Our analysis in the last chapter has indicated that the debtor developing countries were overstrained in terms of their excess outward transfers of financial resources during 1982-92. The prevailing debt burdens in the indebted economies demand sufficient debt reduction as these economies are facing enormous resource crunches from the external sources. If additional external financial flows would have entered the debtor economies then their national savings would have been larger while still keeping their debt-to-GDP ratios on declining trend, provided average interests were held below their GDP growth rates. From a pure solvency perspective, therefore, a debtor should remain creditworthy, implying declining debt-to-GDP ratio through time.

A chronological account of the third world debt management policies including the case-by-case and market-based approaches indicates that these policies could hardly touch upon the issue of revival of real economic growth in debtor economies. It seems that an effort was made in the Baker Plan to emphasise the need for growth recovery in debtor economies as the latter could have provided an expanded market area for the creditor economies, plunged into deep recession. It was not surprising that the Baker
targets were not attained due to reluctance of the banks to extend new credits, reflecting the dominance of interests of finance over the real interests of trade creation in the creditor countries. The unique feature of all the debt management policies is entailed in their continued emphasis on conditionality-led internal adjustment efforts in the debtor economies. As noted in chapter 6, each succeeding policy expanded the nature and scope of conditionalities by making them stricter, leaving little freedom for the individual debtor governments to manoeuvre in the sphere of their own domestic fiscal and monetary policies. For efficient resource allocation, accumulation and real economic growth there is need for domestic adjustment in debtor economies. But how it should be pursued should be governed by the actual conditions prevailing in a debtor economy which greatly vary from one country to another. The decision in this regard should be left to the national governments of the individual debtor countries according to their conditions and requirements including their debt burdens. The multilateral financial institutes including the IMF and the World Bank have a definite role to play by monitoring the implementation and providing necessary technical advices from time to time.

The conditionality-led adjustment in debtor countries provides little space to the debtor governments to adopt policy stances according to their prevailing ground realities. The debtor economies suffered from serious distortion in resource allocation, low investment, high capital flight and high rates of unemployment along with net transfers of financial resources
abroad on account of debt services. As a consequence, their production suffered unabatingly. Domestic capital markets performed poorly with high rates of real interest rates for several years. Simultaneously, the adjustment efforts failed to check speculative behaviour by the domestic economic agents resulting in enormous capital flight from the debtor economies, especially from the Latin American countries.

An active regulatory role of the debtor governments is essential to pursue adjustment programmes in their own terms and conditions. This kind of regulatory intervention should focus on decentralised governance which will effectively open up new channels for additional investments, public as well as private, while safeguarding the interests of the weaker and poorer segments of their population and organise labour to participate in the decision making process.

The mandate of the Bretton Woods, as indicated in the formation of the International Monetary Fund, was to promote international financial order by offering its financial support to the countries in stress with their attempts to normalise their balance of payments. In addition to the necessary exigencies, the success of external adjustment depends most importantly on strengthening the ability of the debtor economy to export and substitute imports efficiently. In the IMF prescription trade liberalisation merely means opening up the domestic economy to the foreign producers by reducing or withdrawing all kinds of trade barriers. The emphasis is put on export promotion while the
over all adjustment policies severely constrain imports via income adjustment policy of GDP compression. What is missed in this approach is the fact that the constraints on imports may adversely affect domestic production and, even more seriously, it may affect new lines of productions of exportables. If export promotion is the concern then attempts should be there to open up new lines of production of exportables. Relying on traditional lines of production of exportables will not help much in export promotion given the international competition. Most importantly, export promotion ventures, which rely mainly on primary commodity exports, are bound to fail given the dwindling nature of their international prices. Adverse terms of trade effects in the latter case will surely jeopardise any effects to normalize balance of payments disequilibrium through export promotion measures only.

Global economy during eighties exhibited uncertainty and instability, perhaps of the highest order in the post war era. Volatile interest rates, dwindling prospects of commodity prices and potential external shocks from adjustments in the developed countries, notably USA, doomed the prospects of recovery and growth in many debtor developing countries. The presence of these factors indicates the advisability of clear rules of the game set by the debtor governments themselves to reduce uncertainty and stabilise expectations of their domestic economic agents so as to allow them to consider new investment decisions and modernisation plans aimed at increasing productivity and international competitiveness.

