

# Managing the Debt Crisis in the 1990s

*The resumption of sustained economic growth should take priority*

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**T**he goal of the debt strategy is often described as facilitating the return of debtor countries to normal and voluntary access to the international capital markets. Indeed, with this in mind, creditors interpreted the situation, in the immediate aftermath of the 1982 debt crisis, as one of temporary illiquidity. Debt restructuring agreements with both private and official lenders, therefore, essentially focused on adjusting debt service to help countries cope with higher interest rates and worsened terms of trade. Under these circumstances, the debtors that pursued strong adjustment policies had little choice but to restrain imports and raise exports. In the process, they generated trade balance surpluses, which enabled them to meet their debt-servicing obligations.

These adjustments, however, were made at a high price. Investment and output levels have fallen, domestic consumption and wages have been compressed, and governments have frequently financed their budgets through inflationary means. As a result, most of the countries in Latin America and Africa now look back at almost a decade of lost growth. Moreover, even for those countries that managed successfully to tighten their belts, the restoration of normal market access has proved to be frustratingly elusive.

It is now becoming clear that after a debt crisis of the magnitude experienced in the 1980s, a new approach for the 1990s is needed to break this debilitating pattern. With the original goal of the debt strategy still far out of reach, we should revise our goal for the immediate years ahead, concentrating instead on the return of sustained economic growth in the debtor nations. We are still a long way from the end, and many more

problems will be encountered en route. But major strides have been made during the last year. A framework for handling commercial debts—the Brady plan—is in place, and the official indebtedness of the poorest countries is being tackled with a variety of initiatives.

## Current debt picture

In assessing where we stand as we enter the 1990s, it is useful to take a look at the experiences of those developing countries that have not had to reschedule their debts through multilateral arrangements in the past seven years. This group, which includes 61 out of 111 developing countries, is concentrated in Asia and embraces most of the developing world's people and most of the world's poor. They have enjoyed continued access to voluntary international capital flows from private as well as official sources. Their economies have tended to grow rapidly, with average per capita growth rates of 4 percent since 1980—equal to or surpassing the growth rates of the 1960s and 1970s.

Why did these countries manage to escape the debt crisis, while others operating in the same global economy did not? There are several reasons for the relatively successful performance.

- First, they were generally less affected by the external shocks of the early 1980s. Being typically less heavily indebted, they did not suffer as much from the sharp increase in real interest rates; being less dependent on commodity exports, they were able to better withstand the decline in commodity prices. The lesser dependence on commodity exports of some of the Asian economies—particularly those in East Asia—reflects in part the outward-oriented

policies that they pursued. When the global recovery began in 1982, they were able to take advantage of the rapid expansion of manufactured goods exports, raising export earnings sufficiently rapidly to reduce their debt/export ratios and escape the debt crisis.

- Second, they treated the exogenous shocks as permanent and promptly undertook adjustment, thereby avoiding recourse to excessive foreign borrowing. By contrast, those that considered these shocks to be temporary aberrations and postponed adjustment—continuing with normal levels of expenditure financed by external borrowing—now faced severe payment difficulties as the borrowed resources were used mainly for consumption. Clearly, countries must be prepared to react rapidly and sharply to negative shocks.

- Third, they followed relatively cautious macroeconomic policies in the 1970s, thereby avoiding high inflation. Simultaneously, they made productive use of borrowed external funds, eased infrastructural bottlenecks, invested in human resources, expanded productive bases, and did not allow public sector enterprises to run massive deficits.

These attributes of good economic management will remain as necessary in the 1990s as they were in the 1980s if these countries are to maintain their good growth performance. They also point to the policies needed to restore growth and development in the 50 or so developing countries that have been hit hard by the debt crisis.

The severely indebted nations are by no means a homogeneous group. They differ in level of average per capita incomes, severity of debt burdens, quality of adjustment efforts, resource endowments, and economic struc-

tures. The design and application of any debt strategy, therefore, must take these differences into account.

About half of this group—the low-income countries, which are concentrated in Sub-Saharan Africa—suffer from deeply rooted structural weaknesses in their economies. They generally have weak financial and infrastructural bases, with export sectors that are heavily dependent on primary commodities. The economic policies and economic management pursued in the past have accentuated their problems. They also suffer from low nutritional and educational standards, exacerbated by rapid population growth. Their debts, totaling roughly \$107 billion, are owed chiefly to official creditors.

