

**The International Debt Problem by Montek Singh Ahluwalia**  
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**PREFACE**

Debts have become a part of individual, national and international living today. In fact under the hire purchase system, the buy now-pay later system, which characterises rich countries and the rich within our country, almost all persons are all the time in debt. Debt becomes a problem for the individual when his debt obligations result in monthly repayments above 15 or 20 per cent of his monthly income. For the country, similarly, its internal public debt must stay within certain limits, so that the yearly interest and part principal repayments do not exceed a proportion of its national income—say 10-12 per cent. Internationally debts are contracted (a) between governments, (b) between a government or under its sponsorship, business concerns and inter-governmental financial institutions like the World Bank or Asian Development Bank and (c) between business concerns or Governments and foreign banks or the foreign capital market.

Internationally, such debts involve the annual payment of interest and repayment of the principal (called debt servicing) in convertible foreign exchange—usually expressed in US dollars. And so the general rule that has grown up on the basis both of theory and pragmatic historical experience is that the international debts that a country contracts should involve debt servicing within 12 to 15 per cent of its yearly export earnings. When it goes beyond that point, as it will for India in the late 80s, upto 20-22 per cent, the danger light begins to flash, calling for action to contain its international indebtedness.

In the 80s, the problem of international indebtedness has arisen with the following features: (a) the total debt owed by the poor countries—the non oil developing countries—amounts to Si,650 billion today: (b) the greater part of this debt is owed by governments or government sponsored private enterprises to commercial banks in the United States and Western Europe; the medium and long term debts owed to the commercial banks constituted two thirds of the developing countries' total debts: (c) the major debtors are some nine countries, Brazil, Mexico, Argentina, Chile, Colombia, Poland, Philippines and South Korea: and (d) the debt servicing of the first three countries ranges between over 50 per cent to over 100 per cent of their export earning against an average 25 per cent for all non-oil developing countries, the servicing of a total \$500 billion posing a sizable problem, calling for more lending by banks.

In this monograph, Mr. Ahluwalia analyses the various phases and facets of this international debt problem. He sets forth the dimensions of the problem, the major causes of the parlous position in which a few countries find themselves—both as borrowers and as lenders (the lending commercial banks), and the respite from the problem (from overwhelming the countries as worked out by the International Monetary Fund. The long term solution to the indebtedness problem suggested is the economic growth and recovery of both the developing and industrialised countries — which suggests that it is world recession and the protectionist policies adopted by the latter group of countries and not only the hiking of oil prices in 1973 and again in 1979 which has brought into the open the problem of indebtedness. There are also short term remedies such as vigorous import substitution policies, which will make available more foreign exchange earning for debt servicing purposes. All these and other issues are explored in the monograph.

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## The International Debt Problem\*

The past few years have seen a growing concern with the problem of international indebtedness to the point where it is today seen as one of the critical elements on the agenda for reform of the international monetary and financial system. In 1979 there was very little concern with the debt problem of developing countries. By 1983 there was great nervousness in the financial markets of the world about the overexposure of the private international banks in developing countries, and the likelihood of a series of defaults by major developing country borrowers which threatened the very stability of the international financial system. Throughout 1983 and 1984 the major factors on the international monetary stage devoted themselves to preventing the threatened collapse. They appear to have had a measure of success in this effort as the immediate threat of financial collapse has receded somewhat. But discerning observers are aware that what has been achieved thus far is a short term patchwork solution to the debt problem of major borrowers. Fundamental problems remain unsolved, and call urgently for a solution.

For our discussion, I would like to structure my presentation of the debt problem in terms of three questions. First, what are the dimensions of the problem of the International Debt of developing countries? Second, how did the developing countries get into this problem? Third, where do we go from here? Although our concern is with the debt problems of the developing world, I hope, in the course of answering these questions, to touch on the problem of external indebtedness as it concerns India also.

Before turning to the structured presentation I would like to draw your attention to the fact that there is an extreme view on debt which regards indebtedness as in some sense unwholesome. This view, though somewhat impractical, has a fairly well established lineage echoing as it does Polonius' advice.

***"Neither a borrower nor a lender be, For loan oft loses both itself and friend And borrowing dulls the edge of husbandry."***

Sentiments such as these are not far beneath the surface of views expressed against borrowing in developing countries and indeed against lending in developed countries! A more reasonable view of external debt however is that borrowing and lending, and therefore debt, are an integral part of modern economic life. There is nothing wrong with being in debt provided the degree of indebtedness is within the limits of the ability to service the debt. This is true of individual economic agents within countries and it is also true of countries borrowing on international capital markets.

Starting from this perspective one can see that a debt problem arises when the volume of indebtedness somehow exceeds the capacity to service the debt. The fact that it has indeed done so is evident on any consideration of the dimensions of the problem.

### I. The Dimensions of the Problem

The dimensions of the debt problem can be seen in terms of a variety of measures. These include the growth of the total volume of outstanding debt, its composition in terms of long term and short term debt, the debt service due on it which is determined by the average interest rate on outstanding debt and its maturity structure, and the relationship between debt/service on the one hand and export earnings on the other. All these measures show a steady increase in the degree of indebtedness of the developing countries over the past decade and more.

