The Crisis of Development Finance and its Impact on Developing Economies: Trends, Issues and Policy Options

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Résumé. Dans l'article qui suit, l'auteur passe en revue les récentes tendances dans les flux financiers, discute de leur impact dans la situation financière interne et externe des pays en développement et indique les divers obstacles politiques à lever pour garantir un financement adéquat dans l'avenir.
Après avoir montré que le financement du développement traversait une crise qui se manifestait sous diverses formes (réduction des principaux composants de ces flux, chute des prêts bancaires, des investissements directs et des crédits à l'exportation), l'auteur en attribue la cause à un mauvais fonctionnement des mécanismes de transfert des ressources qui, pour résoudre cette crise, ont eu recours à des financements "d'entretien", et des prêts conditionnées par la performance macro-économique. C'est pourquoi, l'auteur estime que la stratégie globale de sortie de cette crise doit passer par une meilleure disposition des banques commerciales à consentir des prêts importants à titre volontaire et en cas de difficultés de paiements, elles doivent même pouvoir accepter des accords de rééchellonnement multi-annuel.

Introduction

The deep recession which hit the world economy after the turn of the decade markedly affected both the institutional arrangements for channelling the financial resources and the volume of such resources. Starting in 1982, commercial banks began to react to heavy debt accumulation in major debtor countries by reassessing their exposure. Budgetary pressures in many developed countries and a sharp decline in the OPEC countries' current account surplus were both reflected in the respective aid flows. Other official flows, notably export credits, also experienced a reduction as did direct foreign investment, while flows from multilateral institutions grew at a reduced rate.

The outcome of these developments was a progressive decline which affected most categories of concessional and non-concessional finance. This resulted in lower levels of gross and net flows as well as of net transfers. Indeed, in several countries net transfers have turned negative since 1983 under the combined impact of a reduction in, and increased interest payments on commercial banks' lending. The slow pace of bank lending stems mostly from most banks' reluctance to lend to the many developing countries that were already heavily indebted and/or are experiencing serious difficulties.

Spontaneously lending to developing countries was almost confined to Asia, and it has shown little tendency to revive in countries that have

recently restructured their debt. About 60% of bank lending to developing countries in 1984 and the first half of 1985 was accounted for by concerted lending - i.e. new credits extended by banks under the co-ordination of a bank advisory committee and in conjunction with the restructuring agreements and IMF-supported programmes.

A major factor in the contraction in net transfers can be traced to accelerating outflows, particularly of interest payments which offset the more hesitant growth in gross receipts of financial resources by developing countries. The outflow of debt service payments was accentuated by a rising trend in profit remittances. Profit remittances alone do not, however, fully capture the recent evolution of outflows related to direct investment since they do not take into account another type of associated outflow; transfer pricing by the transnational corporations. It must be pointed out, at this juncture, that this phenomenon is not readily susceptible to measurement and also that estimates often differ widely. However, an attempt will be made first to show the extent of resource outflows from all groups of developing countries in a bid to portray the negative effects of such outflows of their internal and external financial situation.

The over-all impact of this phenomenon on the economies of the developing countries especially as regards their internal and external financial situation - is then reviewed. In adjusting to the sharp fall in the availability of external credit, many countries were forced first to reduce their foreign exchange reserve holdings from already low levels and then to accumulate payment arrears, sometimes in anticipation of debt re-organization which had become unavoidable. The international financial system is now required to cope with the phenomenon of large and frequent payments arrears, repeated reschedulings which have caused banks and other financial institutions to lose control over the maturity of their claims, involuntary lending, costly reserve building in some countries and sharply reduced levels of reserves in others, particularly in Africa. The external financial position of many developing countries has significantly deteriorated over recent years in the face of continued deflation in the world economy, the sharp fall in non-oil commodity prices and the collapse of oil prices. The resulting increase in the need for external finance has not been met. Rather, net capital flows and net transfers have shrunk further. While there can be little doubt that increased efforts are needed in many countries to boost savings and growth performance, the fact that the effectiveness of these efforts often depends on the external environment is not always fully grasped.

Against the background of the crisis, this article also attempts to identify the policy measures which could be considered on the international policy co-operation front to resolve the current crisis of development finance. Enhanced multilateral cooperation is essential for this purpose, involving

developing countries, developed countries, multilateral institutions and commercial banks. Developing countries would need to pursue growth-oriented domestic policy reforms, with major emphasis on export promotion, enhanced domestic savings and major improvements in the efficiency of investment. Developed countries need to improve their own economic performance, thus contributing to the world economic environment, with lower real interest rates, higher commodity prices and increased market access for developing country exports. They also need to encourage higher capital contributions to multilateral lending institutions, without which multilateral institutions are unlikely to meet the challenge of playing the leading role in development finance. Commercial banks should be ready to provide substantial flows, partly in the form of voluntary lending. Where countries with severe debt problems cannot attract it, Multi-Year Rescheduling Agreements (MYRAs) remain crucial in sustaining their financial needs. For many poorer developing countries, the further writing-off of official debt is necessary. Finally, increased non-debt-creating resources should be mobilized.

The Decline in Financial Flows to Developing Countries

Trends in official flows

It is common knowledge that international financial co-operation has traditionally focussed on official flows because of their overall magnitude and their particular capacity to carry terms tailored to specific country situations. But as we shall see below, both the institutional arrangements for channelling official flows, notably export credits, to developing countries and the volume of such resources were markedly affected by the deep recession which hit the world economy after the turn of the decade. The outcome of these developments was a progressive decline which affected most categories of concessional and non-concessional finance and which resulted in lower levels of gross and net flows as well as of net transfers to developing countries.

Aid flows

Net long-term capital flows to developing countries have continued to decline since 1981 (see table 1). By 1985, net long-term inflows were approximately US$ 35.5 billion, down 52% from the high point of US$ 74.6 billion reached in 1981. For the group of heavily indebted countries, the decline has been approximately 76%, from US$42.9 billion in 1981 to an estimated US$10.1 billion in 1985.

