCIAL TIMES* Feb. 24, 1986, *Nigeria announces Cautious Budget to Boost Recovery*, *FINANCIAL TIMES* Jan. 2, 1987; *Nigeria Misses \$30m Interest Payment on Ininsured Trade Debts*, *FINANCIAL TIMES* Jan. 20, 1987; *ECONOMIST*, Oct. 11, 1986. South Africa stopped repaying the principal on \$10 billion of its \$22 billion foreign debt in September 1985 after U.S. banks decided not to rollover the loans because of increasing political pressure at home. Under a February 1986 agreement, the banks agreed to extend the maturities of the \$10 billion in short-term debt to June 1987. South Africa in turn agreed to pay interest on all outstanding loans, to make a \$500 million principal repayment on the \$10 billion, and to pay \$1.6 billion in principal repayment on loans that fell outside the moratorium. The agreement has held to date, but South Africa warns it could break down if sanctions are imposed. The deal will be renegotiated in June 1987. *S. Africa Freezes Loan Repayments for Four Months*, *FINANCIAL TIMES*, Sept. 2, 1976, *South African Bank Deadlock*, *FINANCIAL TIMES*, Feb. 19, 1986, *Luetwiler Quits as South African Debt Mediator*, *FINANCIAL TIMES*, July 4, 1986, *South Africa's Economy: Twenty Six Years of Siege*, *FINANCIAL TIMES*, July 11, 1986, *DeKoch, Investor Doubts Hit South Africa*, *FINANCIAL TIMES*, Aug. 27, 1986, *Pretoria Freeze on Debt Repayment Likely to be Extended*, *FINANCIAL TIMES*, Sept. 7, 1985, *Luetwiler to be Absent from S. Africa Debt Talks*, *FINANCIAL TIMES*, Sept. 8, 1986.

<sup>61</sup> Carneiro, *Brazil and the I.M.F.: Logic and Story of Stalemate*, in *THE DEBT CRISIS OF THE EIGHTIES AND THEIR IMPACT*, (S. Griffith-Jones ed. forthcoming 1987): *Bankers' Latin Headaches are Throbbing Again*, *ECONOMIST*, Jan. 31, 1987.

framework for want of individual bargaining power and/or the economic strength to forego IMF rescues.

## V. CONCLUSIONS AND POLICY SUGGESTIONS

The debt management strategy that evolved after 1982 appears increasingly unsatisfactory after the poor 1985 and 1986 performance of commodity prices, bank lending, world growth and the shift in bargaining power from creditors to debtors. Latin American debtors, with large debts and negative net transfers, seem to have a substantial unexploited bargaining potential and should increasingly use it to re-define the minimum deal acceptable to them while bargaining for reschedulings and new capital flows. That is, debtor countries should force the international financial system to adjust to their development needs by relaxing constraints imposed by inadequate capital transfers.

Clearly such a minimum deal would not be defined in the abstract, but would be made consistent with acceptable minimum levels of growth for the debtors as well as acceptable levels of income, employment and social expenditure for the poor. Mexico's \$12 billion package, with its provision for more loans if growth does not recover, could be a blueprint for other debtor negotiations if the commercial banks follow through. The deal does not require the banks to take losses and adds further to Mexico's debt burden. Therefore this deal may not be the final solution, but it is finally a deal that serves some of the debtors' interests.

The debtor governments could also use their unexploited bargaining strength if they either individually or collectively suspended net transfers for a finite period, or limited debt servicing, as Peru has done, while committing themselves to service their debt in the long term. The suspension of negative net transfers is justified by the need to restore growth and to strengthen debtors' ability to service their debts in the long run, as long as appropriate adjustment and development strategies are followed as well.

Such a conciliatory cessation of negative net transfers would imply that governments would continue to service the debt in amounts equal to new credit or liquidity, creating a strong incentive for creditor governments and/or international financial institutions to expand direct lending or their guarantees. This is to increase international liquidity through, for example, a new issue of Special Drawing Rights (SDRs), or to permit some form of interest capping or debt relief to ease the burden of debt-servicing.

A policy package designed to overcome the crises of debt and growth should strive for the following four features. First, and most fundamentally, the measures need to reduce or preferably eliminate negative net transfers in Latin America and increase positive net transfers to low-

income countries. Thus, debtors should not confine bargaining either to multi-year rescheduling, or reduction of fees and spreads, used in debt renegotiations in 1984 and most of 1985, because such changes are marginal in relation to the size of the problem.

Second, any resources freed by a policy package should be used to sustain growth and increase the population's welfare, especially the poor's. Wealthy citizens should contribute through direct taxes or repatriation of their money abroad, especially if that package entails debt relief or interest concessions.

Third, the package should not excessively favor large debtors, who enjoy relatively stronger bargaining positions by virtue of their large negative transfers and the potential cost to the international system by a default. Debt crises in low-income countries, especially in SSA, began earlier, are even more damaging to their economies and cause even greater hardship than those in Latin America.

Across-the-board, bank-debt-relief or interest concessions would tend to favor more heavily indebted countries and be biased against countries that could not or did not borrow heavily from the commercial banks. Thus, debt relief or interest concessions should probably be combined with some forgiveness of low-income countries' official debt. A new management strategy, like Mexico's, could benefit all developing countries if major debtors get better deals; the precedent could increase the bargaining strength and confidence of less powerful and smaller countries.

Fourth, packages should contribute to global economic growth in the short and medium-term, by reducing foreign exchange constraints on debtors and by introducing counter-cyclical lending and greater stability into the global economy as a whole.

The complexity of the debt problem, the diversity of the debtors, especially in SSA and the size of debtors' external financing gap, seem to require a package of measures rather than a single policy. Governments and official institutions will probably have to play a larger role in international financial intermediation to sustain or increase financial flows to developing countries. Thus, a policy package should probably include an expansion of new official flows through multilateral or bilateral agencies, or an expansion of government guarantees, insurance or lender of last resort facilities that would combine public purpose and private finance or both. Schemes that mainly comfort the commercial bankers, such as co-financing with the World Bank and to some extent, the Baker Initiative, may fail to generate sufficient private flows.

Interest relief also seems important as long as the value of debtors' exports grows slowly or falls and interest rates remain high, to avoid the value of the debt growing too much in absolute terms and in relation to

exports. Concessionary interest capping, then, may help debtors and prove not too onerous for creditors.

Even though the banks have written down a portion of their developing country debt, they have not as yet granted either debt relief or even more importantly, interest relief. The banks could use their reserves to relieve the debtors' burden.

Finally, a package should promote counter-cyclical lending through, for example, a compensatory financing facility for interest rates or a new issue of SDRs at the IMF. Such an increase in liquidity not tied to creditworthiness, would make the world more stable by reducing the damage of the current debt crises and the likelihood of future ones.

The above proposals are not particularly radical and have been incorporated in part in Mexico's new package.<sup>62</sup> They would stand a much greater chance of restoring growth and debt-servicing capability if industrial countries reduced the financial and trade imbalances slowing world growth. Developing countries will have to "solve" their financing problems in large measure by continuing to adjust, freeing domestic resources and insisting on more flexible rescheduling packages that serve their development needs. The traditional debt management strategy focused on debtors' power to disrupt the international banking system. We believe a new debt management strategy should insist that debtor developing countries use their power to make the international financial system stronger, more stable and more likely to support their development needs.

---

<sup>62</sup> *Mexico's Economic Program*, *supra* note 50.