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

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Note: The Honourable Senators William C. Doody, Jacques Flynn, P.C., Royce Frith, Stanley Haidasz, P.C., Renaude Lapointe, P.C., Nathan Nurgitz and Paul Yuzyk also served on the Committee at various stages of this study.

Order of Reference

Extract from the Minutes of Proceedings of the Senate, Tuesday, November 4, 1986:

The Honourable Senator van Roggen moved, seconded by the Honourable Senator Macquarrie:

That the Standing Senate Committee on Foreign Affairs be empowered to examine and report on Canada's participation in the international financial system and institutions and in particular the International Monetary Fund, the World Bank Group and the regional development banks, including the debt repayment problems of developing countries;

That the papers and evidence received and taken on the subject before the Committee during the First Session of the Thirty-third Parliament be referred to the Committee; and

That the Committee report no later than March 31, 1987.*

The question being put on the motion, it was—
Resolved in the affirmative.

Charles Lussier
Clerk of the Senate

* By order of the Senate, dated March 24, 1987, the date of tabling the final report was extended to May 31, 1987.

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FOREWORD

At the time the Committee sought the approval from the Senate to undertake this study, the gravity of the Third World debt problem was not generally recognized. During the course of the Committee's study, events have unfolded in such a way as to make the Third World debt issue a subject of daily comment.

I am most grateful to my Deputy Chairman, Senator Heath Macquarrie and to all members of the Committee for their attention and assistance throughout the public hearings and the drafting of the report.

The Committee wishes to record its gratitude for the helpful staff support provided by the Clerk of the Committee, Mr. Patrick J. Savoie, and for the assistance in organizing the hearings and preparing the report provided by Mr. Peter Dobell, Director and Mrs. Carol Seaborn of the Parliamentary Centre for Foreign Affairs and Foreign Trade. At certain stages of the report the Committee also benefitted from the advice and experience of Dr. Claude Isbister, formerly a Canadian executive director with the World Bank and Professor David Pollock, formerly a senior official with the UN Economic Commission for Latin America and the Caribbean.

George C. van Roggen
Chairman

Ottawa, April 1987

FOREWORD

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George C. van Roggen
Chairman

Ottawa, April 1987

PREFACE

On October 29, 1985 the Senate passed an Order of Reference directing the Standing Senate Committee on Foreign Affairs

> to examine and report on Canada's participation in the international financial system and institutions and in particular the International Monetary Fund, the World Bank Group and the regional development banks, including the debt repayment problems of the developing countries.

In the course of the winter and spring of 1986 the Committee held 13 meetings with 15 expert witnesses, concluding with a meeting with the Honourable Michael Wilson, Minister of Finance on Tuesday, June 10. In June, the Committee also visited Washington, D.C., New York city and Toronto where it held 26 meetings with U.S. legislators, government officials, representatives of the major international financial institutions (IFIs), executive directors of several IFIs, senior officers of Canadian and U.S. commercial banks, academics and consultants. In addition, in September when Parliament was prorogued, the Committee's advisers held discussions in Ottawa with the Honourable Barber Conable, who had recently been appointed President of the World Bank and with Mr. Norberto Gonzales, Executive Director of the UN's Economic Commission for Latin America and the Caribbean. Members of the Committee also met informally in Ottawa in October 1986 with Mr. Idriss Jazairy, President of the International Fund for Agricultural Development.

The focus of the Committee's study has been the international debt crisis and the debt repayment problems of developing countries. Considerable testimony and information have been received on the International Monetary Fund and the World Bank Group not only as part of the international financial system but more particularly as institutions playing an integral part in the debt question, an issue the Committee believes to be of pervasive importance.

The dynamic character of the debt problem has presented a particular challenge to the Committee. The situation literally evolves from day to day, so that it is never possible to find solid ground on which to make judgments. Major negotiations with Mexico, one of the largest debtors, occupied the past year and the final agreement with the commercial banks was postponed several times. In the case of Brazil, another country with hundreds of billions of dollars of debt, the signs were widely perceived as encouraging; that situation deteriorated suddenly in the autumn of 1986. By February 1987, Brazil had suspended interest payments on most of its commercial debt, precipitating the most serious challenge faced by the international financial community since 1982, when Mexico initiated the debt problem by declaring a moratorium on interest payments.

The debt strategy that has been followed for the past five years has proven to be inadequate, but it will not be easy to reach a consensus as to the direction that this strategy should now take. The difficult negotiations have yet to be started; even the determination of who will participate remains a major point of controversy.

INTRODUCTION

The decision of the Mexican government in August 1982 to call a moratorium on the servicing of its foreign debts shocked the international community and forced it to recognize that the world economy faced a major and widespread problem owing to the external debt accumulated during the previous decade by developing countries.

Until the 1970s, international borrowing by Third World countries had been on a smaller, more manageable scale. *Partners in Development*, the report produced by the World Bank's commission headed by former Prime Minister Pearson, devoted a chapter to the debt problem. Published in 1969, it dealt principally with the debt service problem of low-income countries as it related to official debt plans. In a passage that strikes home 18 years later, it warned of the danger of creating future "unmanageable debt situations" that would be "likely to affect international relations profoundly". (p. 153)

From the time that the Mexican crisis first erupted until December 1985, some 60 indebted developing countries had to ask for delays or changes in their scheduled payments of interest and/or principal on their debts. In that period, time was gained and the immediate threat to the financial system was postponed. However, for some individual debtor countries the situation has worsened considerably. After five years, they are deeper than ever in debt, struggling with economic stagnation and social dislocations. Moreover, the largest debtor country of all, Brazil, found itself in such difficulties in early 1987 that it suspended interest payments on most of its huge debt. The initial perception of the problem as primarily one of short-term liquidity is no longer tenable. There is increasing awareness that the problem is long-term and that the very solvency of some developing countries is at stake.

While the debt problem has world-wide dimensions, it has particular importance for Canada because of the significant involvement of Canadian commercial banks and because of Canada's keen interest in the viability of the international financial and trading systems and in assisting development in the Third World.

In chapter one of this report, the Committee reviews the origins of the problem of Third World debt. Between the mid-1970s and early 1980s, the commercial banks of industrialized countries — which became the major instrument for the recycling of petrodollars — increased by tenfold their lending to middle-income developing countries. An abrupt change took place in 1982, when Mexico was unable to meet the scheduled repayments on its debt. Since the Mexican crisis erupted, the banks have been compelled to reschedule many of the loans and to extend their terms. They now find themselves locked into a situation very different from their normal lending patterns and from which there is no quick or easy exit.

In October 1985, the U.S. Administration gave new emphasis to efforts to resolve the international debt crisis by proposing that measures undertaken by debtor countries to produce monetary stability and budgetary controls should be matched by a deliberate policy of new lending by the commercial banks and international financial institutions so as to encourage sustained economic growth in Third World countries. Chapter one examines this initiative, commonly known as the Baker Plan, assessing its importance and some of its deficiencies. The chapter concludes with a review of the important debt rescheduling package worked out with Mexico in 1986.

The current size of the developing countries' debt is described in chapter two. From the perspective of the banking system, the problem is concentrated in Latin America. Ten of the 15 developing countries that were identified by the U.S. Administration after it launched its new approach to Third World debt in Seoul in October 1985 are Latin American states. These include the four largest problem borrowers: Argentina, Brazil, Mexico and Venezuela.

The dimensions of the debt problems extend far beyond the concerns of commercial bankers. Many poorer developing countries, especially in sub-Saharan Africa, have debt repayment obligations that are, relatively speaking, more onerous than the worst cases in Latin America. Although the plight of these countries does not threaten the international financial system, because both in absolute and relative terms the involvement of the commercial banks in the debt of this region is rather limited, their debt repayment problems are nevertheless massive. Chapter two concludes that their situation represents a challenge for the international community that is particularly intractable.

Chapter three comments on the ramifications for Canada of this huge international debt: the effects on the commercial banks, the trade losses that Canada suffers directly and indirectly, and the concern that pressure resulting from the debt servicing burden is a factor endangering the vulnerable democracies of the Third World.

The next five chapters take the major players one by one and examine what their roles might be in the search for solutions to the debt problem. Actions and measures are suggested for the debtor countries, the international financial institutions, the Arab OPEC countries, the commercial banks and the creditor (OECD) governments including Canada. Chapter nine closes this survey with the Committee's broader conclusions on the management of the debt issue. The report includes in Appendix A a brief description of the organizational structure of each of the international financial institutions and of Canada's participation in them.

The debt problem is closely related to the macro-economic environment where sudden developments can have a major impact. Economic policy changes determined within the OECD as well as actions by developing countries exert a constant influence on the situation. A dramatic example is the drop in the price of oil that occurred in 1986, which radically affected the capacity of countries such as Mexico, Venezuela and Nigeria to service their debts, while helping other oil-importing developing countries to handle their obligations. A decline in interest rates of one per cent can reduce the annual debt service load of developing countries in aggregate by $4 billion* a year. The level of economic activity in developed countries and the extent to which new protectionist measures may be applied by them also significantly affect the prospects for borrowing countries. The vigour with which the developing countries implement adjustment policies likewise have a significant impact on the economic climate.

