Canada, the International Financial Institutions and the Debt Problem of Developing Countries

Report of

THE STANDING SENATE COMMITTEE ON FOREIGN AFFAIRS

Chairman: The Honourable George C. van Roggen

Deputy Chairman: The Honourable Heath Macquarrie

April 1987

Canada, the International Financial Institutions and the Debt Problem of Developing Countries

Report of

THE STANDING SENATE COMMITTEE
ON FOREIGN AFFAIRS

Chairman: The Honourable George C. van Roggen

Deputy Chairman: The Honourable Heath Macquarrie

April 1987

SUMMARY OF THE REPORT

(Notes for the Chairman's remarks on the tabling of the report in the Senate)

The Size of the Debt

By 1986 external debt of Third World countries amounted to $1 trillion. This debt has been incurred by developing countries that have borrowed from commercial banks, creditor governments, the IMF, the World Bank and the regional development banks. Over half of this debt — $566 billion — is owed by 57 debtor countries that have problems with their payments. Two-thirds of the problem debt is owed by Latin American countries, much of it to commercial banks in OECD countries. Canadian banks alone have lent over C$27 billion to countries now having debt servicing problems. This situation has caused the commercial banks in creditor countries to experience a fall in income and the international financial system is under strain. Another component of the problem is the debt owed to creditor governments by developing countries; known as official debt, it constitutes an extremely heavy burden for many low-income countries, particularly in sub-Saharan Africa.

The size of the problem debt is growing while the capacity of many debtor countries to make payments is diminishing. The Third World debt problem is serious, complex and worrisome to developing and developed countries alike.

A problem as complex and serious as the debt question can only be reduced to manageable proportions through comprehensive and integrated policies worked out and adopted by the principal actors involved, including the debtor countries, the international financial institutions, the commercial banks and the creditor governments.

The Debtor Countries

Since the 1982 Mexican debt crisis, many middle-income debtor countries have had to put in place fiscal and monetary reforms as a condition to receiving funds from the IMF and the commercial banks. Although these international arrangements have prevented a collapse of the international financial system, the debt burden on the problem debtor countries has not diminished. This situation has caused an increasingly strong reaction on the part of many of the debtor countries that are experiencing economic and social dislocation. Nonetheless, if these countries are to achieve lasting improvements in the way their economies are organized so as to be able in future to enjoy stable economic growth, they must be prepared to persist in the sound economic adjustment measures developed by the IMF, the World Bank and private economic research institutions, including to:

- adopt and maintain competitive exchange rates
- encourage savings and productive investment
- institute sound budgetary controls in order to reduce deficits
- make their economies more market-responsive
- improve their export performance
- encourage private capital inflows
- exercise restraint in the use of subsidies
- divest inefficient state enterprises

They must also introduce measures to discourage capital flight, which reached massive proportions in a number of middle-income countries, notably Argentina, Mexico, Venezuela, Philippines and Nigeria. Such outflows of capital have in many cases considerably worsened the debt burden for these countries.

It is necessary, however, for the creditor governments and the international financial institutions to recognize that adjustment policies undertaken by debtor countries will take effect only slowly and gradually. In the interval, indebted countries that have committed themselves to serious adjustment programs must be sustained in their commitment with investment capital.

The International Financial Institutions

When the Mexican debt crisis erupted in 1982, the International Monetary Fund (IMF) took the lead in co-ordinating the management of that problem, which rapidly engulfed a host of other developing countries that were similarly over-extended. While the austerity programs called for by the IMF are viewed by some indebted countries as being responsible for a decline in their living standards, the international community can consider itself fortunate that the IMF assumed the lead role in handling this problem. The Fund must continue to play a key role. The IMF's participation remains central to the effective management of the Third World debt problem, both by gaining the support of creditors for debt rescheduling and new money and by elaborating economic programs to assist debtor countries to reduce their imbalances and rebuild their creditworthiness.

However, by 1985 the IMF's capacity to lend was becoming severely constrained. Its approach was seen as too short-term to permit adaptation of the structural deficiencies in the economies of the indebted developing countries. The World Bank has since been asked to take a lead in promoting structural adjustment in debtor countries.

The new role thrust on the World Bank will face its management with problems and pressures, to which it will have to respond carefully:

- It should take steps to reorganize its staff as quickly as possible to handle policy-based lending.
- It will be important for the World Bank to temper the conditions that are pressed on debtor countries to adopt economic policies favouring a market economy with an understanding of the differing traditional values and systems of some developing countries.
- The World Bank should try to maintain a judicious balance between its traditional project lending and the more recently emphasized structural adjustment lending.
- Closer collaboration between the IMF and the World Bank will become increasingly important. The Canadian government should press for complementary policies in the two organizations and the establishment of a formal co-ordinating body, a joint Bank-Fund committee, to formulate adjustment and lending policies and to co-ordinate with the commercial banks their joint concerns. Canadian government representatives in the regional development banks should also be instructed to press for closer co-ordination between those banks.