Table 1 - Public and private long-term capital flows to developing countries, 1975 and 1980-1985 (billions of dollars)

Country group and item	1975	1980	1981	1982	1983	1984	1985
All developing countries							
Disbursements	46.4	102.6	121.9	115.5	95.3	86.8	92.9
From private creditors	31.4	75.3	91.4	84.2	64.8	54.3	55.5
Principal repayments	15.8	43.8	47.3	49.3	42.8	46.8	57.4
Net flows	30.6	58.9	74.6	66.2	52.5	40.0	35.5
Low-income Africa							
Disbursements	2.0	4.2	4.0	3.3	3.0	2.5	3.4
From private creditors	0.8	1.6	1.3	0.9	0.6	0.3	1.7
Principal repayments	0.4	0.8	0.8	0.9	0.8	1.0	2.0
Net flows	1.6	3.4	3.1	2.3	2.2	1.4	1.4
Heavily indebted countries(a)							
Disbursements	21.9	53.1	69.0	57.6	38.3	32.5	31.9
From private creditors	17.3	45.9	60.5	48.3	28.8	22.6	18.5
Principal repayments	8.9	24.7	26.1	25.7	18.1	18.2	21.8
Net flows	12.4	28.4	42.9	31.8	20.2	14.3	10.1

Source: The World Bank, *World Development Report 1986*

(a) Argentina, Bolivia, Brazil, Chile, Columbia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia. These countries accounted for nearly half of all debt at the end of 1985.

As can be observed from Table 1, net flows to low-income Africa have been cut to less than half their 1981 level, dropping from US$3.1 billion to US$1.4 billion. In the case of low-income Africa, however, official grants remain important. They increased slightly from US$3.2 billion in 1981 to US$3.3 billion in 1984.

In real terms, the drop in net capital flows was even larger. In addition, total interest payments by developing countries on external public and private long-term debt amounted to US$57.6 billion in 1985 (up from US$41.8 billion in 1981)[1], which represented 11% of their export earnings. Thus, developing countries paid out approximately US$22 billion more in

1 The World Bank, *World Development Report 1986* p. 37.

long-term debt since 1985 than they received in disbursements of long-term lending [2]. The heavily indebted countries accounted for most of this net transfer. These reduced levels of aid and massive resource outflows have coincided with a time when low-income countries were confronted with unprecedented financing needs caused by a combination of factors, not least among them an extremely unfavourable external environment.

Official creditors continue to be the most important source of net lending to developing countries. In contrast to commercial banks, official creditors' share in net disbursements to highly indebted countries were several times their share in total claims on this group of countries [3] Official creditors' net lending of US$3.5 billion in 1988 amounted to 38% of the interest payments they received from these countries on earlier loans (see Table 2) and was responsible for positive total net flows of US$2.9 billion to the highly indebted countries. [4].

Table 2 - Official Lending to Highly-Indebted Countries, 1986-88 (a) (billions of US dollars)

	1986	1987	1988
Disbursements	15.0	14.6	15.8
Principal repayments	8.9	10.7	12.3
Net lending	6.1	3.9	3.5
Interest payments	7.0	7.5	9.2
Net lending as % of interest payments	87.0	52.0	38.0

Source: IMF-World Bank, *Finance and Development*, September 1989, p.14
(a) Includes use of IMF credit.

The heavy involvement of official creditors in several countries led to a rise in the share of official creditors in total debt outstanding. For example, during 1986-88, six countries (Argentina, Bolivia, Chile, Ecuador, Mexico and Nigeria) received more in net disbursements than they needed to refinance their interest payments to official creditors [5].

Furthermore, among the bilateral official creditors, the Japanese government proposed the recycling of up to US$30 billion of Japan's external surplus over 3 years (1987-89) to developing countries [6].

Given the important role of Official Development Assistance (ODA) provided by the Development Assistance Committee (DAC) member

2 *Ibid*, p. 37.
3 See, Ishrat Husain's - "Recent Experience with the Debt Strategy" in *Finance and Development*, September 1989, p. 14.
4 *Ibid*. p. 14.
5 *Ibid*, p. 14.
6 *Ibid*.

developing countries, it is useful to review how the donors have responded to the development challenge. The DAC donors in 1962 provided about US$27 billion (measured at 1987 prices and exchange rates). In 1986, they provided US$44.3 billion, an increase in real terms of more than 60%. But GNP in DAC countries increased nearly threefold over this period, so the 1988 ODA level represents a diminished effort in terms of a ratio of ODA to GNP, a drop from a 1962 ratio of 0.53% to a 1988 ratio of 0.35% [7] On current evidence, donors' performance remains mixed. Aside from the consistent record of the 4 DAC aid givers with the highest ODA/GNP ratios Denmark, Netherlands, Norway and Sweden (see Table 3), 6 other countries which have recently accepted intermediate aid targets have significantly improved their ODA/GNP ratios in the 1980s [8] However there is evidence to support the view that countries which have not accepted specific time-frames for meeting aid targets have performed less well.

Table 3 - Net ODA from DAC Countries in 1988

United States	9.78		0.20	
Japan	9.13		0.32	
France	6.96[1]	4.78[2]	0.73[1]	0.50[2]
Fed. Rep. of Germany		4.70		0.39
Italy	3.01		0.37	
United Kingdom	2.62		0.32	
Canada	2.34		0.50	
Netherlands	2.23		0.98	
Sweden	1.53		0.87	
Australia	1.09		0.46	
Norway	0.99		1.12	
Denmark	0.92		0.89	
Switzerland	0.62		0.32	
Finland	0.61		0.59	
Belgium	0.59		0.39	
Austria	0.30		0.24	
New Zealand	0.10		0.27	
Ireland	0.06		0.20	
Total DAC	47.58		0.35	

Source: DAC, OECD, 1989.

1. Including overseas department and territories
2. Excluding overseas department and territories

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7 Joseph C. Wheeler - "The Critical Role for Official Development Assistance in the 1990's". In *Finance and Development*, September 1989, p. 40.