With these uncertainties in mind, the Committee recognizes that there is no single solution to the debt problem. It therefore avoids categorical conclusions, although it does advocate a substantially increased flow of funds to debtor countries channelled through international agencies and creditor governments. However, the Committee's report takes the position that the problem is much more serious than is generally acknowledged and that the current debt strategy needs to be modified. For this reason and the fact that Canada has a particular interest in multilateral solutions, the Committee considers that a more active and direct involvement of the Government of Canada and other creditor countries is required. In particular it suggests that the time may have come for a dialogue between the creditor and debtor governments and it proposes the creation of a small international advisory group on debt.

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* Since international debt statistics are generally calculated in U.S. dollars, all figures in this report are given in U.S. dollars except where otherwise specified.

PART I

BACKGROUND TO THE PROBLEM

Chapter I

ORIGINS AND MANAGEMENT OF THE DEBT PROBLEM

Testimony and commentary on the origins of the debt crisis generated a considerable range of differing interpretations and emphasis. What stood out in most accounts was the continuing, complex interplay of both internal and external forces, a fact which serves to underline the growing interdependence of the global economy during the 1970s and 1980s.

Some cautionary observations to readers of this report need to be made at the outset. It is important to recognize that it is normal for countries to borrow abroad. This process can be mutually beneficial for debtors and creditors alike. Canada, for example, earlier followed the normal path of borrowing abroad, investing in capital goods and infrastructure, increasing production and foreign sales and ultimately servicing its debt. Today many developing countries are using foreign loans effectively to expand their economic base and repaying these debts as they come due. But others are having difficulty, either because of their deficient domestic economic policies or because of unfavourable developments in the world economy.

The situation of Third World debtor countries varies enormously. At one extreme are countries such as South Korea that have borrowed substantially from commercial banks in OECD countries, and whose exports are sufficient to service their debts without much difficulty. Other countries such as India, having borrowed relatively little, are also not experiencing problems. At the other extreme are some low-income countries — mainly in Africa, but including a few states in Asia, the Caribbean and Latin America — that are unable to service their debt, the greater part of which is composed of official or official-guaranteed debt derived from export credits and official development assistance in the form of low-interest loans. Finally there are a number of middle-income developing countries principally in Latin America which, having borrowed very heavily from the commercial banks, have in recent years had to seek some form of relief from their creditors. Together this latter group of countries constitutes the major part of the debt problem.

Because of these differences, some of the background to the debt crisis will be dealt with in two sections, one devoted to the middle-income developing countries and the other to the poorer developing countries. However, the lines between the two have frequently been blurred as conditions changed, especially after commercial bank lending gradually spread to the second group.

The Middle-income Developing Countries

A dramatic increase in commercial bank lending to Third World countries took place in the 1970s. Contrary to popular belief, this increase was not initially associated with the sudden rise in OPEC oil prices in 1973-74 but with a major commodity price boom in 1972-73. A similar pattern of expanded bank lending appears to have been followed in 1976-78, also in the context of higher commodity prices and prior to the second oil price rise of 1979.

Nonetheless, despite evidence that the spectacular increase in bank lending to developing countries was not actually triggered by the actions of the OPEC oil cartel following the 1973 Yom Kippur War, there is no doubt that the climb in oil prices resulted in very heavy borrowing by many developing countries. For the non-oil-exporting developing countries, it has been calculated that from 1973 to 1982 the extra cost of imported oil amounted to $260 billion.* To cover the large balance-of-payments deficits that developed, countries needed foreign exchange in substantial amounts. Once they had run down the balances accumulated during the 1972-73 commodity boom, developing countries from all parts of the world, but most particularly those in Latin America, turned increasingly to foreign commercial banks for their external financing needs.

Many borrowing countries failed to follow prudent monetary and fiscal policies. At a time when they needed to encourage domestic savings and inflows of foreign or repatriated capital, many actually discouraged such developments by implementing policies that resulted in price controls, subsidies, and overvalued exchange rates. These policies in turn caused increased balance-of-payments pressures that were kept from becoming problems by more borrowings from foreign banks.

In the circumstances that prevailed at the time, however, it was easy for borrowing countries to obtain credit and credit was cheap. Inflation was in the main growing faster than the interest rates charged on borrowed funds. In fact, from 1973 to 1979 real interest rates were close to zero and sometimes even negative. It was the low real interest rates and the falling dollar that made borrowing advantageous, which explains in part why even some oil-exporting countries such as Venezuela and Indonesia became heavy borrowers in the latter part of the 1970s. The high cost of imported equipment associated with energy and infrastructure development was also a factor in the debt build-up of these oil-exporting countries.

For the commercial banks, the decision of the OPEC cartel to exploit its power and escalate oil prices, thereby amassing huge surpluses of what became known as petrodollars, created a new situation. Major oil-exporting countries deposited a large portion of their massive surplus revenues in the banks of the industrialized countries and bankers were faced with the challenge of "recycling" these new funds. The bankers, in turn, loaned many of these deposits to oil- importing countries of the Third World, who were faced with growing oil costs. As the decade progressed, such loans increased heavily. From the banks' perspective, the commodity price boom, the steady growth in the economies of most developing

* William R. Cline, *International Debt: Systemic Risk and Policy Responses*. The $260 billion figure does not include the interest charges on the amounts borrowed to pay for each year's imported oil.

countries and their improved current account balances created an environment where lending to Third World countries was accepted as prudent banking. With real interest rates remaining low and inflation reducing the burden of the debt, the risks associated with such loans appeared to be quite manageable.

As the volume of petrodollars accumulated, competition between banks for Third World business became intense. Mr. David Ibarra, Minister of Finance of Mexico until 1982, recounted, "I had many bankers chasing me trying to lend me more money." (8:25)* In fact, during his tenure, Mexico increased its borrowings by some $30 billion. The large U.S. banks led the way, encouraged by the fact that loans made from the banks' large Eurodollar deposits, where most of the OPEC money was placed, were outside the control of U.S. bank regulatory authorities. In particular, such loans to customers outside the United States could be made without having to put aside non-interest bearing reserves and were therefore more profitable.**

One of the Committee's witnesses, William Cline of the Institute for International Economics, has written that, at the time, "some prominent bankers have asserted that sovereign lending has no risk at all because countries do not disappear."*** To avoid the risk that interest rates might rise and squeeze the margin of profit or "spread" between the loan rate and the rate paid to depositors, the banks opted for variable "floating" rate loans, which provided for interest rates to be adjusted periodically to conform with current interest rate levels. Whatever happened to interest rates, the bankers were assured of a profit.

In this process, loan syndications, involving the grouping together of a number of banks to make loans, played a part. These syndications netted large fees to the lead banks for negotiating, organizing and managing the loans. Unfortunately, as the 1985 OECD Development Assistance Committee (DAC) review has pointed out:

> The syndication technique itself appears to have reduced the incentive to base lending decisions on objective risk assessment, since the fees and margins of lenders and participants in developing-country loans depended on volume rather than attention either to prudent exposure limits or to the economic policies of borrowing countries. (p. 167)

Although the large U.S. commercial banks took the lead in lending to developing countries, they were followed by banks in Europe, Japan and Canada. Subsequently hundreds of small U.S. regional banks were persuaded to become involved in the syndications. As statistics in the next chapter demonstrate, Canadian banks were enthusiastic participants in this lending fever, "swept along in the upsurge of international deposits and loans" according to Mr. Alan Hockin,

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* Footnotes after quotations in this report refer to Committee proceedings and indicate the issue number and page number of evidence taken during the First Session of the Thirty-third Parliament, 1984-86.

** U.S. banking regulations require U.S. banks to keep non-interest bearing reserves on deposit with the Federal Reserve Bank to cover deposits in their U.S. branches or for loans to U.S. customers. Because they do not have to keep reserves on Eurodollar deposits loaned to customers located outside the United States, overseas lending became more profitable for U.S. banks than domestic lending.

*** *International Debt and the Stability of the World Economy*, p. 99.

former Executive Vice-President Investments of the Toronto-Dominion Bank, who had himself been involved in making bank loans. In retrospect, he admitted, there appeared to have been "an excessive degree of acceptance of deposits and lending" by the banks. (13:8)

In addition to the large amounts of long-term bank lending reported at the time, it is possible to see from statistical information now available that the banks were also involved in massive short-term lending, roughly equal in size to the long-term lending that was taking place. (See Table 1) Most of these loans did not come to light until the debt rescheduling negotiations of 1982 and 1983, and indeed, figures for short-term lending prior to 1977 still do not even exist. As the DAC report of 1985 noted, prior to 1977 this "short-term lending escaped proper surveillance and control, either by the authorities in both lending and borrowing countries or by bank managements." (p. 167)

TABLE 1

Annual Commercial Bank Lending to Developing Countries, 1972-84

($ billions at 1983 prices and exchange rates)

	1972	1973	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Long-term	10.46	18.27	17.84	21.63	20.51	25.93	20.16	21.57	29.19	25.89	54.00*	24.00*
Short-term					21.17	19.27	16.40	24.39	21.40	14.94	−19.00	−6.00
Total bank lending					41.68	45.20	36.56	45.96	50.59	40.83	35.00	18.00

* Includes a significant amount of rescheduled short-term debt.