In terms of the volume of debt outstanding the total debt of the non-oil developing countries rose from \$130 billion in 1973 to about \$390 billion in 1979 and continued to rise thereafter to almost \$700 billion in 1983. Total debt outstanding was about 115 per cent of exports in 1973. This ratio had increased slightly to 119 per cent of exports by 1979 but by

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1983 it was 150 per cent of total exports. Thus although debt grew rapidly in the seventies the growth in total debt was matched by a growth in export earnings. This was not the case in the period after 1979.

The structure of the outstanding debt of developing countries also changed in important respects in this period which added to the crisis of external debt feared in recent years. For one thing the structure of the external debt in terms of the mix between short and long term debt changed subsequently. In 1973 about 92 per cent of the outstanding debt was long term in nature. By 1983 the long term percentage had declined to about 84 per cent. The short term component in other words had doubled from 8 per cent in 1973 to 16 per cent in 1983.

Another important structural change is the share of debt owed to private banks. A decade ago, about 25 per cent of the external debt of developing countries was owed to private international banks. The proportion has increased to about 50 per cent.

More important than these changes in the volume and structure of external debt is the change in the debt service capacity of developing countries. I have already mentioned that debt outstanding as a percentage of total exports rose from 115 per cent in 1973 to about 150 per cent in 1983. A more relevant measure of debt servicing capacity is the ratio of total debt service payments (both amortisation and interest) to total export receipts. This ratio, commonly referred to as the debt service ratio, was 16 per cent in 1973 for the group of non-oil developing countries. It rose to 19 per cent in 1979, and then increased to 25 per cent in 1983.

Even these figures do not give a full measure of the extent of the debt crisis and the concern on this subject in recent years. There are some additional factors that need to be highlighted.

Perhaps the most important is that the increase in debt that has taken place over the past decade and, moreover, has been highly concentrated. About ten countries which have been active in borrowing from the private banks over this period accounted for more than 50 per cent of the total outstanding debt at the end of 1983. These countries face a much more difficult debt service problem than is implied by the average debt service ratio of 25 per cent for all non-oil developing countries. The debt service ratio for Brazil was 87 per cent, for Mexico 58 per cent, for Argentina 103 per cent. These are very high levels for the debt service ratio and it is not surprising that they should have caused deep concern to creditors.

The concern was all the greater because a very large proportion of the debt owed by these large borrowers was owed to private banks. Most developing countries, especially the low income countries, have relied mainly on long term borrowing from official and multilateral countries but the large debtors have borrowed short and from private banks. The fact that a sizeable part of the debt that is in jeopardy is owed to private banks is an important difference between the debt problem of today and the debt problems of early times when the principal instrument for borrowing was the issue of bonds. Debt repudiations involving bonds have taken place earlier but this has usually meant that some worthy and virtuous dentist in London or New York is left holding useless stock. Sad though this may be, it does not send the same shock waves and ripples through the international financial system as when a major private bank collapses because of debt repudiation. The fact is that much of the debt owed by large borrowers was owed to banks and that some banks, especially U.S. banks, had become massively "over exposed".

The extent of over-exposure can be judged by the fact that for all U.S. banks taken together the debt owed by the developing countries and Eastern Europe taken together amounts to 155 per cent of their capital base. This average understates the problem because the U.S. banking system is highly diversified and includes a large number of small banks that do not really have any significant international presence. If the ten largest U.S. banks are considered as a group, then the debt of the developing countries plus Eastern Europe to these banks is 300 per cent of their capital base.

The combination of the debt service difficulties from the point of view of the borrower and the extra-ordinary vulnerability of the private financial banks to any kind of debt collapse is what has contributed to a widely shared perception of the debt problem as a crisis situation, a perception that exists not only in the South but increasingly in the North also. And there are certain good reasons why this should be so, because if there was a collapse on the debt front in the form of major defaults the capital base of the leading banks would simply be destroyed. Keynes' aphorism has come to life : "If you owe the bank £1 you are in trouble but if you owe the bank £1 million the bank is in trouble"; and today the leading northern banks are indeed in deep trouble.

## II. Origins of the Problem

Let us now turn to the second question around which I had promised to structure this discussion: how did the developing countries get into this difficulty?

In order to understand how the debt problem arose and grew to crisis proportions it has to be set in the context of global economic developments over this period. Debt cannot be viewed in isolation of the levels of economic activity in individual countries, the evolution of patterns of trade and deficits and surpluses. Any starting point will be arbitrary to some degree but there is some rational basis for beginning the story in 1973 at the time of the first oil shock because this was an event which saw a sharp deterioration in the terms of trade of oil importing developing countries and initiated a period of fairly large current account deficits which were financed by an increased resort to borrowing.

I hasten to add that I do not mean to blame everything that has happened in the seventies and later on the increase in oil prices. Many of the ills of the world economy including the emergence of inflationary pressure in the industrialised countries had their origins in developments which took place before the first oil shock. The oil price increase itself was also justifiable in terms of the economic criteria that should go to determining the real price of a scarce and dwindling resource, though there can be little doubt that a more gradual adjustment would have been easier to absorb. The choice of 1973 as the start of the story is simply because that was the year when most developing countries, including India, suddenly experienced a sharp rise in import costs and therefore in their external deficits.