8 Canada, Finland, France, Italy, Japan and Switzerland.

These mixed trends have meant that the estimated collective DAC/ODA/GNP ratio in 1988 of 0.35% is only half of the internationally targeted level of 0.7% of GNP.

It must be pointed out that, unfortunately, the Arab-OPEC aid which reached the extraordinary level of nearly US$14 billion (at 1987 prices and exchange rates) in 1975 and which ran over US$10 billion until 1981, has since come down to slightly above US$2 billion in 1988 (though still at a high ratio of ODA to GNP exceeding 2%)[9].

Export Credits

Export credits can play a key role in financing the adjustment process of developing countries, by maintaining critical imports. As with commercial bank lending, export credits in the post-1981 period virtually collapsed in response to developing countries' loss of credit-worthiness combined with the compression of their imports. After rising to peak levels of around US$13 billion in 1980-1981, new export lending contracted sharply thereafter to reach an estimated US$3 billion in 1985[10]. The curtailment in export lending reflects the perception of increased risks. In many cases, export credit guarantees and insurance coverage have been limited to short-term operations or suspended entirely following rescheduling operations. It should be noted that demand factors linked to contractionary adjustment policies have also contributed to the decline in export lending.

Multilateral flows

Deteriorating growth prospects in many developing countries and a growing perception that adequate financing will not be forthcoming from private lenders have focused attention on the role the multilateral finance institutions could play in financing adjustment and mobilizing flows from their sources. Following a period of rapid expansion in the late 1970s, the pace of multilateral disbursements slowed down in the first half of this decade. Financial support for the lending programmes of the major multilateral institutions has fallen short of the growing needs for finance since member countries like the US have, for some time now, demonstrated their lack of confidence in multilateralism. The US pull-out from multilateral organizations such as the UNESCO, among others, is a case in point. Consequently, multilateral concessional lending has lost much of its earlier dynamism as programmes such as those of International Development Association (IDA) and the International Fund for Agricultural Development (IFAD) have become increasingly prone to resource stringencies. These

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9 See Joseph C. Wheeler, *op. cit.*, p. 40.

10 For discussion of export credit agency policies and responses to debt-servicing problems, see *IMF Export Credits: Developments and Prospects*, Washington D.C. 1986.

institutions have nevertheless greatly extended their policy influence over the past several years. Acceptance of their policy conditionality by developing countries has, in fact, increasingly been a pre-requisite for the allocation of ODA and commercial bank loans.

At the same time, there has been a growing acceptance within the international community of the need to give more emphasis in adjustment programmes to raising the rate of growth. It is also recognized that the multilateral institutions must play a pivotal role in this process. In practical terms, this has been reflected in such developments as the Baker and Brady Initiatives, the United Nations Programme of Action to African Recovery and Development (1986-1990) and at the level of the multilateral institutions themselves in the appearance of various innovative forms of co-financing, fast-disbursing programme assistance and structural adjustment lending and other special facilities for the needier countries. Even though co-operation among the institutions is being intensified, it must be emphasized that the overall effectiveness of these institutions depends heavily on the adequacy of their capital resources.

Private Flows

International Capital Markets

From the 1970s up to the early 1980s private flows especially bank lending played a dynamic role in underwriting investments and balance-of-payments financing in developing countries. But as confidence rapidly evaporated with the onset of debt-servicing difficulties, both spontaneous bank lending and foreign direct investment sharply receded in 1982 and have remained depressed since.

Following the emergence of major debt-servicing difficulties in 1982, international bank lending to developing countries has continued to decline. Voluntary bank lending is now virtually non-existent and has been replaced by concerted financing with official intervention. In fact, voluntary lending to severely indebted countries has fallen to such low levels that debt service now siphons off a significant part of domestic savings to the detriment of domestic capital formation.

The slow pace of bank lending stems from caution on the part of developing countries and more importantly from most banks' reluctance to lend to many developing countries that were already indebted and/or are experiencing serious difficulties.

The debt strategy emerging from the Baker Plan stressed the importance of increased net lending by commercial banks to the highly indebted countries. But the large flows of voluntary finance from commercial banks have not resumed. If net disbursements or net flows (more meaning indicators) are taken into consideration, it is observed that the commercial

banks have not achieved much by way of contributing to financing current account deficits of highly indebted countries (see Table 4).

Table 4 - Commercial bank lending to highly indebted countries (billions of US dollars)

	1986	1987	1988	1986-1988
Concerted new money[1]				
Commitments	8.3	2.4	5.6	16.3
Disbursements	3.2	5.7	6.0	14.9
Change in exchange rate adjusted claims[2]	3.5	0.6	2.0	6.1
Net disbursements[3]	-0.4	2.3	2.1	4.0

Sources: 1. IMF-World Bank, *Finance and Development*, Sept. 1989 p. 13
2. These claims include identified debt conversions, arrears and other balance sheet adjustments
3. Debt and International Finance Division, World Bank.

It is observed from table 4 that during 1986-88, commercial bank creditors provided only US$4 billion in net new financing on long-term public and publicly guaranteed debt to the highly indebted countries. The general trends outlined in table 4 conceal great differences across countries, but in no case did commercial banks provide more net financing than they received in interest payments[11]. The contribution of commercial banks in meeting the external financing requirements of highly indebted countries during 1986-88 did not, therefore, live up to the expectations of the proponents of the Baker Plan.

One reason for commercial banks' unwillingness to lend has been poor country performance reflected in the deep discounts on highly indebted countries loans in the secondary market. But there are other factors, such as banks' concern with building their capital bases; the competitive pressures they face in increasingly deregulated and liberal domestic financial markets; and the effect on their ability to raise new shareholder equity in the markets of their exposure (outstanding loans) in developing countries[12].

Spontaneous lending to developing countries was almost confined to Asia (to the middle-income newly industrializing countries), and it has shown little tendency to revive in countries that have recently restructured their debt.