The Fund-Bank conditionalities have to acknowledge the above
mentioned fundamentals and policy imperatives in the context of a debtor developing economy. As our theoretical and empirical analyses offered in this thesis indicate the debt overhang might increase over time given the stringent terms and conditions of debt payments obligations. This warrants the need to evolve an effective mechanism of sufficient debt reduction, compatible with the GDP growth rates as are sustainable over time. A part of the remaining debt payments can also be linked with the debtors' economic performances, namely exports. To put the case for debt reduction formally let us recall equation (3.13) in chapter 3:

\[ n = d(r-i) \]

where \( d \) is the debt-to-GDP ratio, \( i \) is the average interest, \( n \) is the net transfer-to-GDP ratio and \( r \) is the rate of growth of debt stock or the net debt flow. In a situation characterised by credit constraints and rationing of loanable funds by the external creditors net debt flow \( r \) is unlikely to increase. If the objective is to reduce debt overhang over time along with injecting growth in debtor economy, then it will not be possible till \( n \) remains negative, as indicated in terms of our theoretical analysis in chapter 3 and 7.\(^1\) The onus then clearly falls upon average interest \( i \) as is evident from the above equation. Average interest \( i \) need to be reduced to the level which allows a debtor country to realise the warranted proportion of its domestic savings to generate desired level of economic growth, as is imminent from the growth equation (3.15) in chapter 3. When net debt flows

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\(^1\) In particular, recall the growth equation (3.15) in chapter 3 which shows that GDP growth rate is limited by negative net transfer of financial resources.
remain frozen due to prevailing credit constraints then, average interest 'i' can be reduced only by reducing interest payments, indicating the need for sufficient debt reduction.

Debts are owed to different categories of creditors, official as well as private, and, so interest payments are divided among different creditors. A debt reduction mechanism, therefore, must deal with the debt obligations of a debtor owed to the different categories of creditors.

As noted in chapter 4 and 5, transactions in secondary market involve purchases of debts with currently available resources or with future resources made available by exchanging new debt for old. Buy-backs and debt-equity swaps fall into the first category of debt reduction where debts are purchased by using currently available resources. As pointed out by Bulow and Rogoff (1988) and discussed in chapter 4, a sovereign debtor does not really benefit by using reserves or borrowing to buy back their debts even at discounts. On the other hand, debt-equity swaps may have inflationary side effects because in such debt conversion schemes foreign debts have to be exchanged for domestic currency before it can be used for equity investment, and the domestic currency is generally supplied by the central bank, causing expansion in money supply. Then, the question is whether it is possible to think of a debt reduction measure like the second category of transactions mentioned

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2 See Section 4.3 in chapter 4.
above which uses future resources made available by exchanging new claims for old ones. In this kind of transactions problem of seniority of new claims vis-a-vis old ones is present. Debtors cannot themselves subordinate old debts to new debts in order to market new debts successfully. Because those who hold the old debts may not agree to it. On the other hand, if the objective is to reduce debt burdens of a debtor permanently then subordination of old to new debts does not serve the purpose. In fact, when debtor's creditworthiness is low in the credit market holders of new claims require some sort of guarantee of payments from the debtors. For example, in Mexican debt exchange deal Mexico bought zero coupon US Treasury securities which were used to back the principal of the Mexican bonds issued in exchange for Mexican debts to the commercial banks. Even then the sales were smaller than expected presumably because of the reason that interest payments were not guaranteed. The promise to pay interest on bonds was not credible to the holders of the bonds when Mexico's ability to pay interest payments on its old debts was in question.

Seen in this light any market-based debt reduction scheme can only marginally alleviate the problem of debt overhang for a large number of developing countries today. First of all, in most of the cases there does not exist the secondary market of debt. Secondly, even where it exists the size of the market is very thin compared to the total debt.
overhang of a country. Thirdly, it may be difficult for each country to issue some "guarantee" of payments unless it is backed by a third party asset. But whether every indebted country requiring debt reduction can make use of such facility is doubtful. Also, a debtor needs financial resources to buy such facility. Above all, holders of new claims may want guarantee for interest payments in addition to guarantee for principal repayments as the Mexican case has revealed. Lastly, debt transaction in secondary market may produce some upward expectation about the market prices of the debts which may adversely affect debtor’s ability to exchange old debts by new claims.