By contrast, the severely indebted middle-income countries are better endowed with higher skilled work forces and developed industrial bases. But with debts totaling about \$517 billion, they have become the focus of much of the discussion on the global debt strategy—especially given the dramatic impact of the debt burdens on their growth (see chart). Unlike the low-income countries, most of their debt is owed to commercial creditors, and for that reason, they are in a position to benefit from the Brady initiative.

**Commercial debt.** The Brady initiative, which was launched a year ago by the US Treasury Secretary, following proposals on the same subject from France and Japan, is primarily aimed at helping debtor nations maintain growth-oriented adjustment programs. The main mechanisms are various forms of debt and debt-service reduction—including debt buybacks, exchange of old debt at a discount for new collateralized (secured by assets) bonds, and exchange of old debt for new bonds at par value (with reduced interest rates)—along with policies to encourage repatriation of flight capital and foreign direct investment. Commercial banks are expected to provide debt reduction and new money, as well as temporarily and conditionally reduce the terms at which the current debt was contracted. The IMF and World Bank are expected to provide up to \$20–25 billion, divided roughly equally for use in reduction of principal and reduction of interest payments.

Already, Brady-style agreements have been reached for four countries—Mexico, the Philippines, Costa Rica, and Venezuela—all of which have made progress in adjustment. The agreements differ markedly in detail, however, reflecting the particular circumstances of each country, the priorities of the authorities, and the diverse interests and domestic tax, accounting, and regulatory regimes under which the commercial banks operate. For Mexico, there will be an infusion

of new money, as well as debt and debt-service reduction through exchanges of new for old debt at preferential terms. The Philippines will also receive fresh inflows, combined with a significant amount of debt reduction through debt buybacks, whereas Costa Rica has preferred to emphasize an eventual settlement of its commercial bank debt, not eager to undertake new commercial bank borrowings anytime soon. The March 1990 Venezuelan agreement represents an important step forward, as the commercial banks had expressed extreme pessimism about the possibility of reaching an agreement during most of the bargaining process.

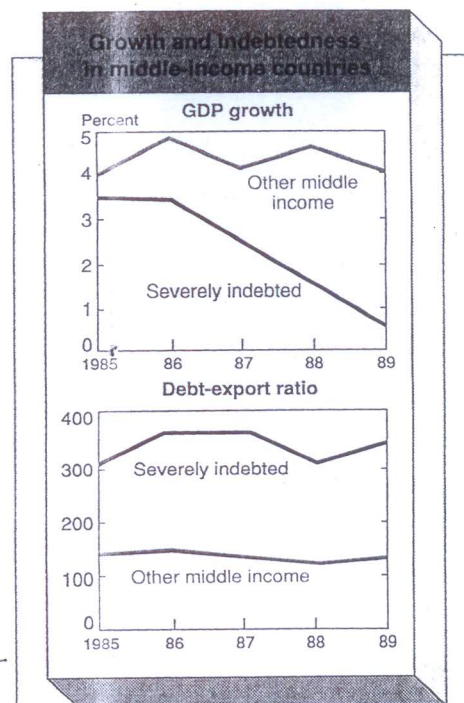
None of the negotiations has gone smoothly, which should not be surprising

given the high stakes involved. In fact, the Mexican agreement was only reached with the active involvement of the US government. It is quite possible that similar intervention by official agencies will be needed to bring about other accords, in order to achieve a convergence of the often wide differences in interests among the parties.

Of course, not all the major debtors will be receiving Brady treatment in the next few years, as some will not seek officially supported debt reduction and some of them still have a long way to go in adopting the prerequisite stabilization and adjustment programs. But through the Brady initiative, the international community can offer extra incentives to those contemplating adopting strong policies while fearing the short-run adjustment costs. Moreover, the Mexican case underscores the potential boost to growth that can come from a proper adjustment program, together with a reduction of the debt “overhang” (essentially, the unserviceable portion of the debt) and consequent improved investor confidence. After the signing of the Mexican agreement, the domestic real interest rate dropped 20 percentage points, in large part thanks to a return of flight capital and a change in perceptions about the risk of doing business in Mexico. Such a decline would, if maintained, result in a much larger stimulus to growth than would be forthcoming from the direct effect of reduced interest payments.