Source: OECD, *DAC Report 1985*.

The pressure on the banks to find new borrowers was intensified by the fact that the initial response of the Arab OPEC countries was to deposit their rapidly accumulating surpluses in the banks of the OECD countries, much of it on a very short-term basis. The amounts were at times very large; Mr. Hockin told the Committee that his bank had been asked "to accept some enormously large deposits, beginning at a billion dollars and going up from there." (13:8) Mr. Hockin went on to speculate on why bank deposits were the preferred instrument:

> ...there was a very strong bias on the part of Middle East countries toward bank deposits and guarantees even when the ultimate borrower is a government of a western industrialized country... . They said they would sooner deposit the moneys in the banks and have the banks turn around and buy the government instruments. Maybe they were worried that if they had too many holdings of government securities that they would become hostages to that government. (13:8)

The World Bank's *World Development Report 1985* analyzed these OPEC placements and included the following observation:

> After the first oil price rise about 50 per cent of placements took the form of bank deposits, mainly in the Eurocurrency markets. After the second oil price rise, this

figure was 61 per cent. In each instance OPEC members thereafter gradually deployed their surplus in higher yielding, less liquid assets. Their initial preference for highly liquid assets reflected both a lag in recognition of the potential size of the surplus and a possible inability to gather information quickly on suitable long-term investments. (p. 89)

Mr. Hockin observed in passing that these newly oil-rich countries were reluctant "to accept new and unfamiliar responsibilities commensurate with their new wealth". (13:7) In fact, although the OPEC countries made few commercial loans directly to Third World countries, they did disburse substantial amounts in concessional aid, mainly through a variety of multilateral institutions.

In any case, the net effect of the Arab OPEC deposits to the commercial banks in industrialized countries was to put the banks in the position of having to find outlets for these huge sums. Whatever the background, the result is that the Arab investors avoided the problems that the commercial banks now have with bank loans to Third World countries and therefore most Arab loans are secure.

International monetary authorities of the time were generally supportive of this bank lending. They were concerned to find a way to channel some of the OPEC surpluses to the oil-importing developing countries so as to avoid the risk of a deflationary spiral in the world economy. However, as Mr. Hockin told the Committee, the funds of the international financial institutions were inadequate to cope with the volume of new payment arrangements required by the developing countries. One possible alternative would have involved some OPEC countries making larger contributions to the IMF, a move that some major established IMF members did not encourage since it would have involved the possibility of a diminuation in their IMF voting power as OPEC voting power increased. Besides, Mr. Hockin added, "the flow of funds became so great so rapidly that one could not wait for the naturally slow process of negotiating new arrangements in the international institutions." (13:7)

For these reasons the IMF supported the strategy that the commercial banks continue to recycle OPEC surpluses with a view to maintaining world trade and economic activity. Indeed the Managing Director of the IMF at the time, Mr. Johannes Witteveen, explicitly endorsed the role of the private banks in recycling petrodollars:

Private markets have a basic role to play here and it is to them that we must look for the main contribution in financing prospective balance-of-payments disequilibria ... . The Euro-currency markets may be expected to be the main channel. These markets are well equipped to handle large volumes of funds and they offer the flexibility and anonymity that the lenders desire.

The banking community did not initially look to the international financial institutions for guidance. At the time, the banks relied on the security of state guarantees and placed minimum conditions on their loans. In fact because loans from the banks came with few conditions attached, unlike many loans from official creditors, they were all the more attractive in the debtors' eyes.

Although much emphasis is now placed on the enthusiasm of the commercial banks for lending and on the lengths to which they went to press loans upon developing countries, it is important to recollect that at the time the actions of the banks received strong approval and even encouragement from the governments of the industrialized countries. The U.S. Administration in particular regarded the commercial banks as the best ready-made mechanism for transferring petrodollars quickly to developing countries. Several Canadian banking authorities told the Committee that they were personally aware that U.S. State Department and Treasury officials had urged the international banking community to act and to "accept the responsibility of being the first channel for moving the new petrodollars." (Hockin, 13:7) The U.S. Secretary of the Treasury told a 1979 IMF meeting that "we all recognize that the private markets will, in the future as in the past, have to play by far the major role in channelling financing from surplus to deficit nations." Successive British Chancellors of the Exchequer, including Mr. Denis Healey and Sir Geoffrey Howe, spoke warmly of the useful role the commercial banks were performing in financing Third World deficits. For example, in September 1977, Mr. Healey told the IMF annual meeting that "the commercial banking system has rightly played the main role in financing these developing country deficits until now and has shown immense resourcefulness in doing so".

As a result of the second oil shock of 1979 the OECD countries experienced greatly increased inflationary pressures and renewed balance-of-payments problems. Many of them decided to meet these challenges by introducing restrictive monetary policies. This response in turn caused a severe recession — even a depression, some would argue — leading to low, often negative growth rates in the industrialized world coupled with a dramatic rise in interest rates in 1981 and 1982. The extensive borrowings of developing countries left many of them highly vulnerable as interest rates climbed sharply.

For many Third World countries that had borrowed heavily, these developments provoked economic difficulties from which they have not yet recovered. The demand on world markets for commodities other than oil had slumped. Commodity prices — which for many of the countries represented the major source of foreign exchange — fell, declining 27 per cent in 1981 and 1982. In many cases overvalued currencies caused imports to soar as foreign goods looked deceptively cheap. With exports shrinking and imports expanding sharply, many debtor countries experienced a severe worsening in their balance of payments and it became increasingly difficult to service their debts. Interest charges on past debts were escalating rapidly with the rise of U.S. interest rates to unprecedented heights. Since 80 per cent of the bank debt was denominated in U.S. dollars and much of it on a floating rate basis, debt servicing costs rose in tandem.

In addition to these adverse external factors, there were internal policies and actions in the debtor countries which fuelled the crisis. Bankers and officials recounted to the Committee that a number of debtor governments mismanaged their economies and followed misguided domestic policies, that an overvalued currency in Venezuela over a 20-year period had caused massive capital flight, that inflationary policies in Mexico and Brazil undermined the international competitiveness of their economies, and that both Argentina and Mexico had worsened their problems by supporting inefficient state enterprises. Underestimating the extent and duration of the recession that was beginning, many countries avoided the necessary adjustments in favour of policies supporting continued consumer consumption. Inefficient state-owned or subsidized industries consumed a good deal of the available capital and in some instances military expenditures ate up capital which might have been put to productive use.*

The problem of capital flight, experienced mainly but not exclusively by some big Latin American debtor countries, compounded an already critical situation. Large amounts of borrowed funds were re-exported by private citizens when their confidence in their own economies waned. Factors which generate the excessive outflow of capital include: an overvalued exchange rate, which makes foreign imports seem inexpensive and can make exports uncompetitive; a high rate of inflation, which erodes the value of money; negative real interest rates, which discourage domestic savings; and an economic environment that is generally not conducive to productive domestic investment. Of these, the overvalued exchange rate was particularly insidious at the time, as it fuelled anticipation of a devaluation in many middle-income countries and encouraged speculative capital outflows. Studies have estimated that as of 1983, flight capital amounted to two-thirds of Venezuela's external debt and approximately one-third of the external debt of Argentina and Mexico. The World Bank has estimated that for the period 1979 to 1982, the combined capital flight from Venezuela, Argentina and Mexico totalled about $70 billion, with capital inflows during the same period amounting to $100 billion. In Mexico's case, it has been estimated that the external debt of that country by the end of 1985 would have been only about $20 billion rather than $100 billion, had it not been for capital flight.

The Crisis Develops

Although Arab OPEC countries deposited large amounts of funds abroad in 1980, these funds had fallen almost to zero in 1981 and, in 1982, Arab countries actually withdrew $16.5 billion from their Eurocurrency deposits. However this dramatic turn-about appears to have been compensated for by new deposits flowing into commercial banks from two sources: domestic and intra-OECD lending stimulated by the historically high interest rates and the huge transfers of flight capital.

Accordingly, debtor countries' repayment problems resulting from rising real interest rates did not initially lead creditors to question the capacity of their borrowers to make payments. In fact in the period from December 1979 to December 1980 when the Argentinian currency was highly overvalued, U.S. banks increased their loans to that country by 42 per cent, and in the first six months of 1982, just prior to the Mexican debt crisis, U.S. banks increased their exposure in Mexico at an annual rate of 34 per cent.