The world adjusted to these deficits by resorting to borrowing. In retrospect it is probably fair to say that very few countries, whether in the north or in the south, resorted to a structural adjustment to the first oil shock. The industrialised countries absorbed the oil shock in the form of higher rates of inflation and the oil price did not increase very much after the first shock so that the real price of oil (in terms of the export prices of industrialised countries) declined somewhat from 1974 to 1978. A falling real price of oil helped by allowing countries to "inflate away" the oil price while in the meantime they borrowed to finance their deficits.

### ***Current Deficit of Non-Oil Developing Countries (Billion US Dollars)***

1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
11.6	37	46.5	32	30	42	62	68	109	82	56	

To some extent of course additional borrowing was a logical response to the need for financing. Many developing countries especially the so-called newly industrialised middle income countries had shown healthy growth in the sixties and had already started borrowing from the private banks even before the oil crisis as euro-currency markets had grown in importance. These countries had a potential for incurring debt and it was appropriate to do so in so far as borrowing was being used to strengthen the productive base of the economy.

Besides, additional borrowing after the first oil shock was not on very costly terms. The climate for international cooperation was much more favourable than it has been in the eighties. A substantial part of the increase in borrowing was in the form of expanded flows of external assistance and long term concessional flows from the multilateral institutions. There was a significant increase in external assistance to oil importing developing countries

from the OPEC countries. Lending through multilateral institutions such as the World Bank/IDA also increased rapidly. The IMF set up the oil facility and after 1976 the Trust Fund was established to help low income countries experiencing balance of payments difficulties.

Interest rates on commercial borrowing were not very high in this period. In fact adjusted for inflation the real interest rate was only about 1 per cent or so. Since inflation helped raise export earnings for given export volumes, it was not difficult to service commercial debts incurred at low level interest rates.

These developments were taking place in a global framework in which the world economy recovered relatively easily from the first oil shock. The industrial countries experienced a recession in 1974 and 1975 with real GNP growing by 0.6 per cent in 1974 and declining by 0.5 per cent in 1975 but then recovered to a growth rate of almost 5 per cent in 1976 followed by 4 per cent per year in the next two years. The non-oil developing countries were less severely affected and their growth rate (these figures exclude China) slowed to 5.5 per cent in 1974 and 3.9 per cent in 1975 after which it recovered to an average of 5.5 per cent in the next three years.

It is because of this relatively healthy state of world economy within two years of the first oil shock that the growing volume of debt did not pose any serious problem in terms of debt servicing. As I mentioned earlier, debt service as a proportion of total export of goods and services rose between 1973 and 1979 but not so markedly as to threaten a crisis.

This relatively comfortable position was again disturbed in 1979 when international oil prices more than doubled leading once again to a sharp increase in the current account deficits of the developing countries. Once again the developing countries responded by financing the deficits but this time the situation grew rapidly out of hand. Within three years it was apparent that many large debtor countries were in serious trouble and had to suspend payments due on outstanding debts. International banks, which in earlier years had cheerfully rolled over outstanding loans as they fell due by extending new loans, suddenly became wary of lending to developing countries and began to withdraw from the markets. This withdrawal in turn compounded problems. Throughout 1983 there was considerable doubt about whether major debtors would be able to negotiate agreements to reschedule their debts and implement effective adjustment programmes.

Why was the situation so different after the second oil shock compared with the first? The answer lies in the functioning, or should I say malfunctioning, of the world economy in this period which contributed in various ways to the emergence of the debt crisis. It is not possible in the time available to give a complete account of what went wrong and why, but I would like to sketch the main features of what is a highly interconnected story.

An important structural difference in the reaction of the world economy to the second shock compared with the first is the realisation in the industrialised countries of the North that they could not expect to adjust to oil shock simply by inflating away against it. Inflation had become a major problem in industrialised countries by the end of the seventies. The average inflation rate in these countries in the period 1963 to 1972 was about 4 per cent. It rose to 7.4 per cent in 1973, averaged 11.5 per cent in 1974 and 1975 years and stayed at about 8 per cent in the next four years. High inflation rates were becoming politically unacceptable and political changes in these countries were making a little more unemployment appear acceptable as a cost of controlling inflation.

Unfortunately the control of inflation was attempted through what is widely regarded as highly unbalanced mix of fiscal and monetary instruments. Large fiscal deficits were allowed to continue in some of the most important industrialised countries, but were combined with tight monetary policy aimed at controlling inflation. High interest rates in the United States have exerted an upward pressure on interest rates elsewhere because of the need to moderate the flight of capital to the U.S. that would otherwise have occurred. It has also led to an appreciation of the U.S. dollar well above levels that might be regarded as sustainable in the

medium term.

This stance of macro-economic policy in the industrialised world has contributed to much poorer performance of the world economy after the second oil shock compared with the first. Real GNP growth in the industrialised countries slowed to 1.3 per cent in 1980, 1.6 per cent in 1981 and declined by 0.2 per cent in 1982. This in turn led to a sharp slowdown in world trade. In the four years after 1973 the growth in world trade averaged 4 per cent in volume terms. By contrast, in the four years after 1979 the average volume growth was only 2 per cent.