**Official debt.** Progress has also been made on official debts, following the swift implementation of an initiative benefiting low-income African countries announced at the 1988 Toronto summit of major industrial country leaders and subsequently implemented by the Paris Club. Creditors can choose from a menu of rescheduling options, including a significant forgiveness of the amount rescheduled, a reduction in the interest rate on the rescheduled amount, and an extension of the grace period and maturity. By December 1989, 15 Sub-Saharan African countries had obtained rescheduling on these terms, and although the initial cash flow relief has been relatively small, its importance should not be minimized. The process slows the debt accumulation, while the benefits of cash flow reduction build over time. As important, the principle of concessional reschedulings of official bilateral claims has been established for severely indebted low-income countries with sound adjustment programs.

Besides the Toronto measures, a number of other steps have been taken to assist low-income countries. One dramatic gesture was a sharp increase in the forgiveness of official development assistance loans (ODA) to countries in Sub-Saharan Africa. The



Source: World Bank.

**Note: Severely indebted middle-income countries** are those in which 1987 GNP per capita was more than \$480 and less than \$6,000, and in which three of the four key debt ratios are above critical levels. These ratios and their critical levels are debt to GNP (50 percent), debt to exports of goods and all services (275 percent), accrued debt service to exports (30 percent), and accrued interest to exports (20 percent).

The countries in this group are: Argentina, Bolivia, Brazil, Chile, Congo, Costa Rica, Côte d'Ivoire, Ecuador, Honduras, Hungary, Mexico, Morocco, Nicaragua, Peru, Philippines, Poland, Senegal, Uruguay, and Venezuela.

**Other middle-income countries** are those in which 1987 GNP per capita was more than \$480 and less than \$6,000, and in which less than three of the four key debt ratios are above the critical levels described above.

They are: Algeria, Bahamas, Barbados, Belize, Botswana, Cameroon, Cape Verde, Colombia, Cyprus, Djibouti, Dominican Republic, Egypt, El Salvador, Fiji, Gabon, Greece, Grenada, Guatemala, Jamaica, Jordan, Korea, Lebanon, Malaysia, Malta, Mauritius, Oman, Panama, Papua New Guinea, Paraguay, Portugal, Romania, St. Vincent, Seychelles, Solomon Islands, Swaziland, Syrian Arab Republic, Thailand, Tonga, Trinidad & Tobago, Tunisia, Turkey, Western Samoa, Yemen Arab Republic, Yugoslavia, and Zimbabwe.

United States announced that it would forgive \$1 billion of these loans beginning October 1, 1989, France has indicated that it will forgive \$2.3 billion, the Federal Republic of Germany has already canceled \$1.5 billion, and Canada plans to write off more than \$425 million. Again, the cash flow relief from these measures is not necessarily large—these debts carry low interest rates and, in many cases, the payments coming due would likely have been rescheduled at concessional terms—but the forgiveness has the effect of immediately and obviously reducing the debt of these countries, as well as contributing to a slowing of the debt build-up.

In 1989, the World Bank also set up a new facility of \$100 million—the Debt Reduction Facility—which will be funded by the Bank's net income to help certain low-income countries repurchase commercial bank debt. Up to \$10 million per country will be made available on a grant basis if the debt repurchase meets the test of contributing significantly to growth prospects. So far, two countries—Bolivia and Mozambique—have benefited from the facility. To qualify, countries must be eligible for assistance from the International Development Association (IDA), the Bank affiliate that provides concessional financing to its poorest members.

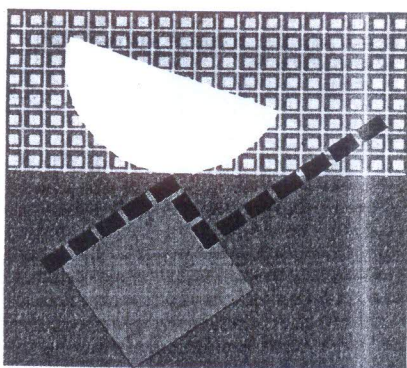
These programs—combined with the Bank's Special Program of Assistance for Africa, the Bank's program for IDA debtors to refinance IBRD interest payments, and the IMF's structural adjustment facility and enhanced structural adjustment facility—have helped achieve a level of net resource inflows in many low-income African countries consistent with a resumption of growth. Moreover, the highly concessional loans and grants provided to these countries have become better attuned to the economic conditions of the recipient.