11 For a more detailed discussion of the recent performance of commercial banks, see UNCTAD, *Trade and Development Report*. 1989.

12 Ibid. and see also Ishrat Husain in *op. cit.*, p. 14.

As for bond finance, the recent growth of the international bond markets has largely by passed the developing countries. Furthermore, most developing countries have very limited access to security-related lending, while note issuance facilities and other back-up credit facilities are largely reserved for prime borrowers from developed countries.

Foreign Direct Investment

Foreign Direct Investment (FDI) has traditionally been an important vehicle for the transfer of financial capital, technological and marketing skills to developing countries. FDI flows grew erratically through much of the 1970s, with a general deterioration in the investment climate. Lately, the problems associated with developing countries indebtedness and with high levels of real interest rates have revived interest in the potential for a greater role of equity in development financing. For highly indebted countries, the importance of non-debt-creating flows (including direct investment) rose significantly.

Between 1986 and 1988, while net lending to these countries fell from a peak of 24.3 billion dollars to a meagre 11.6 billion dollars (more than 52% fall), the total value of direct investment flows almost doubled from 6.6 billion dollars in 1986 to 11.0 billion dollars in 1988 - an increase of 66.7%, (see Table 5), accomplished in part through debt-equity swaps[13].

Table 5 - Net Resource Flows to Developing Countries, 1986-1988 (billions of US dollars) - All Countries

	1986	1987	1988
Aggregate net resource flows[2] of which	51.5	41.4	44.2
Direct investment	6.6	10.3	11.0
Net lending[3]	24.3	10.4	11.6
Total external resource balance	55.8	51.6	51.0

Source: IMF debt and International Division, World Bank
See *Financing and Develonment*, September 1989, p. 13.

Whether FDI can assume a larger financing role will depend on a number of factors. At present, a number of negative influences would seem to be working FDI growth in the developing countries. First, sectors traditionally favoured by FDI such as mineral and petroleum are now depressed and marked by overcapacity[14]. Moreover, economic uncertainties in major debtor countries act as deterrents to new investment flows.

13 For further discussion see, "New Financing Approaches in the Debt Strategy", by Klaus Regling in *Finance and Development*, March 1988, p. 15-18.

14 See, Report of the 13th Session of the Commission on Transnational Corporations, E/C.

Reactivation of FDI in major borrowing developing countries is conditional on a satisfactory resolution of these countries' debt problems, since foreign exchange stringencies associated with debt-servicing difficulties also tend to limit profit remittances. More recently, the slackening of world economic growth bringing with it renewed upsurge of protectionism has discouraged FDI flows that are export-oriented[15].

The general conclusion to be drawn from the foregoing analysis is that, by and large, development finance to developing countries has exhibited a downward trend due to several factors some of which have already been discussed. However, a major factor that needs to be emphasized in the contraction in net transfers can be traced to accelerating outflows, particularly of interest payments, which offset the more hesitant growth in gross receipts of financial resources by developing countries.

The outflow of debt service payments was accentuated by a rising trend in profit remittances. However, profit remittances alone do not fully capture the recent evolution of outflows related to direct investment, since they do not take into account another type of associated outflow. For instance, transnational Corporations are often in a position to shift working balances in times of acute financial or political difficulty. Furthermore, net financial flows and net transfers hardly reflect the effect of capital flight which constitutes an additional source of reverse flow from developing countries. It is worthy of note that this phenomenon is not readily susceptible to measurement and estimates often differ widely. The next section shall consider the trend of resource outflow from the developing countries in a bid to throw some light on recent developments on the issue.

Financial Outflows from Developing Countries

The Net Financial Transfer of the Developing Countries

As a whole, the developing countries are still transferring resources abroad, as they have been doing since 1984. Apart from 1982, 1983 and 1986 with net accumulation of reserves (due to several reasons chief among which was a drastic reduction of imports), all developing countries transferred financial resources abroad reaching a peak of US$36 billion in 1987 (see Table 6). But there seems to be three separate stories behind the overall flow.

One involves the energy-exporting developing countries which are generally referred to as "capital-surplus countries". As shown in Table 6 they have actually been net recipients of financial transfers from abroad since 1982 as weakening oil prices (until the invasion of Kuwait by Iraq on August 2, 1990) and a major military conflict in the Gulf area (the 8

10/1987/2.

15 Ibid.

year-old Iran-Iraq war) cut deeply into their ability to transfer resources abroad.

The large net transfer made by four generally small Asian economies constitutes a second net-transfer story. They comprise a group of very successful exporters of manufactures, namely, Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China. Their aggregate net transfer of financial resources abroad was about US$16 billion in 1989, down from US$23 billion the year before (Table 6), owing mainly to the sharp cut-back in the trade surplus of the Republic of Korea. Such transfers were also made possible particularly through their ability to invest abroad at a rapid pace in both financial and direct investments, especially in the major developed market economies and in the developing economies of Asia and the Pacific [16].

Table 6 - Net Transfer of Financial Resources of Groups of Developing Countries, 1982-1988[a] (billions of dollars)

	1982	1983	1984	1985	1986	1987	1988
Surplus energy exporters	2.0	26.4	17.8	11.5	28.7	11.8	15.8
Capital-importing economies	31.0	-5.9	-33.0	-24.4	-16.5	-47.8	-40.8
of which							
Africa[b]	13.9	7.7	1.9	-1.5	5.4	-0.2	3.9
Latin America and the Caribbean	3.4	-25.6	-35?2	-31.4	-15.0	-19.3	-22.4
Four recent surplus economies in Asia[c]	-0.3	-4.1	-8.3	-10.9	-22.7	-28.5	-23.4
Other Asia and Europe	14.0	16.1	8.5	19.3	15.8	0.2	1.0
All developing countries	33.0	20.5	-15.5	-12.9	12.1	-36.0	-24.9

Source: Department of International Economic and Social Affairs of the UN Secretariat based on IMF data and official national sources.

a). Expenditure basis (negative of balance on payments of goods, services and private transfers, excluding investment income).

b). Excluding Libyan Arab Jamahiriya and South Africa

c). Hong Kong, Republic of Korea, Singapore and Taiwan Province of China.