The above arguments indicate the need for a creation of debt reduction facility which will take into account these problems associated with market-based debt reduction strategies. One may argue that Brady Initiative is an effort to that effect. There is no doubt that Brady deal has given momentum to market-based debt reduction schemes. In fact, official bilateral debt conversion in some countries came in wake of the Brady deals in the middle income countries. Despite this many countries with their large debt overhang find it difficult to reduce their debts owed to different creditors in the same manner.

There were many proposals for the creation of new debt
facilities. The proposal put forward by Peter B. Kenen is noteworthy. In terms of the Kenen Proposal an International Debt Reduction Facility (IDRF) can be set up which will deal with the debts owed to all kinds of creditors - private, bilateral and multilateral. Although total multilateral debt obligations of most countries are lower in proportion to the total debt obligations owed to bilateral and private creditors the proportion of total debt service to the multilateral creditors are much higher than those to the other creditors. As the NAM Study has reported 26% of the long-term debt of the 58 countries in 1992 was owed to the multilateral creditors, 49% to bilateral creditors, and 24% to private creditors. The pattern of these countries' debt service payments was quite different - 39% of their total debt services to the multilateral creditors, 20% to the bilateral creditors and 41% to the private creditors. These are the countries with arrears in excess of 20% of their scheduled debt service payments. If the five largest debtor

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4 Kenen suggested that an International Debt Discount Corporation (IDDC) be set up by the developed country governments. It can be an independent entity or an affiliate of the IMF or the World Bank. Its capital will be raised by subscription from its sponsors which will be in proportion to their share in the capital of the World Bank or their quotas in the IMF. IDDC will buy up debts at market prices. But the rate of discount will be chosen in advance in order to prevent any untoward expectation by the market about the IDDC operation. Claims discounted by the IDDC will be converted into long term debt at or slightly above the discounted value of those claims. The difference between the face value of the new debt and the discounted value of the old debt will yield a profit that the IDDC may hold as reserve or any use it for selective interest rate relief. Debt to the IDDC may be amortised over a 25 year period with a 5 year grace period. It will bear an interest rate 50 basis points above the average rate on the IDDC's own bonds. See Kenen, P. B. (1990); op. cit.

5 See NAM Study (1994); op. cit.; Table 12, pp. 26.
countries are excluded then proportion of debt services to the multilateral creditors becomes larger for the remaining 53 countries. The debt outstanding of the remaining 53 countries was 32% to the multilateral creditors, 49% to the bilateral creditors and 19% to the private creditors. Of the total debt service payments, 51% was made to the multilateral creditors, 24% to the bilateral creditors and 25% to the private creditors. Hence by leaving out the five largest debtors the proportion of debt services to the multilateral creditors becomes larger. As noted down in chapter 6, the multilateral creditors, especially the IMF and the World Bank, enjoy the status of preferred creditors. Generally, a debtor country renders first priority to their debt services to the multilateral creditors because any delay or failure to meet its scheduled obligations on this account may call for severe penalties from the multilateral creditors. The net flows from multilateral creditors may be curtailed or terminated, and/or more stringent conditionalities for domestic adjustment may be imposed on the debtor. Above all, failure to meet debt service payments to the multilateral creditors may lower the creditworthiness of the debtor in the international capital market. While multilateral creditors enjoy preferred creditors’ status arrears pile up on scheduled debt services to bilateral and private creditors. Moreover, the varying degrees of concessionality, associated with different types of debts,

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6 The five largest debtor countries are Nigeria, Peru, former Yugoslavia, Syria and Cote d'Ivoire. See NAM Study (1994), op. cit.; Table 12, pp. 26.
make the situation more critical for a debtor when arrears on bilateral and private debts mount up. Debts to multilateral and bilateral creditors may be concessional as well as non-concessional. But, in recent times as we have noted in chapter 6, the proportion of concessional debts from these two categories of creditors has declined. Debts to private creditors are generally non-concessional but do not contain any conditionality. Therefore, arrears accumulate faster in the case of private and non-concessional bilateral debts making the situation more vulnerable for a debtor economy. This calls for serious attention of the policy makers while chalking out a strategy of debt reduction. Arrears only help to constraint the inflows of much needed external finance for development in an indebted economy. Hence, unless a new debt reduction facility takes into account the debts owed to the different creditors and associated problem of their varying degrees of concessionality, debt burdens along with rising arrears on scheduled debt services will continue to persist.