By 1982 all the adverse factors, external and internal, converged. Externally, the international recession, high interest rates, the continuing impact of the second oil price rise and the price collapse for other commodities presented many developing countries with increased problems. Within the debtor countries themselves, inappropriate policies, including continued heavy borrowings even in

* At the same time, it must be added that a World Bank study has established that much of the borrowing done by developing countries in the 1970s was spent usefully, stimulating their economic growth. In fact, the growth rate in developing countries in the 1970s exceeded that of the OECD group.

the face of high interest rates, and a slump in exports made matters worse. Finally in August 1982, a crisis situation erupted when Mexico was forced to announce a moratorium on service of its debt. It was simply unable to borrow enough to make payments on the interest and principal on loans coming due. Mexico's total debt exceeded $80 billion at the time and almost 30 per cent was due within one year. It was but one of many developing countries in a similar predicament. By 1983, 47 debtor countries were involved in negotiations with banks and official creditors to reschedule their debt due to inability to meet their obligations.

The Mexican declaration of August caused shock and consternation, and was followed by an almost immediate freeze on bank lending to Latin American countries and to many Eastern European countries. For many private banks, loans to debtor countries represented a dangerously high proportion of their portfolio and the amounts at risk when viewed in terms of their total capital were cause for alarm.

The Low-income Developing Countries

In the period prior to 1982, external pressures similar to those faced by the middle-income borrowers were also experienced by the low-income countries: the two commodity booms of the 1970s, the two oil shocks that led to manifold increases in the price of oil, the sluggish economies of the industrialized countries, the growth of inflation, and finally in 1981 and 1982 the severe global recession.

Faced with higher energy import costs after 1973, these countries had sought new sources of funds to sustain the growth that had been stimulated by the expanded commodity exports of 1971. Official development assistance (ODA), a traditional source of funding, was not keeping up with their needs. According to a Commonwealth study, while ODA disbursements to these countries rose by 54 per cent between 1975 and 1982, in real terms ODA flows actually declined. In their search for funds from sources other than ODA, multilateral institutions and some private investment in resource development, the low-income countries looked increasingly to export credits and to those commercial banks that were seeking to recycle the OPEC surpluses. Like the middle-income borrowers, they found borrowing from the banks attractive in a period of negative real interest rates. As a result, in the years between 1972 and 1982 — although the absolute numbers were not large — a striking shift toward capital market and non-concessional debt occurred in the low-income countries, including those in sub-Saharan Africa. According to a World Bank study, for countries of sub-Saharan Africa, borrowings from the private financial markets increased tenfold — from $1 billion to $10 billion — between 1972 and 1979, at an annual rate of 40 per cent. By 1982, they had reached $18 billion, a sum which represented 36 per cent of the total borrowings of these countries.

Although the mix of their loans was different, with bank debt comprising a smaller proportion, the low-income countries were hit just as hard as the large debtor countries by the second oil price hike and the subsequent recession. While a comparatively larger portion of their overall debt involved loans from ODA or multilateral institutions at low, concessional, fixed interest rates, repayment of both this debt and the bank debt from private financial markets presented a major difficulty for countries with a limited range of exports, which consisted mainly of commodities. Both the volume and revenue of exports of these countries declined in the late 1970s due to the global recession. More seriously, a World Bank study estimates that the terms of trade for oil-importing countries of sub-Saharan Africa fell an average of 11 per cent between 1980 and 1982. With interest rates soaring, debt service became an enormous problem compounded by the fact that new bank financing, both from private and official sources, abruptly declined. In many countries of sub-Saharan Africa, a continent-wide drought rendered even more formidable the problems of this particularly difficult period.

As with the Latin American and other larger debtors, inadvisable domestic policies played their part in making a bad situation worse including ill- conceived and extravagant public sector spending, uneconomic agricultural projects, and overly ambitious outlays on infrastructure. For some of these countries weapons imports were also a costly drain, devouring capital which might have been spent on measures to stimulate economic growth. However, the total exposure of the commercial banks in most of these countries was not large enough to jeopardize the banks' own financial stability. This probably explains why considerably less attention has been focussed on the debt problems of this low-income group of countries, even though the burden of their debt is relatively more onerous than that of the major debtor countries.

Is Anyone to Blame?

There is a natural tendency when serious problems develop to look for causes and to lay blame, particularly when costs have to be borne. In retrospect it is not difficult to see that there were shortcomings on all sides.

In respect to the commercial banks, a number of factors contributed to what in hindsight is seen to have been an excessive amount of bank lending to developing countries. The banks were recipients of a huge supply of Arab OPEC deposits that they had to re-lend. Aware of the considerable profits to be made through such loans, they became keenly competitive in their marketing. For the U.S. banks that led the way, lending to Third World countries was more profitable when done outside U.S. regulatory authorities on the Eurocurrency markets,through which most bank lending was subsequently channelled. In the process the banks appear to have misjudged the risks associated with sovereign loans and loaned more heavily than, in retrospect, prudence might have dictated. Moreover, the development of loan syndication spread the risks among many banks while stimulating lead banks to organize larger and larger loans. Floating interest rates attached to the loans gave the banks an additional sense of security against the risks.

For their part, the borrowing countries were both victims of the external economic environment — the global recession, high interest rates, commodity price drops — and the authors of their own difficulties through inappropriate domestic policies, including currency overvaluation that generated high import and low export levels and huge flights of needed capital. Many persisted in basing their growth strategy on continued borrowing on floating rates of interest even as these rates rose dangerously high.

During the 1970s and early 1980s both the governments of the OECD countries and the international financial institutions encouraged and even praised the commercial banks' role in petrodollar recycling and failed to forecast the consequences.

Finally, while statistics show that developing countries were stepping up their borrowings from foreign banks well before the first OPEC oil price rise, there is no doubt that it was the huge sums of petrodollars deposited by the Arab OPEC countries in western banks and the resulting balance-of-payments problems of oil-importing developing countries that provided a strong stimulus for the excessive borrowing and lending.

Underlying all the misjudgments that were made at the time was, as Mr. Hockin pointed out, an "inflationary euphoria" based on the continuing rise of commodity prices. "Everyone — lenders and borrowers, governments, financial institutions and individuals — were all caught up in this inflation of expectations" that commodity prices would "go on rising and rising, creating conditions for borrowing countries to service their debts without any problems." (13:9-10)

In addition, the Committee was advised that one of the reasons that public and private financial authorities did not ring the alarm on debt build-up was that they did not have adequate information. A New York investment banker observed to the Committee that as recently as 1982 the World Bank was reporting total problem Third World debt as only $125 billion, when in his opinion the actual debt was two and a half times greater. Apart from statistical lags, the Bank did not include short-term debt in its figures, although short-term loans were an important component in the borrowings of the major debtor countries prior to the debt crisis. Indeed, the existence of much of the short-term debt did not even come to light until the debt rescheduling exercises began in 1982. Further, the publication of figures assembled by the Bank of International Settlements in Geneva on the exposure of the commercial banks to individual countries had a significant time lag, as did the fact that maturities of the debt were being shortened for many problem countries. Another aspect of the problem undoubtedly related to the fact that some of the statistical information was held in confidence and not divulged. Mr. Richard Erb, Deputy Managing Director of the IMF admitted to the Committee that there should have been more timely and comprehensive data-reporting procedures, not only for figures on debt, but for economic statistics generally. Hindsight suggests that it would have been helpful to have better surveillance techniques both nationally and internationally. Indeed, the private banks have tacitly agreed to this conclusion, as they have since formed their own organization, the Institute of International Finance, whose primary mandate is to close the information gap by providing data about the borrowing countries.

Initial Responses to the Debt Crisis

The process of managing the debt crisis since the Mexican moratorium of 1982 has been on a case-by-case basis and has resulted in a number of solid achievements. Despite the initial consternation in 1982, there has been no international financial collapse, no major debt repudiations and no failures of major banks related to this international debt problem. Balance-of-payments deficits have been substantially reduced or even turned into surpluses. For example, the ten countries with the largest bank debt were able to transform the merchandise trade deficit of $45 billion, which they had in 1981, into a $25 to $30 billion surplus by 1983, mainly by halving imports. Between 1983 and 1985, reschedulings or new financial agreements were arranged between the banks and 31 countries, and affected $140 billion of debt. During the same period, the Paris Club — the group of creditor countries rescheduling official debts — came to agreements, also with 31 countries (not all the same), to restructure official or officially guaranteed debt. In a number of cases short-term debt was exchanged for debt of longer maturities; spreads on interest rates were narrowed in some instances; and a few multi-year rescheduling agreements took place both with commercial bank and official debt. These MYRAs, as they are called, extended maturities on loans, even those not due immediately.

The Paris Club

The Paris Club is a group of industrial creditor countries that, since 1956, has dealt with renegotiations and rescheduling of official or government-to-government debt, including officially guaranteed export credits. Its meetings are traditionally held in Paris and the secretariat always comes from the French Treasury.