16 United Nations Department of International Economic and Social Affairs, *World Economic Survey 1990*. E/1990/55/ST/ESA/218.

With respect to the generally termed "capital-importing developing countries", their net resource transfers abroad started in 1983 (see Table 6) albeit in a totally different context. These are countries with recent debt-servicing difficulties and which have been the most likely to make net outward transfers under the dual impact of reduced bank lending and higher interest rates, since a large part of their outstanding debt had been contracted at market related, variable terms. For this group of countries, debt-service payments, particularly the interest component, have accelerated faster than gross inflows, especially after the collapse of voluntary lending from mid-1982. From 1983 onwards, net transfers turned sharply negative reaching a peak of more than 47 billion dollars in 1987 (see Table 6) and would have attained far greater magnitudes were it not for the cushioning impact of concerted lending and debt rescheduling[17]. In spite of this factor, it can be observed from table 6 that the total transfer of resources abroad from Latin America and the Caribbean amounted to over 148 billion dollars over the period 1983-1988.

Relatively speaking, low-income countries in Africa have been more insulated in this respect since much of their borrowing has been on concessional and relatively stable terms. Thus, as can be observed from table 6, real resource inflows significantly took a down-ward trend. They reached negative levels in 1985 and 1987 with some recovery in 1986 and 1988 due mostly to drastic cuts in imports, debt reschedulings, and a considerable redirection of ODA to these countries, coupled with substantial emergency financing.

The emergence of several developing countries as net providers of financial resources is a serious cause for concern, primarily because it is taking place during a period of acute pressure on growth and in the external accounts of these countries. In the first place, the sudden decline in net transfers to developing countries suggest that the shift took place as a result of a rapid rise in interest rate on the one hand and a breakdown in the mechanism for rolling over maturities, on the other. Secondly, many of the countries affected are far from the stage at which they could reasonably generate domestic savings at a rate which could offset shortfalls in external flows of the size encountered in recent years. It is thus not hard to understand why governments of the highly constrained developing countries have had grave and protracted difficulties, as discussed later on, in bringing about economic stabilization and structural adjustment.

While the general trends outlined above conceal great differences across countries, the indications are that, although the various flow categories

17 See Michael P. Booley and C. Maxwell Watson, "Reinvigorating the Debt Strategy" in *Finance and Development*, September 1989, pp. 8-12.

underwent some modifications (eg. modest rebuilding of official reserves), the overall effect, however, was a reduced volume of net inflows compared to increasing net outflows. Below the impact of the foregoing scenario shall be examined in terms of several factors of particular importance to the developing countries.

An Assessment of Trends and Related Issues

Qualitative Assessment of Recent Trends in Financial Flows

The declining volume of external financial resources available to developing countries which has characterized the 1980s reflects both the tendency for the major components of such flows to behave in a pro-cyclical fashion and the close linkages among them. Thus, the availability of bank credit, upon which many developing countries had come to rely heavily and which depends largely on perceptions of the borrowers' credit worthiness, decreased dramatically as developing countries' growth slowed down and balance-of-payment situations began to worsen.

Structural changes in capital markets and in official flows during the 1980s have further complicated the situation for developing countries. Whereas in the 1970s, balance-of-payments finance was readily available from capital markets, given the necessity to recycle the OPEC surplus, and official flows from both bilateral and multilateral source rose significantly, the situation has changed considerably in recent years, with implication for both the volume and the quality of financial transfer to developing countries.

The present situation with regard to the provision of development finance is characterized by 2 main features: the predominance of "maintenance" financing by creditors and the pervasive practice of policy-based lending. The former is designed primarily to prevent the collapse of debtor countries' economies rather than to restore the flow of financial resources needed to revive growth. Banks that lend just enough to a debtor country to ensure that it can meet current interest payments, export credit agencies that lend enough to ensure minimal maintenance of export markets and tolerable levels of unemployment in key export industries and aid agencies that divert funds to provide the imports necessary to sustain current output, are all engaged in "maintenance" or "defensive" financing![18] While such policies might be appropriate responses from the viewpoint of creditors, given the availability of resources, they can play only a limited role in bringing about the changes in economic structure necessary not just to overcome current difficulties of debtor countries but also to promote long-term growth.

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18 For a comprehensive discussion of "Maintenance" and policy-based financing as well as related issues, see, *Official Development Assistance: selected issues* (TD/BC.3/213).

The second change has been the expansion of policy-based lending which is designed to assist debtor developing countries in remedying perceived policy shortcomings. Such lending implies that sustained financing can only be forthcoming if accompanied by appropriate policy changes - the so-called structural adjustment programmes - in borrowing countries. Policy-based lending has typically been granted in support of efforts to liberalize policy in areas deemed to interfere in the efficient operation of markets. The objective of such lending has therefore been to lay the groundwork for a more efficient allocation of resources and to provide greater flexibility to the economy in responding to changing market forces[19].

The growing trend towards policy-oriented lending has subjected many debtor countries to prolonged periods of negotiation with different institutions thus leading to the delay both in financing and policy adjustment[20]. Strong imperatives are therefore placed on the need for expeditious as well as planned and coordinated negotiations and financing within an overall adjustment package. Active participation by the borrowing country is also important if it is to identify fully with the adjustment package.

The Emergence of Financial Disorder

The international financial system has been plagued in the last few years by financial disorder. In adjusting to the sharp fall in the availability of external credit, many countries were forced to draw down their foreign exchange reserves, sometimes to minimum levels and to accumulate payments arrears, sometimes in anticipation of a debt reorganization which had become unavoidable. The international financial system is now required to cope with the phenomenon of large and frequent payments arrears, repeated reschedulings which have caused banks and other financial institutions to lose control over the maturity of their claims, involuntary lending, costly reserve building in some countries and sharply reduced levels of reserves in others, particularly in Africa. Some of these phenomena are discussed below.