Our analysis and the policy imperatives are valid only in the context of credit constrained third world economies. The decade of eighties is the mirror image of the decade of seventies. During seventies developing middle income countries were afloat with external funds whereas during eighites they along with the other developing countries of the world were denied access to these funds. Along with decline of funds from the private creditors flows from the
traditional sources, which include the financial assistances from Arab countries and the former Soviet Union, dried up as well. Simultaneously, there is now growing competition for limited funds, which are available, among a rising number of countries. The World Bank has identified four different classes of newly emerged claimants for its concessional disbursements of financial resources. While the number of claimants, recognised as eligible for concessional finances, is growing fast the total budget for such finances has not registered fast growth in recent time. To make a modest suggestion for policy imperatives in the given context, on the presumption that the latter will not change radically in immediate future, the need for debt reduction looms large than ever before to restore growth in the developing world.

Ensuring debt reduction to all the indebted countries of the world equivalently in terms of their debt burdens and prevailing internal conditions warrants a "common set of guiding rules and principles". These "common" "rules and principles", as entailed in the NAM Study, ought to be the following:

(i) Debt negotiations with regard to the 55-60 indebted countries must aim at debt reduction, but

The different classes of newly emerged countries, claiming concessional disbursements from the multilateral sources, include: (a) the countries which are presently eligible only for concessional borrowing given their domestic economic conditions like Angola and Mongolia; (b) the countries which will be eligible for receiving aid only due to exceptional factors like wars, e.g. Afghanistan, Cambodia, Iran, Jordan and Viet Nam; (c) the countries which are now eligible for receiving aid from the developed countries like the republics of the former Soviet Union and Eastern European countries; and, (d) the countries which are receiving bilateral assistance and is now eligible for multilateral concessional funds owing to their inability to support non-concessional lending following worsening economic conditions there like Cote d'Ivoire, Egypt and Honduras. See World Bank, Global Economic Prospects and the Developing Countries, 1993; pp. 46.
not debt rescheduling.

(ii) The extent of debt reduction in each case should be determined by the capital requirements over the medium term, the likely debt servicing capacity over the long run, and the price of debt in the secondary market of the country concerned, or, if the latter is not available, by debt prices of other developing debtor countries in similar circumstances.

(iii) Debts to all classes of creditors should be subject to reduction. And reduction should be carried out in proportion to the debt outstanding in each category of debts and according to their degree of concessionality.

(iv) Debtors should be placed into a more equal position with creditors than has previously been the case. A more equal position would be achieved by providing the debtors with international assistance, advice, and technical support; and, changing the institutional arrangements for country debt reorganisations from the presently creditor-managed fora to a forum jointly managed by creditors and the debtors. In this respect, one particularly refers to the reorganisation of Paris and London Club as debt renegotiation fora. The multiplicity of debt renegotiation fora should be replaced by a single and joint forum of creditors and debtors alike.
(v) An across-the-board review of an indebted country in each case should be taken up before undertaking any debt renegotiation exercise with a particular country in order to appraise correctly the nature and dimension of the debt overhang and to chalk out the warranted strategy to reduce the debt burdens. A genuine case-by-case review of situation in each debtor economy is required to adopt an effective debt reduction approach.

The persistence of the debt servicing problems in large number of debtor developing countries, as noted in the NAM Study (1994), is result of "the gravity of the crisis combined with external and internal factors that were not sufficiently understood". There was no dearth of efforts but dearth of comprehensive efforts to deal with the debt problem of the severely indebted developing countries en masse, not in pieces. In this regard, a study by the UNCTAD is worth mentioning\(^8\), which was carried out to gauge the effects of implementation of the enhanced Toronto terms\(^9\) on 22 low income countries. It has been found that for only half of the potential beneficiaries the new terms will reduce their debt service ratios substantially to a level that will be compatible with their capacity to pay. However, for the other half, their debt burden will remain high, above their capacity to pay. The World Bank too has

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recognised that the total effects of official bilateral debt reduction for the low income countries are quite modest to date\textsuperscript{10}.