Paris Club negotiations have never reduced, written off or forgiven debt obligations. Their function has been to postpone payments due on the debt. Their primary objective has been to ensure that the best terms possible are negotiated for the creditors as a group, with no one creditor receiving privileged treatment.

Rescheduling of official debt has accelerated in the past few years. During the 23 years up to 1980, there were 39 reschedulings involving 15 countries, whereas during the next five years, 38 reschedulings took place involving 32 countries.

The Paris Club has no formal charter but has developed practices which its member countries follow carefully. For example, a key precondition for creditor government agreement to rescheduling is that the debtor country should have an IMF stabilization program in place. Brazil's 1987 rescheduling is the only major recent exception. The final Paris Club agreement, signed by all parties, provides "guidelines" to the creditor governments. The terms and conditions will vary somewhat in the bilateral agreements that are subsequently concluded between the debtor and each creditor but generally include the following: a consolidation period referring to the specific time-frame in which the loans are to be rescheduled; the details of the treatment of the principal, interest and arrears components of the debt; and the maturity and grace period of the rescheduling. After the bilateral agreements are concluded, sometimes in itself a lengthy process, each agency of the governments concerned will restore export credit financing to the debtor country involved.

The Paris Club agreement only becomes effective legally when the bilateral agreements are implemented. The individual creditor-debtor agreements can contain softer but not harder terms than those agreed to at the Paris Club negotiations. The precise interest rate and fees on rescheduled debt are determined separately by each individual creditor government.

In managing the crisis, the IMF has played a central role. It set the tone in arranging the necessary bridging funds in each of the four rescue operations in 1982-83 affecting Mexico, Brazil, Argentina and Yugoslavia. The situation which the IMF and the international financial community faced in 1982-83 differed from any previous Third World debt repayment problem both in the scale of the need and in the attitude of the bankers toward extending further financing. Previously the Fund's adoption of a program of lending automatically generated private bank lending. As soon as it became evident after Mexico's declaration in

1982 that the banks were resisting further lending, the IMF's Managing Director at the time, Jacques de Larosière, secured the agreement of the Fund for a new and tough position. He made it clear that unless the private banks first agreed to restructure over $20 billion of Mexico's debt and provide $5 billion in new loans, there would be no IMF funding. The message was unmistakeable. Without the IMF funds, the entire rescue operation could fail and Mexico would have only one choice — to default, taking some banks down with it.

In arranging the rescheduling agreements for each country that was in difficulty, the IMF drew up a series of policy adjustments — some quite rigorous — based on the actual situation in that country and designed to promote short-term stability. Once the IMF was able to negotiate an agreement with a debtor country, that country was allowed to draw on the resources of the Fund in a series of instalments, each of which depended on the implementation of mutually accepted policy adjustments. These policy prescriptions included: the phasing-out of subsidies on food and transportation, the institution of wage and price restraints, compression of imports, devaluation of overvalued currencies, the expansion of exports, and reductions in the public sector. The emphasis was on the introduction of market-oriented policies, and countries were encouraged to privatize some areas of the public sector. The IMF agreements came to be regarded by the commercial banks as a prerequisite — an IMF stamp of approval — before they could be persuaded to engage in "involuntary lending".

The Mexican rescheduling arrangements that were worked out in 1982 have been used subsequently as a benchmark by the banks. If countries were diligent in implementing domestic reforms, it became the practice to agree to a more lenient financial package, including more time to pay off the loans and lower interest rates. For example, in recognition of its serious efforts to adjust, Mexico in 1984 was able to improve the terms and conditions of its own rescheduling: payments on principal falling due through to 1990 were postponed and repackaged into a new loan due in 14 years with lower interest rates.

Bankers with whom the Committee met in New York and Toronto spoke of the problems encountered during each of the debt reschedulings in getting agreement from the hundreds of different commercial banks of various creditor countries — and especially from representatives of the regionally dispersed American banking system. In each instance, a lead bank chairs an international consortium of banks — normally one per creditor country and usually the largest creditor bank of that country — which acts as a bank advisory committee and negotiates with the debtor country. Once a rescheduling agreement has been reached, the members of the consortium are responsible for persuading — by a process known among U.S. bankers as "dialing for dollars" — all other banks in their respective countries to take up their *pro rata* share of any new obligations that are agreed upon. The challenge is to rally all the participants in the syndication to come forth with the additional lending, since banks are very reluctant to have to increase their share. The procedure has required organization, ingenuity and persistence.

Since Canadian banks have lent heavily to Latin American and Caribbean countries, they are centrally involved in this process. Because of the regional structure of the U.S. banking system, special difficulties have been experienced in maintaining the participation of smaller U.S. regional banks, many of which are heavily extended domestically as a result of loans made in the past to the energy, agricultural, real estate and shipping sectors. As minor partners in the foreign loan syndicates, it has been tempting for them to try to clear their portfolios of developing country debt and a few have found ways to do so.

The economic recovery of the OECD countries after 1983 helped many developing countries, particularly those in Asia and Latin America, to expand their exports. The lowering of interest rates provided a degree of general relief although in real terms they remained high. Third World countries were able to resume modest economic growth even though the export prices of primary commodities failed to improve significantly. By mid-1984 and early in 1985 there was wide support for the view that the strategy followed so far — a mix of adjustment and new financing — had averted a breakdown in the financial system.

The Debt Problem Grows More Acute

The early signs of improvement did not generate further progress. Doubts began to surface in 1985 as to whether the situation was really improving. More fundamentally, as time passed and the process began to stagnate, it became increasingly evident that the financial community was not simply faced with a liquidity crisis. Rather, as Mr. Robert Hormats, formerly Assistant Secretary of Economic Affairs in the U.S. State Department and now with Goldman Sachs, a New York investment firm, told the Committee in New York, it was becoming more and more clear that Latin America's problem was one of "long-term solvency". In his view, since the difficulties were fundamental and not self-correcting, the situation could not be resolved by making new short-term loans. The Canadian Minister of Finance, the Hon. Michael Wilson, similarily concluded that the adjustment strategy had not addressed the more fundamental problem:

> As growth rates slowed in 1985, debt problems began to re-emerge and weaknesses in the post-1982 strategy became apparent... . The adjustment policies introduced after 1982 had largely addressed the external balance problem and had focused on restrictions on imports and demand. These were and continue to be necessary first steps. However, they did not address the more fundamental problems which were preventing investment and savings, promoting capital flight, and preventing the growth in the earning capacity of these countries. (14:6-7)

Economic growth in Latin America became virtually stagnant. Among the heavily indebted developing countries, particularly in Latin America, the very high inflation rates failed to decline and even rose higher in some countries. Mr. David Ibarra told the Committee that the average inflation rate for Latin American debtors had risen at a yearly rate of 50 per cent between 1979 and 1981 but had jumped to 195 per cent in 1984 and 328 per cent in 1985. Commodity prices, which would normally be expected to move up with international economic recovery, remained depressingly low — lower than at any time since the 1930s. In 1985 alone, non-oil commodities prices declined by 12 per cent. Agricultural commodities were particularly affected due at least in part to the increasing trade barriers and associated price support policies of the industrial countries. World sugar prices dropped by 26.9 per cent and wheat prices by almost 10 per cent. The result for Latin America was a 6 per cent decline in export earnings in 1985 and a

1 per cent decline in export volumes. Mr. Horace Barber, former Minister of Finance of Jamaica and currently Alternate Director at the World Bank, described the impact of deteriorating terms of trade in the Caribbean area:

> Jamaica earned on external accounts roughly U.S. $784 million from bauxite and alumina exports in 1980, and that became $250 million, in round figures, in 1985... . Bananas, coffee and other agricultural exports also suffered both in a quantitative sense and in a pricing sense, and, of course, the terms of trade were even further deteriorated. This situation faced the Caribbean area in 1983-84, and it faces it in an even worse sense in 1986. (5:9)

Further, world oil prices declined in 1985 to under $15 a barrel. While this was an important benefit to fuel-importing developing countries, it was a heavy extra burden for oil-exporting debtors including Mexico, Venezuela and Nigeria. The average cost of borrowing money declined from 11.3 per cent in 1984 to 8.6 per cent in 1985; this decline in interest rate levels was of some help, especially to major borrowers. But when real interest rates are related to developing countries' export prices, they are seen to average well over 10 per cent. Moreover, total interest payments on long-term debt actually rose due to the increase in the amount of outstanding debt resulting from rescheduling arrangements.

Although there had been a major improvement since 1982 in the borrowers' balance-of-payments positions, this had been largely achieved through import compression. With the passage of time, import restraint caused shortages of essential raw materials and spare parts, which in turn reduced the productive capacity of many debtor countries and with it weakened their ability to increase exports. Coincident with these developments, the continuing appreciation of the U.S. dollar during these years had the effect of increasing the real cost of Third World loans, which are largely denominated in U.S. dollars, without a corresponding increase in revenue from exports, many of which are sold in non-U.S. markets. The result of this along with general economic weakness, was depressed prices, in U.S. dollar terms, for traded goods.