Payments arrears

As a result of growing payments difficulties, cumulative arrears of developing countries have been rising since the end of 1982 as well as the number of countries that have been experiencing arrears[21].

Although, the IMF pays particular attention to the question of arrears in its programmes with member countries, the persistence of arrears suggests

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19 Ibid.
20 *Ibid.*
21 The World Bank, World Development Report, 1989.

that the problem is of a scale not amenable to solutions on the basis of current policies.

Arrears tend to be extremely costly. In the first place they block access to trade credits and result in significant mark-ups on normal commercial transactions [22]. In order to recoup losses as a result of defaults, suppliers frequently levy premium charges even on goods financed by confirmed letters of credit [23]. Secondly, various precautionary measures adopted by export credit agencies also result in higher costs to the importers. One type of response has been to reduce the proportion of the value of sales which can be insured. In extreme cases, this may be zero [24]. In response the exporter may raise prices even in situations where the importer is not in arrears.

A further difficulty may arise when the size of the accumulated arrears is such that they cannot be repaid out of current foreign exchange earnings in the short-term. In this case, the arrears have to be rescheduled as part of a debt reorganization and on terms which tend to be harder than on current maturities [25]. Thus, the growth in outstanding debt proceeds in an environment in which the prospects for eliminating arrears tend to decline.

Repeated Reschedulings

Traditionally, debt reorganization has been considered as a last measure, resorted to only in case of acute balance-of-payments difficulties because of the potential for loss of credit worthiness and disruption of financial relations. The key objective of rescheduling [26] has been to secure a manageable profile of debt repayments as part of a package of national and international measures which would ensure the level of imports required to safeguard the development process. Rescheduling of the magnitude witnessed in the 1980s undoubtedly provided a source of financing and relief which enabled most countries involved to maintain a level of imports higher than would otherwise have been possible and helped prevent a collapse in international financial relations. By and large, however, debt reschedulings were not accompanied by a resumption of new lending from commercial banks except in the form of involuntary lending.

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22 See, Peter Kranevald - "Keeping export credits competitively neutral" in *The OECD Observer*, No. 147, August/September 1987, p. 16.

23 *Ibid*

24 *Ibid.*

25 *Ibid.*

26 For a more extensive discussion of the adequacy of present arrangements for multilateral debt rescheduling, see, UNCTAD Review of the implementation of section B of Trade and Development Board Resolution 222 (XXI) (TD/B/980, and UNCTAD, Conclusions drawn by the UNCTAD Secretariat following consultations in pursuance of conference resolution 161 (VI) (TD/B/950.

Several features of rescheduling arrangements have been a source of growing concern: firstly, in relation to the scale of the difficulties experienced during the last several years, the amounts rescheduled represented only a fraction of outstanding debt[27]. Secondly, many of the countries which have rescheduled continue to face payments difficulties and to accumulate arrears. Very few countries which succeeded in eliminating their difficulties through debt reorganization have yet re-established normal access to either private or official and other trade-related financing. Particularly serious has been the difficulty experienced by countries in the sub-saharan region and major debtor countries in Latin America. Countries which have had their debt rescheduled in the Paris Club have continued to face serious difficulties ensuing from restrictive policies applied by the export credit agencies affecting access to insurance cover[28]. In many instances cover has not been restored, even after the completion of rescheduling agreements. The practice of repeated reschedulings, each associated with a short consolidation period, not only imposes high costs on debtor countries in terms of continuous damage to their credit worthiness but also exerts strains on the scarce time of senior officials.

The short-term character of debt rescheduling has often led to the repetition of reschedulings of debts owed by the same countries. However, the emergence of multi-year rescheduling arrangements (MYRAs) starting in 1984 between Mexico and its private creditors, has been a positive sign heralding changes in creditor policies[29]. Following this development the first MYRA was extended by official creditors in 1985. This agreement with Ecuador was followed by others with Côte d'Ivoire and Yugoslavia in 1986. These agreements were, however, limited to the rescheduling of repayments of principal only MYRAs have, so far, relieved only marginally the financing constraints faced by heavily indebted developing countries and thus have not led, as expected, to a rapid restoration of credit worthiness.

Reserves

As regards reserve building, recent upheavals in financial markets have had a major impact on trends and incentives underlying the accumulation of reserves. When their access to the international capital markets became severely restricted in 1983, developing countries were abruptly confronted with the need to acquire and maintain more prudential levels of reserves. For example, countries like Argentina, Brazil, Mexico, Philippines, Republic of

27 *Ibid.*
28 Peter, Kraneveld *op. cit.*
29 Despite the innovative character of the Mexican rescheduling, however, it has not enabled that country to establish conditions for resumption of voluntary borrowing, nor has Mexico been able to secure improvements in its payment situation of a size to enable it to resume growth.

Korea and Venezuela have shown sustained efforts in building reserves. For instance, Venezuela's external reserves which stood at only 1,047 million dollars in 1970 jumped to a high of 11,510 million dollars in 1987 equivalent to 10 months of imports of foods and services capable of cushioning off future financial disturbance (see Table 7).

Table 7 - Reserves Position and Months of Import Coverage of Selected Developing Countries 1970 and 1987.

	Gross international reserves Millions of dollars		In months of import coverage
	1970	1987	1987
Middle-income countries			
Mexico	756	13,692	6.2
Brazil	1,190	7,477	3.0
Argentina	682	3,734	3.5
Korea, Republic	610	3,739	0.9
Venezuela	1,047	11,510	10.1
Low-income countries			
Ethiopia	72	245	2.3
Zaire	189	417	1.8
Tanzania	65	32	0.3
Zambia	515	111	1.4
Sierra Leone	39	6	1.0

Source: The World Bank, *World Development Report* 1989 pp. 198-199

In contrast, countries in Africa, in spite of some reduction in current-account deficits, experienced a considerable attrition of their reserve levels in 1987. For this group of countries, reserves fell to levels equal to little more than one month of imports of goods and services, leaving no margin for manoeuvre in the event of financial disruptions: Sierra Leone, Zambia, Tanzania, etc. fall into this group (see Table 7).