Against this background the emergence of the debt crisis in 1982 can be explained in the following terms:—

- (i) Faced with a sharp increase in their current account deficits because of the second oil shock, developing countries were forced to either contract their domestic economic activity or to borrow.
- (ii) Flows of longer term finance did not expand as they had done earlier and there was especially heavy recourse to private short term borrowing. To some extent developing countries were themselves to blame for undertaking such large volumes of short term borrowing but the private international banks are also at fault for encouraging excessive lending of this sort.
- (iii) High interest rates which are the result of improper mixes of macro-economic policy in the industrialised countries have greatly added to the debt burden of developing countries. This is particularly so since a large proportion of developing countries debt incurred in the later years was on "floating rate terms" and was incurred in the expectation that real interest rates would remain reasonable.
- (iv) The portion of short term debt had increased considerably after 1976. This was itself the result of the uncertainty about inflation and exchange rate movements which probably encourages savers to prefer shorter term lending.
- (v) High interest rates and shorter maturities add to debt service obligations and this occurred at a time when export earnings were severely depressed. The slow down in world trade hurt both export volumes and also export prices realised by developing countries.
- (vi) The appreciation of the U.S. dollar, itself largely the result of misconceived macro-economic policy in the industrialised countries, has also had an adverse effect because most developing-country debt is denominated in dollars and this has greatly inflated the real repayment burden.
- (vii) Many debtor countries found that with the first emergence of difficulties there was a significant withdrawal of private banks lending to these countries which went well beyond what might be justified by the underlying longer term economic reality.
- (viii) The trading environment facing developing countries is also deteriorating with an intensification of protectionist barriers limiting access to the already slow growing markets in industrialised countries. The rise of protectionism is itself partly the result of recession in industrialised countries combined with exchange rate misalignments.

These are some of the important global influences that have contributed to the emergence of an international debt problem. I hasten to add that I do not mean to suggest that countries facing debt problems are themselves entirely blameless. In retrospect it is clear that in most cases the total exposure to external borrowing should have been more carefully regulated to ensure that debt incurred remained more closely within repayment capacity. There is certainly an important lesson in them for the future, for all countries, including those not currently burdened so heavily with external debt problems.

### III. The Indian Experience

This is perhaps an appropriate point at which to review our own experience regarding external debt. There is widespread countrywide concern, and quite rightly so, that we should exercise extreme caution to avoid entering into a debt situation that is not manageable. Fears are sometimes expressed that we may in fact be getting into such a situation. These fears are unwarranted. India is nowhere near such a danger, and for very good reasons, which I will now outline.

First, during the 1970s India did not adopt a strategy of expanded recourse to shorter term borrowing which would have led to an unmanageable accumulation of debt. Instead we adhered mainly to the normal sources of long-term borrowing that we have utilised in the past. In fact we borrowed from the IMF's oil facility in the mid-seventies, in anticipation of a financing need but were able to repay that loan in advance of the stipulated date because our external payments position improved rapidly after 1975. There are a number of reasons why this happened. During the 1970s, Indian exporters did extremely well partly because of the introduction of new export commodities which proved very dynamic such as garments and gems and jewellery. There was also a tremendous spurt in invisible earnings due to the outflow of workers to the Middle East, who sent home a substantial amount of their earnings.

In short, India did adjust to the 1973 oil shock and indeed India's balance-of-payments position before the second oil shock was in fact very strong. In this respect India differed from many other developing countries which did not make real adjustments to the first oil shock but simply resorted to additional borrowing to finance their external deficits.

Secondly, having entered into the post-second oil shock period without an excessive accumulation of debt, India has displayed a much more controlled response to the second oil shock than many other countries. First a tight rein was kept on the permitted amount of external borrowing. Under our system, it is not really possible for economic agents to run up large volumes of short term debt. The use of external financing in terms of the level of financing and also its pattern of use is determined by the government in the light of overall economic priorities. The Sixth Five Year Plan recognised that in adjusting to the oil shock it would be necessary to finance longer deficits for some time and accordingly went in for an extended IMF arrangement, under which it could draw upto SDR 5 billion over a three year period. These resources are available on favourable terms involving a concessional average interest rate and a ten-year repayment period. In addition with IMF arrangement we have also engaged in some additional commercial borrowing, but this has been strictly monitored. There is no doubt that the degree of financing that India resorted to was much more controlled than in any of the other borrowing countries.

Most important, India has achieved a very substantial structural adjustment to the external deficit created by the oil shock through efforts at increasing the domestic production of certain sectors where large import savings are possible. The most dramatic of these, of course, is oil. In 1980-81, the total production of crude oil in the country was about 10.5 million tonnes ; and the total volume of crude oil and product imports, measured in terms of crude oil equivalent, was 24 million tonnes. In 1983-84 the domestic production reached 26 million tonnes and in 1984-85 it is expected to exceed 29 million tonnes. The volume of oil imports (in terms of crude oil equivalent) as a proportion of total consumption has declined from about 70 per cent at the start of the Sixth Plan to about 30 per cent at the end.

Similar success has been achieved in the volume of imports of large and important items such as fertilisers, steel, cement and this has been made possible basically through increased domestic production. In short, the economy has not actually been denied these inputs, but there has been an increase in the domestic capacity to supply these inputs thus saving on imports. This is an extremely important adjustment that has taken place on the import front, which has enabled a reduction of the trade deficit.

Like other developing countries, India too has suffered from the adverse world economic situation in certain areas, particularly in the area of exports. Despite significant efforts to

improve the export strength and capability of the economy, it has not been easy to do so while the world remained in recession. Nevertheless, our efforts at creating export incentives and export capability are not lost. When world recovery begins, we can expect to be in a much stronger position in terms of export capability, within the limits of growth of world trade.