Debtor governments for their part began to realize that, in spite of undertaking stringent adjustment measures — which may or may not have been appropriately implemented — their economies were stagnating and their debt load was growing rather than diminishing. The burden of servicing their debt was becoming heavier. Demands on their sparse hard currency supplies were increasing due to a bunching of the maturities on loans. Outflows of interest payments were not being offset by new borrowings, and debtor governments were thus faced with the politically difficult task of explaining to their citizens why their countries actually had net capital flows to the industrialized countries. Many countries recognized that the future only held prospects of further declines in real per capita income and that the economic outlook would remain bleak until at least 1990, even under the most optimistic scenarios.

There were heavy political and social costs as well. A number of newly democratic regimes became concerned that the unpopular economic measures they had tried to administer could lead to their political overthrow and a return to authoritarian government. Worse still, there was growing fear in many countries that social unrest could cause instability, turmoil and violent upheaval. Mr. Ibarra warned that Mexico was "running out of time" before a major social crisis took place due to the fact that the purchasing power of workers had declined by as much as 25 to 40 per cent between 1980 and 1985:

> The scenario I foresee is this: Between the governments and the people of Latin America there will develop more and more cleavages, because the governments have a commitment to increase the standards of living for the populations and they are unable to do so. As a result Latin American societies will become less and less easy to govern. (8:18)

Among the debtor countries there have already been signs of unrest, if not revolt. In 1984, Peru, facing interest payments on its debt equal to 35 per cent of its gross exports earnings, called a halt and announced it was unilaterally limiting payments on its foreign debt to 10 per cent of its export revenues. Nigeria followed, indicating it wanted to limit debt service to 30 per cent of export revenues. The 11 most heavily indebted Latin American countries, known as the Cartagena Group or the Consensus of Cartagena*, put their views in a declaration after a ministerial meeting in Montevideo, Uruguay in December 1985. Noting that living standards in Latin America had slipped back by a decade in the past five years, they urged that a series of emergency measures be adopted without delay. Of all measures cited, they singled out two as most critical: the need to return real interest rates to their historic levels and the elimination of trade restrictions.

As bankers perceived that austerity adjustment measures introduced by the borrowing countries were not generating the economic recovery they had anticipated, they became increasingly alarmed that they were "throwing good money after bad". Faced with a growing realization that the crisis was not a short-term one and that they were locked into long-term commitments, their instinct was to try to limit their exposure. Bank lending to problem debtor countries almost dried up as a result. It grew harder and harder to maintain the cohesiveness of the international banking community, since those who were least exposed financially were increasingly tempted to cut their losses. Constrained by differing national regulatory regimes, the financial squeeze caused banks in each creditor country to pull in different directions.

In the face of these developments, by 1985 there was an increasing awareness by the debtors, the banks, the international financial institutions and the creditor governments that the ingredients of the package that had been worked out to handle the Mexican crisis of 1982 were failing to resolve the overall problem of Third World indebtedness. Although a major breakdown of the financial system had been averted and the commercial banks had gained time to strengthen their balance sheets, such economic adjustments as the problem debtor countries had put in place were not generating the results needed to resume regular service of their debts. A senior Finance Department official told the Committee:

> I think the impression that had developed by 1985 was that the adjustments in many countries had been skin-deep, affecting largely the external sectors of their economies, the current accounts, and not their inner workings. (3:14)

The implication was that the middle-income debtor countries would have to accomplish more serious long-term structural adjustments to their economies if

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* See Appendix B, Glossary of Terms, for list of member countries.

another and more serious crisis were to be avoided. There was also a recognition that while the IMF had met and successfully managed the 1982 crisis, as time passed its capacity to intervene effectively had diminished. It was at this juncture that the U.S. Administration put forward what has since become known as the Baker initiative.

The Baker Initiative

This was the context in which U.S. Treasury Secretary James Baker addressed the Joint Annual Meeting of the IMF and the World Bank in Seoul, Korea in October 1985. The proposals made in that speech are widely referred to as the Baker plan or the Baker initiative.* The initiative was cast in general terms but the fundamental principle was the recognition that, for developing countries, austerity had to be linked with the promise of growth.

During its visit to Washington and New York, the Committee was told by American officials and bankers, including Deputy Secretary of the Treasury, Mr. Richard Darman, that the Baker initiative represented a dramatic "90 degree change" in the direction of U.S. policy on the international debt question. Until then the approach of the Reagan Administration had been not unlike that of U.S. President Calvin Coolidge who, when the United States was asked by European countries for relief of their World War I debts, responded, "They hired the money, didn't they?" The American approach had involved a classical call for restraint and financial discipline, with a reliance on market forces to achieve the necessary corrections. The new element that Secretary Baker injected into the analysis was a belated appreciation by the U.S. Administration that the economies of many Third World debtor countries were stagnating because they suffered from basic structural problems. "To improve the prospects for growth," which the Baker initiative called for, more time and substantial injections of new capital were needed.

The Baker initiative consisted of three sets of mutually interrelated measures:

- Agreement by debtor governments to apply comprehensive macroeconomic and structural policies aimed at promoting economic growth and balance-of-payments equilibrium without inflation. At the heart of these important structural adjustment prerequisites was a powerful emphasis on supply-side measures, involving a reliance on market forces to generate higher and sustained levels of economic growth. Examples include encouraging private foreign and domestic investment, while cutting down on the number and size of public sector enterprises; reducing import barriers that had prevented foreign competition; and in particular "getting prices right" by putting into place more realistic exchange rates, interest rates, and fiscal policies.
- Increased and more effective structural lending by the multilateral development banks (MDBs) and in particular by the World Bank, to complement the existing role of the IMF. The international financial

* This report refers to these proposals as the Baker "initiative" to emphasize that the U.S. Administration was providing a new impetus rather than offering a precisely designed rescue plan.

institutions were urged to play a pivotal role in initiating, supporting and monitoring the internal adjustment programs to be implemented by the debtor countries. It was proposed that the MDBs increase their disbursements to the principal debtor countries by 50 per cent over recent levels to an annual average of $9 billion during 1986-88. Taking scheduled repayments into account, this would generate $20 billion in net new lending over the three years referred to in Secretary Baker's speech.

- New and expanded lending commitments of up to $20 billion during 1986-88 by the private commercial banks to increase capital flows into debtor countries.

Secretary Baker tried to find a realistic compromise between international agreement on some general principles — especially the need to revive growth in the debtor developing countries — while maintaining the existing emphasis on a country-by-country approach. His initiative has bought time. It has also injected a much needed sense of momentum into international debt negotiations at a critical moment when country-by-country talks had bogged down in a mood of uncertainty and recrimination.

Reactions to the Baker Initiative

While there was satisfaction in international official circles that the U.S. Administration had adjusted its approach and now recognized the broader problems, the Committee has been made aware of criticisms of Secretary Baker's proposal. This initiative, by focusing mainly on the countries that constitute the principal debtors to the United States, understated the financial implications of the Third World debt picture viewed as a whole. The U.S. list of 15 debtor countries* was not accepted as definitive by other governments, the IMF or the World Bank. Canadian bankers told the Committee they would have added other countries of more relevance to the debt owed to Canadian banks. In any case, two more countries — Jamaica and Costa Rica — were subsequently added. Moreover, the calculations of the U.S. Administration were made before the dramatic fall in the price of oil at year-end 1985 and for this reason they underestimated the scale of the problem for oil-exporting countries such as Mexico. Estimates by the World Bank as to the net borrowings required for modest economic growth by even the Baker 15 countries illustrated that the U.S. funding proposal would be inadequate. In discussions with the Committee, Canadian bankers also suggested that the U.S. financing estimate was based on conservative assessments, particularly since Mexico would require such large sums. Furthermore, they pointed out that future new bank lending would have to be related to a case-by-case assessment of the creditworthiness of the borrowing countries. The Baker initiative, one Canadian banker concluded, lacked any concrete new undertakings that would lead to "voluntary" disbursement of the $20 billion of new bank lending suggested.

Some debtor countries also were sceptical of the initiative. For example in December 1985, the Cartagena Group concluded that the "Baker Proposal was inadequate . . . since the amount of resources envisaged can hardly be large

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* Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia.

enough to enable the debtor countries to meet their obligations vis-à-vis their creditors while at the same time supporting sustained growth." They considered that by emphasizing commercial bank debt, the Baker initiative downplayed the situation of many other problem debtor countries where official debt is much more important. Finally, while the creditor governments were mentioned as participants in the proposal by the U.S. Treasury Secretary, there was no precise commitment or role suggested for these governments in the promotion of growth in the Third World debtor countries. This omission was also noted by commercial bankers.