The World Bank has indicated that it intends to increase substantially its annual levels of lending and to improve its rate of disbursement. This is a welcome and necessary development. However, in order to sustain this increased lending, the World Bank needs a General Capital Increase (GCI). Given the time needed to complete a GCI, the Canadian government should press for a decision to negotiate a new GCI in 1987. In particular, it should urge the United States to agree to begin negotiations as soon as possible. The Canadian Government should instruct its executive director at the World Bank to work with other representatives on the executive board in order to achieve the largest possible mutually-agreed increase in the Bank's capital as well as that of its soft loan affiliate, the International Development Association (IDA).

When the international financial institutions were established, the United States had a dominant financial position internationally and, as such, was given the power to veto the institutions' decisions. Since then, a number of other countries have gained impressive economic strength and it is in the common interest that these countries be able to increase their contributions to the World Bank without constraints. The attempt by the United States to perpetuate its special status discourages other states from assuming increased responsibilities.

In connection with the next GCI for the World Bank, it has been argued by some that reducing or eliminating the percentage of paid-in capital to callable capital might make it easier for countries to agree to a larger capital increase. However, a major reduction in the ratio of paid-in capital could send a wrong signal to the borrowing countries, as it could appear that the donor countries were not honouring their commitment to the developing world. For this reason, the Canadian government should resist proposals for any significant reduction in the proportion of paid-in capital in the next General Capital Increase of the World Bank or of the regional development banks.

Increased emphasis should be placed on the efforts of the World Bank affiliate, the International Finance Corporation, to promote investment in Third World countries and to create equity mutual funds for investment in developing countries.

There is a trend by the regional development banks to shift away from project loans, which have been their specialty, to policy-based or program lending along the lines of the new World Bank thrust. However, these regional banks lack the staff to design or administer such loans, to which important macroeconomic policy conditions are attached. This change in emphasis by the regional development banks is unwise. Project lending should remain the central activity of the regional banks.

The Arab OPEC Countries

The massive increase in oil prices in the 1970s produced large balance-of-payments deficits among oil-importing developing countries, deficits which had to be financed from external sources; much of this external financing came from funds deposited in OECD country banks by Arab OPEC countries. This cycle contributed to the current Third World debt problem. In the future, OPEC could make a significant contribution to the management of the debt problems of developing countries by bringing its consideration of oil prices within the scope of international consultation and co-operation, where the effects of oil price changes on the world economy and the interests of the developing countries would be appropriately recognized.

The World Bank has pointed to an enormous gap of $1.5 billion a year in the funds available for the needs of low-income sub-Saharan African countries until 1990. Those Arab OPEC states that have the financial resources should be urged to try to increase their funding to the International Fund for Agriculture Development (IFAD) in order to bring the total OPEC contributions to that institution up to its earlier, higher level, a step that would automatically be matched by proportionately higher OECD contributions to

IFAD. In addition, increased OPEC support for IDA as well as for the African Development Bank could help to bridge important multilateral funding gaps.

The Commercial Banks

The commercial banks were aggressive in seeking to make loans to the developing countries during the 1970s and early 1980s. While there are differences of opinion as to how much damage the banks have suffered to date, no one contends that they have been unscathed. They have large non-performing loans on their books. They are continually pressed to provide new funds for loan reschedulings to uncreditworthy countries. Further, in most countries they have had to increase substantially their provisioning reserves against loans to some borrowing countries, a process that has inevitably been costly. The banks will have to carry an increasing share of the cost of handling the debt problem.

One way for the commercial banks to reduce the burden for indebted developing countries would be to cap or even reduce interest rates. Unfortunately because of the uneven levels of provisioning that are required in different OECD countries, it is difficult to develop a co-ordinated approach to this possible method of debt relief. The Canadian government should press for international agreement on a reasonable level for general provisions by banks in OECD countries.

Another, albeit marginal, mechanism for reducing Third World debt is for the commercial banks to swap debt for an equity interest in corporations in the debtor country. Debt-equity swapping arrangements would appear to offer a means to alleviate somewhat the commercial debt problem in some debtor countries. Newly privatized enterprises in certain countries could be attractive investment prospects. The benefits of the debt-equity swap mechanism would not be applicable to all countries. Nevertheless, where it is applied, by reducing the debt load at the margin, it reduces the overall debt repayments. As another means of increasing the flows of much-needed capital to debtor countries, the commercial banks should increase their use of the World Bank cofinancing mechanism.

The Creditor Governments

Creditor governments, while supportive of efforts to resolve the debt problem of Third World countries, have so far remained more or less in the background.