During this period inflows on the invisibles account have continued to be substantial. A number of incentives have been provided in recent years in order to encourage inflows on invisibles account and also to encourage term deposits in Indian banks by Indians residing abroad. These have been highly successful in stimulating an inflow of non-resident deposits. As a result of all these factors India has been able to manage a reasonably successful adjustment to the second oil shock without making herself vulnerable on the debt front. The current account deficit has declined as a percentage of GDP from a peak level of just under 2 per cent GDP in 1980-81 to about 1.5 per cent in 1983-84. The improvement in the balance of payment position was faster than expected and enabled the government to terminate the IMF arrangement in May 1984 after drawing only SDR 3.9 billion out of the SDR 5 billion originally envisaged.

The volume of outstanding debt has of course increased but it remains well within manageable levels. The debt service ratio is only about 13 per cent. It will rise in the years ahead but there is room for some increase from this fairly low level. Like other developing countries India will experience a difficult external payment situation in the rest of the decade as the prospects for world trade expansion are modest at best and there does not seem much prospect for improvement in external concessional flows. This means that we will have to plan for a modest level of deficit on the current account which can be financed within the limit of available external assistance plus such levels of commercial borrowing which keep the debt service ratio within tolerable limits. We are below these limits at present, and with continued caution on this front we can stay below them in future.

#### **IV. Towards a Solution of the Debt Problem**

I would now like to turn to some of the solutions to the debt problem that have been implemented and others that are being proposed in various quarters.

To begin with we must recognise that a solution of sorts has indeed been implemented over the past two years which has prevented an international financial collapse of the type feared in some quarters. However this is in the nature of a fire-fighting operation aimed at providing short term solutions to the problems faced by individual debtors. The main features of these rescue operations can be summarised as follows. Debt negotiations have taken place on a case by case basis with no generally agreed rules or guidelines. In most cases (but not all) the IMF has played a crucial role. Debtor countries have had to accept IMF adjustment programmes as part of an overall package. Traditionally, the IMF's seal of approval is given on the basis of a programme agreed between the country and the IMF, and this seal of approval is supposed to be useful in a country's efforts to attract capital from other lenders in separate negotiations or transactions. In the case of the recent debt negotiations however the IMF has played a much more active and coordinating role in bringing the other commercial banks on board. In fact the IMF took the stand that the Fund would *not* put in money unless the commercial banks were willing to continue lending and indeed to programme an increase in lending. This approach was adopted in the case of Argentina, Brazil, Mexico and Yugoslavia and had the effect of supplementing the \$12 billion provided by the IMF over a three year period by a rescheduling of \$45 billion of bank loan repayments together with about \$10 billion in new medium to long term loans.

The amount of debt rescheduled in these fire-fighting operations is indeed substantial. Since January 1983 more than thirty countries have rescheduled their debts. A total of \$56 billion was rescheduled in 1983 compared with a total amount of \$1.5 billion rescheduled in 1978 and \$5 billion in 1982. The rescheduling had the effect of reducing debt service payments in 1983 by \$19 billion.

The general approach is that interest payments due have not been rescheduled. Rescheduling has been applied to principal payments due and is generally restricted to guaranteed public sector debt. Banks have provided new loans to cover interest payments due. The maturities on restructured debt are about seven to eight years with two years grace and interest charged is the market rate with spreads ranging from 1/2 per cent to 1 1/2 per cent and an additional fee of 1 per cent of the amount restructured. Thus banks engaged in rescheduling have been able to show healthy earnings to their shareholders even as they are locked into assets which are far from attractive from a market point of view.

What is wrong with this situation? The basic problem arises because these rescheduling exercises have only deferred the burden of debt servicing without effectively reducing it or increasing the capacity of debtor countries to meet debt service obligations. In fact debt service obligations for these countries will increase very substantially once the grace period is over, but there is little confidence that the adjustment programmes adopted will, even if adhered to, actually ensure that debtor countries will be able to meet debt service obligations.

The adjustment programmes are aimed at achieving a massive improvement in the trade balance of debtor countries and in this they have achieved some success in the short term. The countries with the largest bank debt such as Mexico, Brazil, Venezuela, Chile, Yugoslavia, Nigeria, Peru, Ecuador and Turkey have shifted from a deficit of \$45 billion in 1981 to a surplus of \$25-30 billion in 1983. But this improvement has been achieved essentially by a massive reduction in imports effected through drastic domestic austerity measures. This has immediate social and economic costs in terms of output and employment and the resulting decline in standards of living of large sections of the population raises doubts on whether such measures can be sustained. What is more, it is not at all clear that the adjustment programmes are capable of bringing about the structural change that is needed to ensure a resumption in growth in the near future. Most of the adjustment programmes depend for their medium term success upon a healthy growth in exports being achievable. It is not clear that this export growth can be achieved, at least not by all countries, in view of the uncertain prospects for world trade. Besides the reduction in investment

in many of these countries may actually reduce export capability in the longer run. Because of these considerations, there is understandable doubt whether the large debtor countries, and the banks that are holding their debts, are well and truly out of the woods.