### Future evolution

The challenge ahead is to build on the progress that has taken place on the commercial and official debt fronts. The current debt strategy rests on three pillars: a favorable international economic environment, strong and sustained adjustment efforts by indebted countries, and adequate flows of external financing. The combination of these three essential elements can pave the way for the restoration of sustained economic growth.

**Economic environment.** Industrial countries have the responsibility for creating a favorable external environment that can help resolve the debt crisis. Central to this action is to improve, rather than constrain, the openness of the international trading system, especially given their entirely appropriate emphasis on outward-oriented development

strategies. Increased use of nontariff barriers would create undesirable obstacles. The successful completion of the Uruguay Round is essential. In addition, the continued high real cost of external debt would exacerbate debt-servicing problems. For example, a two-percentage-point increase in international interest rates would completely wipe out the maximum amount of debt and debt-service reduction that could be achieved under the new strategy, leaving borrowers with an additional \$30–35 billion to service just from the debt reduction operations (see *World Debt Tables 1989–90*, World Bank, p. 4). High real interest rates are largely the result of low private saving and—in aggre-



gate—a poor macroeconomic policy mix in the industrial countries, where the inflationary effects of loose fiscal policies will have to be contained by tight monetary stances.

**Strong and sustained adjustment.** Economic adjustment policies in the indebted countries will also remain critical. As official debt begins to replace commercial debt, the debt structure itself becomes more inflexible. This increasingly leaves little room for future economic policy slippage by debtors, meaning rapid responses will be required to external shocks—an additional reason to emphasize the need for adequate policy reforms and economic management as part of any debt and debt-service reduction operation.

Domestic policies will also be essential for helping to restore investment to the levels needed for sustainable growth. Given the continued stagnation in international capital flows to many indebted countries, they will necessarily have to rely more on their own saving and on policies designed to attract flight capital. The surest way to increase domestic saving is to cut budget deficits. However, the availability of savings does not guarantee that investment will take place. Macroeconomic stability, combined with microeconomic measures to remove impedi-

ments to efficient investment, as well as an environment that welcomes foreign direct investment, will remain the key policy ingredients of an economic recovery.

**External financing.** The large resource transfers from debtors to creditors in the 1980s need to be reversed, but commercial bank lending on the scale of the 1970s is inappropriate and unlikely to be available. For some time now, banks have been withdrawing from balance of payments lending to the severely indebted countries, an inevitable result of the simple fact that they were overextended in these countries. So where else can these debtors expect to turn for help?

- One possibility is official development assistance. But the trends in ODA growth—in spite of the welcome generosity currently evident in Japanese development assistance—do not indicate that ODA will fill a major part of the funding needs of developing countries, certainly not beyond those of the poorest. Moreover, ODA resources are not even available for most middle-income developing countries.

- Foreign direct investment may be more promising. It provides resources in a manner that shares the risk between the host country and the country of origin, bringing with it foreign technology and management skills. Two Bank affiliates—the International Finance Corporation and the Multilateral Investment Guarantee Agency—can help increase the flow of foreign direct investment; the latter has recently issued its first guarantees. Furthermore, as developing country capital markets deepen, equity investment may play a greater role in development finance.

- Multilateral official lenders no doubt will continue to take a growing share of exposure to heavily indebted countries. Many bilateral official lenders, especially export credit agencies, have reduced their net flows to these countries, and it would be most useful if they could expand their lending once again.

- Creditors and developing country borrowers should consider new forms of financing as well. To be successful, these innovations should take advantage of natural risk-sharing matches. For example, commodity-price-indexed bonds may provide useful long-term hedging opportunities for commodity consumers and producers alike, reducing the risks of debt default and renegotiation. For countries that are already creditworthy, the Bank recently launched an experimental expanded cofinancing program designed to match developing country borrowers with appropriate lending partners. Once troubled debtor countries return to creditworthiness,

they will also be eligible. In addition, commercial lenders should find project-based lending to some of these countries attractive.

• As financial stability and growth prospects in the debtor countries improve, some of the flight capital will return; in certain instances, as with Mexico, this may occur quite quickly. But the bulk of what returns will come back only slowly. While most of the capital held abroad by residents of the heavily indebted countries ought to return, we should not expect all of it to return, for sensible portfolio diversification implies that some assets would normally be held abroad.

### Country specific approaches

Although the three elements of the debt strategy described above are required in general, their detailed application must be dictated by country circumstances and the likely behavior of the various creditor groups.