Recent reserve building has been associated with growing uncertainties in the international environment. The slow recovery, coupled with uncertain prospects for capital flows, for the future evolution of the United States trade deficit and for the dollar exchange and interest rates, have increased downside risks for developing countries, particularly the highly indebted ones. The effect of these uncertainties has been to add to precautionary demands for reserves. More cautious policies in reserve building have additionally been induced on the supply side by acute shortages in the availability of international liquidity caused by the gradual reduction in

access to less conditional fund facilities and near impossibility for many developing countries to borrow reserves on the international capital markets[30].

Impact on domestic savings[31]

The disorder in the international financial system has reduced not only the availability of external finance but also the capacity to finance development through domestic savings. Surely, the reduction in net financial flows to developing countries and the emergence of negative net transfers make it all the more important to improve the effective mobilization of domestic savings. While there can be little doubt that increased efforts are needed in many countries to boost savings and growth performance, the fact that the effectiveness of these efforts often depends on the external environment is not always fully grasped.

The worsening terms of trade of developing countries during the 1980s has meant that supply available for domestic use has fallen in relation to domestic output. Consequently, the maintenance of investment out of a given volume of domestic output would require the full brunt of the reduction in the real output available for domestic use to fall entirely on current consumption.

The consequences of the deterioration in the external financial environment have also been serious. Since interest payments to non-residents are a first claim on domestic savings, an increase in interest rates on outstanding debt necessarily reduced national savings (defined here as domestic savings less net factor income payments to non-residents) and hence also the volume of investment that could be financed from domestic savings.

A large number of developing countries have experienced a marked deterioration in both the external financial and trading environments during the 1980s[32]. While the order of magnitude involved varies from one country to another, the additional savings efforts required to offset the adverse consequences of the decline in the terms of trade, the rise in interest rates and the cut-back in lending has been substantial. The difficulties experienced in their external accounts have led governments of debtor developing countries to adopt policies designed to redress external imbalances. However these policy responses, often including currency devaluation, frequently have had the unwanted side-effect of impairing the capacity of private business to

30 Thom B. Thurston and K. Aufhauser and company - "The Changing Institutional character of International Financial Markets in the 1980s" in *Supplement to World Economic Survey 1985-1986* (ST/ESA/188).

31 For a fuller discussion of this issue see, *Trade and Development Report*, 1986, chapter VI.

32 The World Bank *op. cit.*, 1989 pp. 44-49.

save and invest. The financial position of domestic firms that had borrowed substantial amounts in foreign currency was impaired, often very considerably, by the increase in the domestic currency equivalent of their foreign obligations. Firms' balance sheets and profits were also generally weakened where domestic demand contracted and interest rates were sharply increased. For these reasons, in many countries, business lost, in whole or in part, the capacity to generate savings. This in turn had an impact on the viability of domestic financial institutions, through the effect on the quality of their loan portfolios. The domestic financial system has thus been impeded from playing its role of mobilizing domestic savings and allocating them among alternative domestic users.

With respect to the capacity of governments to generate public sector savings, sharp currency depreciation has been a serious obstacle since it has raised the domestic currency cost of servicing the external public debt and hence has aggravated the budget problem created by high interest rates and debt-service obligations. Furthermore, in many developing countries, receipts from tariffs have been an important source of governmental revenue. Where external payments difficulties required sharp cut-backs in imports, government revenues fell correspondingly, reducing public sector savings. The effect was exacerbated where tariffs were replaced by currency devaluations as part of an adjustment programme.

Thus, the deterioration in the external financial and trading environment has widened the gap between aggregate (i.e. domestic and external) savings and the investment necessary for steady growth. In some Latin American countries (Argentina, Brazil, and Chile) the fall in national savings relative to gross domestic product has been of the order of 10 percentage points. In China the fall has been such that national savings alone are now insufficient even to maintain the capital stock[33]. In most countries where efforts to increase domestic savings have been successful, national savings and investments as a percentage of GDP have nevertheless declined, or failed to rise, because of worsened external financial conditions. Thus, in countries where domestic savings efforts were successful, they were not sufficient to compensate for the deterioration in the external environment, even during the recent period of recovery. This experience suggests, therefore, that most developing countries are unlikely to be able to make up, to any significant extent, for the non-availability of external finance and the deterioration in trading conditions through an improved savings performance, at least in the relatively near future. Rather, the success of such efforts will depend essentially on the resumption of growth and hence on the improvement of the external environment and the availability of development finance.

33 *Trade and Development Report op. cit.*

Various policy options that could be considered by policy makers in order to remedy the situation are reviewed below.

Conclusion

The Policy Options

The foregoing analysis has shown the extent to which disruption of financial flows can lead to external financial disorder and economic stagnation mostly in developing countries. It has also shown how quickly external financial difficulties spill over into the domestic financial sector of developing economies making it difficult to generate and mobilize domestic savings and diverting savings from domestic investment precisely at the time when increases in such investment are mostly needed.

The policy response to these problems has registered certain successes but on the whole has not been adequate, given the full dimensions of the crisis. There is now virtually universal agreement that downward pressures on growth must be reversed and that the objective of restoring adequate rates of growth must stand at the centre of any viable international strategy on debt[34].

Thus, on the home front, developing debtor countries will have to make firm commitments to further strengthen their economies by adopting additional market-oriented economic policies, relying more heavily on supply-side actions such as tax and labour reforms, transference of inefficient state enterprises to the private sector, liberalization of trade practices, and adoption of policies to attract more foreign investment. In some countries, serious efforts to convert large parts of the public sector to private ownership have been undertaken. Some countries - Mexico, Argentina, Chile, Costa Rica, Ecuador and Ghana - have done much more than others and it is hoped that the rest will follow suit.