If the present arrangements are unsatisfactory for the large debtors, they are of course hopelessly unsatisfactory for the small ones. International attention has been focussed largely on the problems of the large debtors because this is also the problem of the international banks. The debt problems of the small low income countries on the other hand have been largely ignored. Yet many countries in Africa have debt service ratios that are quite high. The average for Africa is 25 per cent and many are above this level. Considering that many of these countries in any case have very limited access to world markets high debt service ratios pose serious problems in terms of severely squeezing the future availability of resources.

Can we see a way out from these difficulties? This is a subject on which one can only offer tentative suggestions. A recent report by a Commonwealth Group of Experts entitled "The Debt Crisis and the World Economy" outlines a number of possibilities. The Report of the Group of Five NAM Experts on Reform of the International Monetary System also goes into these issues. There is considerable agreement in these reports that a lasting solution to the debt problem would require the following:

To begin with, it is important to recognise that the debt problem of developing countries probably cannot be solved in isolation from the prospects for growth in the world economy. As long as the world remains stuck with low rates of economic growth, world trade is depressed, and its future prospects remain uncertain because of rising protectionism, it is difficult to see how debtor developing countries can use the time bought by the short term rescue packages negotiated in the past year or so to achieve a more sustainable medium term adjustment.

Ideally, debtor countries should be able to "grow out of their debt problems". This means they must be able to maintain healthy rates of economic expansion while at the same time keeping consumption and domestic absorption in check so that additional output can go to improving their external accounts through improved export performance.

Such an adjustment, which protects the growth process, can only take place if the international environment is one of robust growth with a healthy expansion in world trade. Without this, debtor countries may not be able to achieve the expansion in their exports that is needed if they are to service their external debt without having to squeeze their imports and investment levels drastically. The present international environment is far from congenial from this point of view. For example, it has been reported that the adjustment programme adopted by Brazil requires a 9 per cent volume growth in exports to restore external account viability. The question arises whether any set of domestic policies can achieve a 9 per cent volume growth in exports by large numbers of countries if world trade expands by only 5 per cent because of policies currently followed by the industrialised countries. One country can perhaps always do better than the average, but only by eating into the export share of others, which creates its own problems.

The pace of economic recovery and trade expansion in the world is, therefore, crucial for a successful solution of debt problem and in turn depends on the stance of macro-economic policy in industrialised countries. Thus far, these policies have not been conducive to a broad based expansion in the world economy. This has to change. We need a resumption of growth in the industrialised countries based on better coordination of macro-economic policy, lower rates of interest, correction of exchange rate misalignments, and a rollback in protectionism in the industrialised countries.

These improvements in macro-economic management in the industrialised countries are essential but they are probably not enough. Many debtor countries will still not be able to meet the heavy burden of debt servicing that has accumulated even in conditions of world recovery. For these it may be necessary to consider mechanisms for orderly rescheduling of debt so that debt service payments can be kept in line with export capacities. The following are some of the proposals being discussed in various fora:—

- (i) Rescheduling exercises should be of the multi-year type covering all debt maturing in the next three to five years. This reduces the uncertainty associated with the present year by year treatment.
- (ii) Maturities for the rescheduled debt should be made considerably longer than the seven to eight years currently being negotiated. Some debtor countries have talked of 20 to 25 years maturities.
- (iii) Interest rates should be "capped" to prevent wide fluctuations in interest payments. The idea is that if interest rates rise above some level then the additional payment due should be capitalised in one way or another. An alternative approach suggested in the Cartagena consensus arrived at by Latin American debtor countries is to limit interest payments to a certain percentage of exports.
- (iv) The above proposals are essentially restructuring proposals which do not involve any write off of loans but aim at lengthening maturities, often very considerably. There are limits to the amount of restructuring that commercial banks can allow while keeping the loans on their books. To tackle this problem suggestions have been made from some quarters for the creation of a new international institution which would buy the developing country debts at a discount from the commercial banks and then restructure the debts. Alternatively Central Banks in industrialised countries might "bail out" their own banks in this way, without creation of a new international institution. All such proposals, which include a mechanism for supervision of debtor country performance in repaying restructured loans, usually take the form of IMF supervision. The main point about these proposals is that they establish that creditor banks will have to take some

losses.

- (v) Along with restructuring of old debt it is also essential to maintain the flow of additional finance to developing countries in debt. Industrialised countries have a very important role to play in creating a climate in which commercial banks will continue to lend. They are also directly involved in determining the flow of export credit which is an important source of finance for many countries. Equally important is the role of international financial institutions such as the IMF and the World Bank. An expanded flow of resources from these institutions would add to confidence in the international financial system and its ability to meet temporary crisis.
- (vi) Finally there is a need for an agreed multilateral framework for handling debt crisis situations. Thus far we have seen case by case rescue operations with no broad framework of medium term perspective within which solutions are to be sought. The international community needs to evolve such a framework in the near future.

These are some of the elements which must go into designing a viable and lasting solution for the debt problem of developing countries. I do not propose to go into the question of how these elements can be put together into a workable design. That is a matter for detailed evaluation of alternatives and, where institutional changes are involved as they may well be, detailed negotiations. As the Report of the Commonwealth Group of Experts put it "any workable arrangement is likely to be eclectic in character combining several of the more attractive features of the prototype schemes, by dealing simultaneously with the debt 'overhang', new lending and strengthening the banking system against the possibility of major shocks".