A central feature of Secretary Baker's proposal was the major role ascribed to the World Bank, especially as a provider of structural adjustment lending as distinct from specific project lending. The impression has been conveyed that this represents an entirely new activity for the Bank. In fact, as this report notes in chapter five, the Bank has had a structural adjustment lending program since 1980, and had experimented with such loans even earlier. What was new in the Baker proposal was the relative importance ascribed to such lending in future, and the increased risks that this activity would entail for the Bank.

In the months following the elaboration of the Baker initiative, the adequacy of the targets set out in the proposal for resolving Third World debt problems was the subject of much debate. During the visit to Washington and New York, the opinion among many of the Committee's interlocutors was that the debts of Third World countries would be manageable under the approach proposed by Secretary Baker providing some or all of the following economic conditions prevailed:

- the OECD countries did not increase trade barriers;
- the world economy grew steadily year over year at a rate of at least 3 per cent, which should translate into a 4.5 per cent annual growth in world trade and 6 to 7 per cent growth in Third World countries;
- interest rates continued to decline, or at least remained at current levels;
- oil prices did not rise too sharply; and
- inflation in OECD countries remained at modest levels.

The Committee found it difficult to imagine that such favourable circumstances would prevail uninterruptedly during the next decade or so. While not invalidating the Baker initiative, the Committee considers that it is vulnerable to any deterioration in the state of the world economy.

A crucial assumption of the Baker initiative is that the debtor countries will be able and willing to make the necessary changes to their domestic economies. Mr. Robert Hormats raised this problem in New York. Contrasting the success of a number of Asian countries, less well endowed than the countries of Latin America, in developing responsive and outward-looking economies, he was doubtful that the South American countries could adjust sufficiently to take advantage of the opportunities that the Baker initiative offered. Moreover, he feared that their economies were overly dependent on commodity exports.

The U.S. Administration's proposals did not address squarely the problems of the poorer developing countries, mainly in sub-Saharan Africa. Secretary Baker noted only in passing that they would require separate and special treatment and suggested that they should benefit from the reflows to the earlier IMF Trust Fund. For these countries, at a much earlier stage of development, a quite different set of policies is required. But their needs cannot be ignored.

In summary, while the Committee found general support for the Baker initiative, it heard many doubts on two main points: first, whether the state of the world economy and the immediate prospects were conducive to the success of the Baker approach; and second, whether the amounts of net transfers of capital to the debtor countries envisaged by Secretary Baker were sufficient to ensure success.

Differing opinions were expressed by Committee witnesses as to whether the Baker initiative should be invoked for Mexico. There were those such as a Canadian banker who considered that Mexico's debts were so large and its economy in such poor shape that it did not offer a fitting launch for Secretary Baker's prescriptions. Some U.S. and Canadian bankers questioned whether the Mexican economy could achieve sustained growth in the medium term; this accordingly raised doubts as to whether the commercial banks would come forward with sufficient new lending. Others, such as Mr. Paul Volcker, Chairman of the Board of Governors of the U.S. Federal Reserve System, saw Mexico as a test case. Ultimately Mexico's financing requirements could not be ignored or postponed.

The 1986 Mexican Package

The package of arrangements negotiated by the Mexican government with the U.S. Treasury, the IMF and the World Bank and announced on July 22, 1986 was something of a surprise to the international financial community. Not only was it considerably larger in terms of resources to be made available than had been anticipated, and not only did it include some novel features such as the linking of the size of the loans to the performance of the Mexican economy, but some of the conditions called for from the Mexican government were less onerous than expected.

The significance of the arrangements negotiated with Mexico can best be assessed by comparing the elements of the agreed package with the expectations conveyed to the Committee during its visit to Washington and New York only a month and a half before the agreement was announced. In June the Committee was told by a number of witnesses in Washington that Mexico had demanded $9 billion of funds in aggregate, an amount termed "outlandish" by Mr. Horst Schulmann of the Institute of International Finance. It was predicted that the final settlement would be in the neighbourhood of $4 billion. Of this amount, the commercial banks would be asked to put up about $2.5 billion, the World Bank $1 billion and the IMF another $600 to $700 million. In addition, it was indicated that Mexico would have to agree to reduce its budgetary deficit from about 13.5 per cent of GNP to around 5 or 6 per cent.

A comparison of these figures with the July announcement of the negotiated arrangement indicates that Mexico was able to persuade the IFIs and the U.S. government to accept substantially better terms than they had earlier talked about in public. The cash value of the Mexican loan package is set out in Table 2. It is noteworthy that the total amounts to over $12 billion, roughly three times as much as was being discussed only two months earlier.

TABLE 2
Mexican Loan Package
($ millions)

Source	1986	1987	Total
International Monetary Fund	700	900	1,600
World Bank	900	1,000	1,900
Inter-American Development Bank	200	200	400
Commercial banks	2,500	3,500	6,000
International export credits	500	1,000	1,500
U.S. farm credits	200	600	800
Total	$5,000	$7,200	$12,200

Although the July proposal called for the commercial banks to put up $6 billion, that is, more than double the amount discussed earlier, the bank advisory group for Mexico had not agreed, prior to the announcement, on any figure. It took over two months of intensive negotiations between Mexico and the lead banks to secure agreement to the terms under which the commercial banks would furnish the full amount of $6 billion in private loans that had been projected. In addition, a contingency fund totalling $1.7 billion to be financed by the banks was set up, called the "investment support facility". This included a credit from the banks of $1.2 billion for public and private investment if the price of oil were to fall and remain below $9 a barrel for three months and an additional $500 million if Mexico failed to meet its growth target of 3.5 per cent in 1987. The terms were, however, less generous than Mexico was seeking:

- Mexico had hoped that the commercial bank lending would be medium term, that is extend beyond the 18 months covered by the IMF program. In fact, the bankers held out for a shorter, 15-month term. Of the $6 billion in bank loans, $5 billion is to be repaid over 12 years with a five-year grace period. The remaining $1 billion, involving cofinancing with the World Bank, is to be repaid over 15 years, with a nine-year grace period.
- $44 billion of outstanding debt was rescheduled with payments to extend over a 20-year period, with a seven-year grace period on repayment of principal.
- The interest rate finally agreed upon for both parts was higher than Mexico wanted, although lower than the rate which it had earlier been paying. It has been calculated that this slight reduction — to 13/16 from 1.8 per cent over the rate the banks charge each other for borrowing — could be worth $300 million a year to Mexico or $6 billion over the 20-year repayment period.

In assessing the significance of these bare figures of the overall package, some supplementary financial information needs to be taken account of:

- Bridge financing of $1.5 billion was provided by central banks and some of the larger commercial banks until the final package was negotiated.

- The IMF, which agreed to loans of $1.6 billion over the 18-month period, will also guarantee $600 million to Mexico if oil prices drop below $9 a barrel by the end of 1987.

- In addition to the World Bank funding of $1.9 billion over the period, the Bank will guarantee to the commercial banks $250 million of the commercial banks' contingency fund related to Mexican economic growth and $500 million of the $1 billion which the commercial banks are cofinancing with the World Bank.

- International export credits, farm credits and a $400 million credit from the Inter-American Development Bank will provide another $2.7 billion.

For its part, Mexico undertook to carry out a number of measures:

- to reduce its budget deficit from 13.5 per cent to 10 per cent over the 18-month period of the agreement (in calculating the deficit, the effect of inflation on the debt charges is to be ignored);

- to open further the domestic market to competition by removing quotas and licences and reducing tariffs and subsidies;

- to restrict the supply of money in order to discourage capital flight;

- to modernize the economy by merging or closing up to 500 state enterprises;

- to limit the deductibility of business expenses;

- to join GATT and abide by its rules;

- to encourage domestic investment by such devices as a savings instrument whose value on redemption in Mexican pesos is tied to the value of the U.S. dollar; and

- to repay $1 billion in loans by banks to Mexican corporations and the $3 billion advanced by banks to facilitate petroleum exports.

The terms made public indicate that Mexico was able to persuade the IFIs and the U.S. Administration that more resources were required to generate growth in the Mexican economy than had originally been forecast. A major reason for this was the drop in oil revenues suffered by Mexico, which placed that country's economy in even worse straits than had been perceived when Secretary Baker spoke in Seoul. It is also probable that the commercial bankers wished, by means of their demonstrated support for Mexico, to encourage Brazil to continue to service its debt. It remains to be seen, however, to what extent other countries including Brazil will receive comparably generous treatment from the banks and the IFIs or whether Mexico has received preferred treatment as the most exposed of the problem debtors and as a major country lying adjacent to the United States.

There are many who think it was inappropriate to treat Mexico as a test case. Its debt is very large and its economy is generally regarded as being inefficient. For these reasons some observers are doubtful that Mexico can turn the economic corner, even with large loans. Chief among these are the bankers who have reluctantly agreed to lend billions of additional dollars to Mexico. The negotiations among all the creditor banks involved were quite difficult and the final agreement was not concluded until March 1987. It is true that Mexico's position could change rapidly should the price of oil rise significantly during the next five to ten years. Such a development is possible, and if this happens, Mexico's capacity to handle its debt load could improve markedly.