Over the long term, the most constructive step that OECD countries, including Canada, could take to reduce the debt problem to manageable proportions would be to improve the access of developing countries to their markets. Debtor countries require high export growth in order to earn foreign exchange with which to service their debts. Further, any success that creditor governments might jointly achieve in lowering interest rates, reducing domestic deficits and generally expanding their economies would indirectly improve the prospects for developing countries.

Creditor governments should try to achieve a greater degree of harmonization of their bank regulations and their tax treatment of banks and should try as well to reach agreement on a reasonable level of general provisioning to be attained by all banks in OECD countries.

OECD countries should continue to work towards enabling the banks to extricate themselves gradually from their current Third World lending difficulties. In subsequent negotiations with other problem debtors, somewhat less emphasis should be given to new lending by the commercial banks than in the 1986 negotiations with Mexico and more emphasis on lending by the creditor governments and the international financial institutions.

A basic need at this juncture is to maintain a flow of fresh capital to Third World countries that have adjustment programs in place so as to give these programs the time needed to take effect.

- One way to do this would be for governments to greatly enlarge their funding of the World Bank so that it would be able to increase its lending and relieve some of the pressure on the commercial banks to put up new money. This would require committing substantial additional sums to official development assistance (ODA), and earmarking them for multilateral disbursements.
- Without export credits it may not be possible for problem debtor countries to import the equipment and materials required for development projects. At this time, governments and other agencies are better placed than the commercial banks to extend credit to debtor developing countries. For this reason governments of creditor countries should encourage their official export agencies to resume and even increase their export credits and insurance coverage to those countries that have implemented adjustment programs endorsed by the IMF or the World Bank.

In order to assist the indebted low-income countries, there are a number of steps that creditor governments could take specifically directed at relieving the burden of payments on their official debt.

For example, the announcement in the Canadian government's 1986 budget that henceforth all ODA will be entirely on a grant basis rather than on a partial-grant and partial-loan basis, as was the case previously, is a commendable measure, as is the 1986 Canadian offer to low-income African countries of a 15-year moratorium on debt interest repayments for Canadian ODA, in effect writing off the debt. Other OECD governments should adopt as a minimum the 1986 Canadian offer of the 15-year moratorium on the interest payments on their official loans.

There are a number of further measures that Canada could take.

- Specifically, the proportion of Canada's ODA committed to the multilateral development banks, which now stands at just under 19.4 per cent, should be increased to around 25 per cent.
- In its next budget, the government should commit itself to increase the funds devoted to official development assistance by small, annual increments, spread over 13 years, to achieve the 0.7 per cent of GNP target by the year 2000.

The current difficulties between debtors and creditors are capable of threatening the under-pinnings of the world financial system. To avoid serious disruptions to their own domestic economies, creditor governments will have to participate more directly in the management of the debt problem. The time may have now come for creditor governments to lift their objections to direct dialogue with debtor governments. Such discussions could serve a useful purpose in building a consensus to strengthen commitments on both sides for an agreed debt strategy. It would also give hard-pressed debtor governments some evidence that creditor governments understood their plight and were sympathetic. The Canadian government should publicly endorse and advocate the principle of a dialogue within the IMF's Interim Committee involving creditor and debtor governments.

In addition, to fulfill a need for an ongoing source of advice on the various dimensions of the debt problem, a small group of knowledgeable and competent persons from North and South should be formed. This group could advise on both official and commercial debt questions and help build a better perception of the commonality of interests between the principal participants. This group could be known as the Advisory Group on International Indebtedness.

Managing the Debt Problem: the Committee's Approach

In the present situation, it is important to reaffirm the need to pursue some basic policies.

- In general terms, the case-by-case approach which has served a useful purpose so far must be modified to deal with the evolving debt problem. The debt strategy pursued since 1982 needs to be supplemented by arrangements for an increased flow of funds to debtor countries through international agencies and creditor governments.
- Canada should increase market access to indebted developing countries and encourage other OECD countries to do the same.
- The Canadian Inspector General of Banks should again raise the targets for Third World debt provisioning that were set for Canadian banks in late 1986.
- The Canadian government should modify the regulations governing the tax treatment of reserves in Canadian banks to permit the full costs to be treated as business expenses, until the Third World debt problem has assumed manageable proportions.
- Creditor governments should be formally represented in future negotiations on debt problems in acknowledgement of the seriousness of the situation and in recognition of the fact that they may have to become directly involved in the search for ways to reduce the debt burden. To avoid serious disruptions in their own domestic economies, creditor governments must be prepared to join with debtor governments and the commercial banks in carrying a part of the debt burden.
- The Canadian government should take a leading role in efforts to build a consensus—within the World Bank, the IMF and the OECD—in favour of ad hoc measures of debt relief and an increased role in lending by the World Bank.