Finally, Mr. Chairman, I would like to remind this Group that the debt problem is only one aspect of the problem of financial flows facing developing countries. To some extent countries that have not got into an unmanageable debt situation are countries which have exercised conscious restraint in their exposure to international borrowing. Their need for financial flows remains large. It is essential that as we think of changes in the international financial system designed to tackle the debt problem we should set the financial needs of debt ridden countries in a wider framework which also takes due account of the financial needs of other developing countries. The industrialised countries seem much more concerned today about the debt problem because the stability of their own financial institution is directly involved. This concern, born of self interest, needs to be widened into a broader concern for reform of the international monetary and financial system. Self-interest is relevant here also, but it is less immediately apparent. What we need is a large dose of foresight and a larger vision. Unfortunately, these are commodities in somewhat short supply in the international community at present.

## **Comments from the Floor and General Responses**

### **Comments**

1. I must join the Chairman in complimenting Montek, because this has been a very impressive performance, giving an overall picture in such a short time.

However, I don't agree with some parts of it, obviously. A point I would like to clearly state is that if one considers the pattern of lending in the earlier period and the countries involved, there is no question but that there was a political role which certain countries, particularly the USA, were playing in this regard. And I would say that what is astonishing is that today the American policy is to treat the crisis as over. But as you very correctly point out, the crisis is *not* over: all that has happened is to postpone it. But the argument is being used, in fact, to show that no structural change, either in the IMF or International Lending Corporation, is needed. In fact, what is being suggested is a larger magnitude of commercial loans: even for those countries which were earlier dependent on institutional loans. The Philippines and South Korea, which you have not specifically mentioned, are included in that set.

Obviously there is a small group of countries—the USA, Japan, to some extent Germany—that are being made to participate in this game; certain types of political arrangements are being made. When the IMF, or BIS, or any other mechanism is put forth, the role of those national governments is apparent. The Japanese government, for instance, has taken the responsibility of rescuing the Philippines partly because the Bank of Tokyo and Fuji Bank have, between the two of them, the largest exposure in that area. If that is true, then my suspicion is—and this is where I question the general drift of your argument—that the developed countries, particularly the USA, are going to opt for an exclusive case-by-case operation, using this particular crisis for establishing a certain type of relationship which they regard as being in their own national interests. Therefore, my suspicion is that in this particular type of crisis, they are not as interested in resolving it in the way that you have in mind: namely that a smooth solution emerges; exports increase; growth takes place, both in the developed and the developing countries; restructured World Bank and IMF loans and credits happen. My suspicion is that their interest does not lie in that direction at all.

Their interest lies in a system that does not threaten the existing system, that does not create a crisis for them—and nevertheless enables them to stage manage the system.

2. I have the same kind of point, so you might answer both questions together.

You may recall that in this hall, about eight or nine months ago, Mr. Urquidi gave a lecture on "Latin American Development". The cases you have cited, except for Poland, happen to be in Latin America. And the point that he made was that the whole development of Latin America, which had been planned by a U.N. body over a period of years, had been distorted : in the sense that, unlike many developing countries, including our own, the rate of foreign investment by private firms, banks, etc. was tremendously high; the whole picture of development was wrong; and the mess in which they had landed, namely, the debt problem which you are talking about, was partly due to this. You yourself referred to the fact that this debt problem had to be looked at in the light of the development pattern in the developing countries also. You might like to bear that in mind when answering this question.

3. One of the election platforms of Argentina was that they were going to seriously investigate the debts contracted by the Generals since 1978. Apart from the Falklands war, convincing evidence is now available to show that a lot of Argentinean banks abroad had contracted debt beyond the published figures. Now where this money went and how this money was spent will be known.

Second, if you take Mexico under Lopez Portillo—before the time of Miguel de la Madrid, another Mexican economist committed to self-reliance very much in the way some of us are here—money was doled out to about 42 sick industries, many of whose Directors were relations of Lopez Portillo. Now the situation sounds very similar to current affairs at home! Then, the way money was spent by the Portillo government on a variety of items, whether they were really in the interest of Mexican development, is seriously in question. A similar situation prevails in Brazil in the last four years: namely, the debts contracted by the government are way beyond its means. In the case of Poland, the situation is very unique. The \$30 billion which the Poles owe has been very largely the result of the falling productivity at home — which, in turn, has been the result of the peculiar political situation in Poland since 1980.

So that is the political side which I think should be borne in mind when discussing the debt problems, or the economic problems of many Third World countries. One has to remember the actions of a number of Generals and venal politicians. And there is no need to hold the North responsible for all the problems.

Next, I would like to know why South Korea and Taiwan, whose exports, in comparison with their GNP, are far greater than those of either Argentina or Brazil, why is it that they don't have that serious a debt problem as the Latin American countries ?

I would also like to comment on the solution. I think you are right in saying that the

solution proposed is not a solution, but simply a palliative—to put up these rescue packages and hope that the problems will be sorted out in the next three or four or five years. But there is another side to it, and I see a great compulsion towards a serious rethinking of the International Monetary System. Now if you take a conservative economist like Paul Walker—he says that because of recession, or because of this economic slump in Latin America, 22 per cent of the American exports to these countries in the last three years have slumped. He certainly would not want a conference on monetary arrangement, that's true. But the problem is this: that in the next two or three or four years, this rescheduling of debts is not going to solve the major problem, which is that the United States, like West Germany, is highly dependent today on exports to these fast-growing countries. All the ten countries you have mentioned are really fast-growing countries. Now the U.S. etc., are dependent on exports to these countries and something has to be done, simply because, as Fred Bergsten, who was earlier in the Carter administration, said, American economic health is today vitally dependent on the health of Mexico and Brazil. There is just no way out.