The question nevertheless remains as to how the financial requirements of future growth and development are to be met. Domestic savings will remain the principal means of financing investment for development. However, in the poorer developing countries, domestic savings will not be sufficient, even under the most optimistic assumptions, to allow rapid inroads into the present levels of absolute poverty. Whatever the success in this area, external financial flows will continue to have a critical role to play in the financing of development. The declaration in 1985 in Seoul by James Baker, the former United States Treasury Secretary on this issue should thus be seen as a bold step in the right direction. His current position as Secretary of State should help translate the declaration into concrete measures.

34 This idea constitutes the cornerstone of such initiatives is the Baker Plan, the Brady Initiative, the Miyazawa Plan, the Mitterand Proposal and the Brundtland Report etc.

The challenge before policy-makers is to come to a fresh understanding of how under present and prospective conditions in the world economy, external financial flows could make the necessary contributions to reviving and sustaining development.

The Baker declaration and the recent Brady initiative of the US Treasury Secretary called for more money from commercial banks and enhanced role for the World Bank and more growth in the developing world. But it is needless to say that the multilateral financial institutions cannot function properly in the face of the skeptical attitude and suspicion of its main shareholder - the US government. Unless the United States openly backs both an increase in the World Bank's capital and changes in its lending practices - which, so far, it has refused to do - the Baker plan and other initiatives will fall through.

The commercial banks have been asked by the Baker plan to continue to lend to the heavily indebted developing countries and to increase their exposure by at least 2.5% per year [35]. But here too most European commercial banks would not lend more money nor make funds available on long-term maturities because they do not consider most developing country borrowers to be sufficiently credit worthy. In such circumstances, there is a strong rationale for involving official entities in the process of financial intermediation so as to ensure that loans are guaranteed. It is precisely this reasoning which led to the establishment of the World Bank and the regional development banks. In this wise, the World Bank has to guarantee portions of a loan, particularly in the tail end of the maturities due. This guarantee applies to principal only. In order to obtain such a guarantee, bankers pay a fee which effectively reduces their rate of return. Such guarantees in fact reduce the risk that a debtor country will default, because the commercial banks are more willing to lend the amounts required. Provided such financing and guarantees are coupled with strict monitoring of the economic performance the country, the chances of success increase significantly [36].

For those countries whose debt servicing problems can be speedily overcome by lower interest rates and rapidly rising export earnings, a return to normal (i.e. voluntary) financing from private capital markets can be envisaged if the external environment improves accordingly. Access to such flows are unlikely to expand again at the pre-crisis pace, but such flows can nonetheless make a significant contribution to external financing.

Again, for many poorer developing countries whose debts are growing faster than their net export proceeds, the banks and industrial governments

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35 See, Christine A. Bogdanowics-Binder - "World Debt: The US Reconsiders" in Foreign Affairs, Winter 1985/86 vol. 64 No. 2.

36 *Ibid.*

should consider writing off part of their debts[37]. In fact, a number of banks have already written down, though they have not written off, a sizeable portion of their exposure to small debtors. There would not be any major consequences for banks to write off debts, provided countries benefitting from such an exercise do not present a risk to the financial system. A write-off by the banks for some countries would obviously have to be reviewed carefully, to examine the possibility that the debtor could further reduce imports, adjust its economy or generate additional exports.

In this context, a safety clause to guard against free rides by debtor countries can be made so that in the event of a country enjoying a sudden, unexpected increase in foreign exchange receipts, because of a jump in cocoa or copper prices, debt cancellations would be reviewed. However, in situation where countries are considered to be technically in default because of endemic economic devastation resulting from civil wars, poor resources, *inter alia*, like in Chad, a debt write-off could be justified, not only to respond to the debtor's bankruptcy, but also to protect international financial structure and practices.

As regards official debts owed to governments, these can be converted into grants as an alternative to debt write-off. An African nation's obligations to Britain, for instance, would be redefined as grants; but the debtor would not necessarily be excused from some kind of *quid pro quo*, because payments could be accepted in the currency of the country. If such an arrangement were made with Ghana, for instance, Britain could spend its acquired cedis on consular and other British personnel purchases locally. Ghana's foreign obligation would, thus, be cleared. This would also allow a reduction in pound sterling inflows to Ghana for embassy operations.

With respect to FDIs, relevant investment policies should be improved upon by the host developing countries so as to attract them and the World Bank's Multilateral Investment Guarantee Agency (MIGA) should provide guarantees for direct investments in developing countries. Again, export credit agencies need to increase their lending and guarantee programmes. Bilateral assistance should be increased significantly. Japan, which has the world's biggest current account surplus, has proposed the recycling of up to US$30 billion of its external surplus over three years 1987-1989 to developing countries[38]. This is an encouraging development. But other official bilateral creditors (e.g. export credit agencies) also need to do more

37 The initiative proposed by President Mitterand in May 1989 to forgive French official debt to 35 last developed and most indebted countries should help considerably to reduce the financial imbalance confronting them.

38 See Saleh H. Nouli - "Structural Adjustment in sub-Saharan Africa" in *Finance and Development*, *op. cit.* p. 33.

if financing requirements for the resumption of even minimal per capita growth in the highly indebted countries are to be met.

The direct provision by donor governments of concessional flows would also require detailed review with an eye to reaching a broad consensus on the rationale, scope and indicated distribution of such assistance in the future. Particular emphasis would need to be given to ensuring an expanded flow, in a more coordinated manner, of highly concessional aid to the poorest developing countries.

There is thus, reason to believe that a stronger official presence will be required in financial intermediation for development in the future than in the past. However, given the great variety of circumstances of developing countries, direct flows from private lenders and investors will also have an increased role to play for many. In this area, what needs to be encouraged is the evolution of financial instruments so as to ensure that these flows occur in ways that are best adapted to the needs of developing countries, in particular, as regards the maturity and certainty of flows and the mixture between debt-creating and non-debt-creating finance.

We should not forget that the collapse of developing countries' economies will definitely have calamitous results for the entire international financial system - to say nothing of the political and human consequences across the continents.