Similarly, there are problems with reduction in debt owed to the private creditors. In fact, commercial bank debts to the low and lower middle income countries constitute a very small fraction of the balance sheets of the banks. It seems that there is no incentive for the banks to reorganise their low and lower middle income country loan portfolio, as they do not face any systemic threat of collapse due to these loan exposures. A new debt reduction facility has to deal with these debts. In accordance with the Kenen Proposal we can suggest that the banks which will not conform to the new facility's terms and conditions and will not agree to reduce their claims will face debt default from their clients. It will hardly affect their profitability. One can argue that this will jeopardise the long term credit standing of the low income countries with the international commercial banks. However, in future these countries are the least likely recipients of commercial bank loans either.

The question of reduction of multilateral debt burdens of the low and lower middle income countries is more demanding in the current context than the private or bilateral debt reduction. It is generally argued that

multilateral debt reduction will entail huge losses to the multilateral creditors, and may adversely affect the investors' and other creditors' confidence in these institutes. There are plausible measures which can be adopted to cover such losses. They include the following:

(i) In the given circumstances there is a need for a special issue of Special Drawing Rights. There is a fear that increase in global liquidity through SDR emission may have inflationary impact. The current low inflation environment reduces this risk. Rather, a case for a tailored SDR emission can be made in the present global situation to offset the negative consequences of deflationary forces. In fact, this proposal is not something new. More important is how to allocate such SDRs. In this regard one can mention the proposal put forward by John Williamson. First the IMF would make an estimation of the number of its member countries which are unable to borrow at an interest rate close to the SDR rate. If a substantial number of countries, whose quotas in total amount to one-third or one-quarter of the total, are found to be like that then SDRs will be issued as these countries reveal their desire to hold. The revealed desires of a country will be

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measured by the actual past increase in their reserve holdings during the preceding five years period, referred to as the "basic" period. The Fund will then calculate the scale of SDR allocation that will be required to provide those countries in aggregate with a similar reserve increase during the forthcoming basic period of five years and will issue SDRs on that scale. It is hoped that this will end existing "payments of reverse aid" (by the poor to the rich) rather than constitute additional aid. However, one is not sure whether this kind of SDR allocation will really change the reverse flows from poor developing countries to the rich developed ones. For allocations based on past increases in reserve holdings will help to continue the present transfer of real resources from the developing to the developed countries, but will not be able to reverse it.

(ii) Some losses of the multilateral institutes can be covered by a partial drawdown of accumulated reserves. The multilateral banks now possess substantial amounts of retained earnings accumulated as a result of generating high profits, paid for by the developing countries, and not paying out dividends to their shareholders. Apart from these they have set aside substantial provisions and/or reserves to protect themselves
against any possible non-payment of multilateral debt services. The World Bank has reported that its reserves amounted to $14.8 billion in 1994 and reserve-to-loan ratio was 13.9%. These earnings, provisions and reserves are currently not being deployed in any asset other than to bolster the balance sheets of the multilateral developmental banks. A partial draw down of these reserves and earnings to provide some debt reduction to the indebted developing countries may help to ease out the current debt problem of these countries considerably.

(iii) There is a third possibility through which some multilateral debts of the indebted countries can be written off. This refers to the multilateral debt-equity swap. The NAM Study has proposed a conversion of a part of the multilateral debt into equity with the participation of the International Finance Corporation and of similar regional financial institutions.

We have attempted to provide some policy imperatives to improve the debt situations of the several indebted countries which may help them to revive growth and foster development in the future. Our proposals are modest as they are built upon the presumption of the prevailing global economic situations and global political conditions. In

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fact, we have not argued in favour of global economic co-operation in terms of policy co-ordination among the major creditor nations and economic adjustments therein. Rather, assuming that the current political and economic scenario will prevail in the near future we have proposed a debt reduction mechanism which is less demanding in terms of radical transformation of the global political and economic order. In that context, we have argued that partial but sufficient debt reduction and reorientation of conditionality-based domestic adjustment programmes in the indebted developing countries are of utmost necessity. Any delay in this regard may risk a chaotic development with its far reaching implications for the world economy, jeopardising even those debt claims which still now appear stronger. The attempt here is not to portray a scenario for the debtor developing countries without any debt, as world without borrowing is a case in absurdity. Rather, this thesis is an attempt to prescribe a modest path for the debtors and creditors alike to avoid any recurrence of global debt crisis in future.