So, don't you think that over a period of time, regardless of the policies of the present administration, there is a compelling need for a larger solution, apart from just debt rescheduling?

4. I am not as optimistic as you are of the Indian scene. For me, looking at 1986, which is now two years around the corner, when we have to make our repayments to the IMF, Rs. 3100 crores will be the debt service for that year; and, at that time, the balance-of-payments deficit will also be in the range of Rs. 3000 crores, I do not see how we are going to honour these commitments (our exports will never pay for our imports) without contracting further loans—concessional or non-concessional. This is just one facet of the domestic scene which disturbs me, and I wish I could share your optimism.

The other question I have is: shouldn't we treat the problem of the ten countries concerned somewhat differently from the other non-aligned countries ; that is, not combine all into one package, calling it "International Debt Problem"; because that is exactly the game that they— those who want to perpetuate the kind of servitude that the first speaker referred to— would like us to play.

### ***Response by Dr. Ahluwalia***

This has been a most interesting discussion and I am in agreement with much of what has been said. There are a few points however on which I would like to comment.

First of all, let me say a few words on the attitude of the industrialised countries. It is quite true, as one discussant pointed out, that the U.S. Administration does not share my vision of what is needed in terms of international monetary and financial cooperation to solve the debt problem, and more generally to provide expanded official and multilateral flows to developing countries. Other industrialised countries also are, on the whole unresponsive though some of the smaller industrialised countries are broadly supportive. Underlying the lack of response from the industrialised countries as a group is a strong preference for private financial flows rather than official flows and increasingly for bilateralism rather than multilateralism. I also agree that at root, these positions are reflections of broader political perceptions and objectives.

However, it is one thing to say that industrialised countries do not perceive the reform we are talking about, as being in their interest and quite another to say that they are in fact not in their interest. If the world has indeed become interdependent, as it has, and if it consists of nations rich and poor in which the poor nations cannot be subjected quite as easily today as in earlier times, then I think the world has no alternative but to look for cooperative international solutions. This will happen whether the industrialised countries like it or not but cooperation will bring it about more smoothly for all concerned. The realisation of interdependence and the need for cooperative multilateral solutions had been growing over time, but in recent years it has received an unfortunate setback at least as far as the official position of the major industrialised countries is concerned.

Even here, there has been some movement towards co-operation and multilateralism when self interest became clearly perceived. Two years ago the United States was espousing the view that there was no need for a quota increase in the IMF, there being more than enough liquidity in the private financial markets of the world. On this view countries that were unable to obtain finance simply were not credit worthy and should learn to do without. The eruption of the Mexican debt crisis late in 1982 led to a realisation that private financial markets would not solve all financial problems and there was an important role for multilateral institutions such as the IMF. This produced a quick turnabout in the U.S. position and the IMF's resources were replenished in the Eighth Quota Review. The replenishment was much less than was needed, but the point I am making is there was forward movement when it became clear that the IMF had a role to play and things could not be left entirely to the functioning of the private financial system.

Unfortunately a complacency of sorts has again developed with the implementation of various debt rescue packages, which have staved off an immediate collapse, and the existence of an international recovery of sorts in 1983 continuing into 1984, from the deep recession of 1982. The developing countries, and many other observers have taken the view that these are short term gains which will not be sustainable unless something more fundamental is done. If we are proved right, we can expect that perceptions in the industrialised world will also begin to change. Let us hope this happens before the world economy is sent into a serious tail in spin from which recovery might prove both difficult and unnecessarily costly.

One discussant pointed out that in many cases loans that were contracted by developing countries were not really in the interest of the countries, and in this connection reference was made to wasteful expenditure financed by external borrowing. In the view of the discussant, this showed that the problems of the developing countries were not entirely due to the actions of the North. I would agree that the debt problems faced by many developing countries are not solely due to the actions of the North. Better anticipation and prudent debt management on the part of the debtor countries would have left them in a much better position than the one they face today. It is also true that a part of the debt incurred was for purposes other than those which contribute to the development of a productive base, and this only made the management of external debt that much more difficult. By contrast countries that have shown good economic management—and I would include India in this category along with the other examples cited—have avoided serious difficulty. Part of the debt problem is undoubtedly due to management failures, but my point simply was that the problem has also been exacerbated by developments in the world economy. This included high interest rates (much higher than developing countries had anticipated when they incurred the loans), dollar appreciation, financial insecurity in the international private banks, collapse in export prices etc. It is these developments, as much as excess borrowing and wasteful expenditure, that have transferred a debt problem into a debt crisis.

Finally let me also comment on the concerns expressed by one discussant and our own debt servicing problems. It is certainly true that our debt service ratio will rise in the next five years as we begin to repay the loan undertaken in recent years which were of relatively shorter maturity. However the important thing is that even with this increase, the debt service ratio will remain within tolerable limits. This is especially so if export performance in the years ahead can be improved and if we continue to keep a close watch on the debt situation to ensure that exposure to additional borrowing remains strictly within the limits of prudent debt management. I think we can ensure that these requirements are met.