For the large group of developing countries that have managed to service their debts and retain access to international capital markets through the pursuit of responsible policies, the approach should be twofold: providing the necessary support to prevent debt-servicing difficulties from emerging, and maintaining market confidence. The low-income countries in this category deserve continued and expanded concessional flows of funds to maintain growth rates, alleviate poverty, and diversify productive bases. Any diversion of resources to support other ventures would create harmful effects on their vast populations.

Another group—which includes countries such as Colombia and Chile that have made considerable progress in resolving debt problems in recent years—does not need exceptional balance of payments finance, except perhaps commercial bank loan refinancing. In the near future, Mexico, the Philippines, Uruguay, and Venezuela may be able to join this league, provided they maintain the present pace and intensity of economic reforms and restructure existing debt. At that stage, they should be able to adopt appropriate liability management techniques to better manage currency and interest rate exposure and reduce finance costs.

There are also countries that have yet to put in place a realistic and sustainable program of economic reform. As things now stand, they will be left out of the strengthened debt strategy and continue to carry a heavy burden of external debt until they achieve the political will to adopt the necessary adjustment measures. For such countries, the main thrust should be to persuade them to undertake credible and lasting economic policy changes that can make them eligible for debt and debt-service reduction.

Between these extremes are countries—such as the Congo, Côte d'Ivoire, Ecuador, Morocco, and Nigeria—which are moving in the right direction, gradually undertaking policy and institutional changes that will provide more flexibility to the economic structure. But this group of countries cannot rely on commercial bank financing, at least in the 1990s. While their private sectors should receive commercial bank trade and project financing and investment loans, the volume is likely to remain limited relative to external financial requirements. They will need, for quite some time, increased multilateral and bilateral assistance; for some, a blend between concessional and nonconcessional flows.

The debt-service problems of low-income severely indebted countries, particularly in Africa, remain very difficult. Existing tools may need to be improved and expanded, and in some cases, new tools may be called for. The impact of the concessional rescheduling terms agreed at Toronto needs to be evaluated and appropriate changes made, if required. Good policy performance and the inability to service debt while maintaining stable growth should be the main criteria for debt relief.

Finally, two sets of countries with debt difficulties fall outside the scope of the existing framework for debt reduction. The first is a set of severely indebted countries that come in the lower range of the middle-income category—such as Cameroon, the Dominican Republic, Egypt, Honduras, Jamaica, and Syria. Their debt is mainly official, limiting the usefulness of the Bank and IMF programs aimed at reducing commercial debt. Their income levels, and in some cases, their geographic location keep them outside the scope of the Bank's Special Program of Assistance for Africa and they may not be able to benefit from the Toronto rescheduling terms. Moreover, past efforts have centered on official debt reschedulings through the Paris Club on conventional terms. The success of their adjustment programs could be placed in jeopardy by their debt "overhang" unless some way of reducing their debt burden is devised, whether through new programs or special concessions on a case-by-case basis.

Another very small group of countries faces a different sort of debt problem. These countries—including Guyana, Sudan, Zambia, and a few others—have continued to hold large arrears to official multilateral creditors. Even if they adopted realistic adjustment programs, it would be difficult for the IMF and the Bank to extend the necessary external support so long as they were in arrears to these institutions. Not surpris-

ingly, therefore, their adjustment efforts are discouraged by these bleak prospects. Solutions must be found to end their economic drift. Over the past two years, efforts have begun to be made outside the debt strategy—such as the Fund's intensified collaborative approach, which uses support groups to help members with protracted overdues. At the same time, other debtor countries should take heed that neglect of debt-servicing problems can cause these problems to build, erecting an almost insurmountable barrier to sound economic growth.

### Conclusion

It is safe to say that over the past year an important corner has been turned. Of course, the debt crisis is far from over, with recovery, at best, beginning for only a few countries. Debtor nations remain vulnerable to external shocks, notably increased protectionism in their export markets, higher real interest rates, and world recession. Some will take time to become eligible for the Brady plan, and others, which have already received Brady treatment, will undoubtedly experience reversals.

But there is forward momentum. The international community and debtor countries must now keep up the pace, using existing tools to the fullest, and adding more, where needed. Moreover, the case-by-case approach, tailoring actions to the unique needs of each country, remains valid and should be strengthened. The goal of the 1990s must be the restoration of sustained growth in the severely indebted developing countries. ■



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