Nonetheless, an important consideration is whether Mexico will be able to summon the political will, in a pre-election period, to implement the structural changes envisaged by the package. Moreover, since the $12 billion loan arrangement is for 18 months only, after Mexico services the debt interest and principal payments due in this period, there will only be a very modest amount of the new funding left to be devoted to economic growth restructuring. Mexico's situation remains difficult and uncertain.

What the Mexican case points up is that each country's problems have unique features, which means that the case-by-case approach is essential and generalizations are dangerous. However, it also highlights the extent to which each development creates new conditions. Thus, unless the Mexican economy suddenly enjoys unexpected success, the banks will be more resistant to making large loans to other debtor countries in future, a condition which, in view of Brazil's 1987 decision to suspend interest payments on its debt, could make negotiations with that country more difficult.

Chapter II

THE SIZE OF THE DEBT

The total amount of loans to developing countries by commercial banks, creditor governments and their agencies and international financial institutions is now estimated at $1 trillion. About half the Third World countries, 67 in number, are having difficulty keeping up with their payments. Their combined debt amounted as of 1986 to $566 billion. Apart from putting a severe strain on the international financial system, the serious concern about this debt is that it is expanding, growing year after year, while the capacity of the debtor countries to make payments is in many instances diminishing.

It is important to draw attention to certain factors that make it difficult to pinpoint the precise extent of the "problem" debt. Chief among these is the fact that various interested institutions or governments base their statistics on different groups of countries, depending on what issues they are seeking to illuminate. The IMF presents statistics on 57 "problem" Third World debtor countries and this is usually regarded as the most comprehensive list. In 1985, the U.S. Treasury identified 15 — since raised to 17 — countries, comprising mainly those that are most heavily indebted to U.S. commercial banks but including a few countries such as Ivory Coast and Nigeria, where U.S. banks are less heavily involved, but which have been added, some witnesses suggested, for "political" reasons. In 1984, the Canadian Inspector General of Banks identified 32 debtor developing countries against which the Canadian commercial banks were directed to establish reserves in the form of general provisions. In 1986, a slight revision of the list raised the number to 34 countries.

It is also difficult to define precisely what constitutes external debt. Loans from governments in the form of official development assistance and loans from the commercial banks of the OECD countries represent two major forms of debt. Most export development financing from government agencies is also included in debt totals. On the other hand, suppliers' credits for periods of less than a year are not usually counted, but will be picked up as a debt obligation should the term be extended beyond a year as part of a debt rescheduling agreement. Lines of credit extended but not taken up are difficult to categorize for obvious reasons. The IMF, whose credits are short-term, does not include its own obligations in debt statistics it publishes, although the figures are public and readily available. Information on some forms of lending — notably from the Euromarkets where supervision and controls are minimal — is often not picked up until reported by borrowers, usually on the occasion of a rescheduling. Accordingly, depending on which categories of debt are included or excluded, quite different statistical results may emerge.

The IMF's list of 57 countries identified as "problem" debtor countries, includes all countries that since 1982 have experienced difficulties making payments on their loans and have had to reschedule them or seek some additional form of financing. Of their $566 billion problem debt, more than one half, or $310 billion, is owed to commercial banks, while the rest is divided between debts to governments or their agencies or to non-bank private creditors. Despite the international attention directed at the debt question, the obligations of the problem countries have continued to increase since even those that have secured current loans have used them largely to continue their debt repayments.

The 15 countries which were singled out for special mention in 1985 by U.S. Treasury officials following Secretary Baker's October speech in Seoul account for more than 85 per cent of the total debt of the 57 "problem" countries and comprise mainly the debtor countries most heavily indebted to the commercial banks. Two-thirds of the problem debt, over $380 billion, is now owed by debtor countries in Latin America. Ten of the 15 countries are in this region. By 1986 the debt of some countries of this area had reached dramatic proportions. Brazil's debt was $104 billion, Mexico's $96 billion, Argentina's $50 billion and Venezuela's $34 billion. In many countries, the proportion of debt owed to commercial banks as distinct from debt owed to other governments is extremely high. Mexico, for example, owes over 81 per cent of its debt to the banks. These factors explain why the bank debt of Latin American countries, rather than of other regions, has been the focus of attention by the international financial community.

But the debt problem is not only a bank problem and is not confined to Latin America. There are also government creditors and other private creditors. At the end of 1986, the 57 problem countries owed $166 billion to other governments — either in the form of development assistance loans with concessional terms or through bilateral government-to-government loans such as export credits from official agencies. Sub-Saharan Africa, excluding Nigeria, has approximately 20 per cent of the problem debt; almost two-thirds of it is owed to official creditors. While the amounts are smaller than bank debt and the terms less onerous, a number of African countries including Sudan, Zambia and Tanzania find that official debt represents an extremely heavy burden.

The balance of the debt of the 57 problem countries, amounting to $91 billion, is owed to other private non-bank creditors. This segment of debt is defined by the IMF as "all unguaranteed debt . . . owed mainly to private creditors". Most of these debts are owed to non-financial companies and suppliers who shipped goods on credit and they are termed non-guaranteed suppliers' credits. The amounts owed have declined from a peak of $115 billion in 1982, reflecting lower volumes of goods shipped by exporters in OECD countries. (see table 3)

In addition to the debts that developing countries owe to the banks and official creditors, there are also debts on loans provided by the preferred creditors, namely the IMF and the multilateral lending banks, which, because of their preferred status, are not usually included in the total debt figures. In the two years after the 1982 crisis, the IMF in particular increased its lending substantially, accounting for 10 per cent of the financing available. In 1982 and 1983 for example, the Fund transferred $12 billion to countries with debt servicing problems.

TABLE 3
Foreign Debt of 57 Problem Countries by Type of Creditor, 1986
(exclusive of obligations to IFIs)

	$ billions	per cent
Government-to-government loans	166	29
Commercial banks	309	55
Non-bank private creditors	91	16
Total	566	100

Generally speaking the developing countries of the Asian and Pacific regions have had a more varied experience with external debt problems than have countries in other areas of the world. Asian countries have an outstanding debt of about $250 billion, over 80 per cent of which is being handled without difficulty. South Korea, for example, is the fourth largest debtor country after Brazil, Mexico and Argentina, but it is servicing its debt and obtaining "voluntary" lending from commercial banks to pursue its economic goals. India has borrowed cautiously and avoided serious debt servicing problems; as a result it is in a position to borrow new capital from private sources. The Philippines has a major debt problem and has experienced serious capital flight as well, and several other countries such as Indonesia and Malaysia are having increasing difficulties.

A comprehensive survey would not be complete without a reference to the countries of Eastern Europe. Even though these countries are not considered Third World or "developing countries", their debt affects the availability of new loans to Third World countries from commercial banks of OECD countries. In 1982, the outstanding debt of Eastern European countries stood at $63.5 billion of which the $26.5 billion Polish debt constituted more than a third. Poland owed approximately one-half of its external debt — or $13 billion — to commercial banks. In 1981, even prior to the Mexican crisis, Poland had trouble meeting its debt obligations and asked for debt rescheduling. Shortly afterwards, there were liquidity problems in Romania, Yugoslavia, Hungary and East Germany which have all had reschedulings. So far, however, except for Poland and Yugoslavia, the state-directed economies in these countries have been better able than Third World countries to institute the rigorous adjustment programs required. Canada and several other western countries, notably the United States, France, Germany and the United Kingdom, are substantial creditors, along with their banks, to some of these Eastern European countries.

Decline in New Lending

Far more serious than the size of the debt owed by the problem debtor developing countries has been the fact that new net lending by the commercial banks is no longer flowing to the "problem" Third World countries. In fact, many of these countries are currently faced with a serious net outflow of capital. In 1981 commercial bank lending to all developing countries amounted to $50 billion. By 1985 such loans had dropped to $16 billion, most of which was lent to Asian developing countries; by 1986 new bank lending to Latin American debtor countries had declined to almost zero.

The debtor countries have also been concerned by the drying-up of export credits that has followed after the Mexican crisis. According to the World Bank, the level of official or officially-supported export credits to developing countries dropped from $14 billion in 1981 to $8 billion in 1983. In the low-income developing countries, the decline in trade financing was even more severe, falling from $1.2 billion in 1980 to $250 million in 1983. These cuts reflected the understandable caution of export credit agencies — faced with reschedulings and heavy insurance claims — to continue financing customers who were no longer judged creditworthy. They also reflected the lack of demand for such credits by developing countries themselves as their investment programs contracted.

Even the international financial institutions are contributing to the reverse flow of funds from developing countries. Because IMF loans made in 1982 and 1983 were on a relatively short-term basis, it was not long before funds began to flow back. IMF statistics indicate that in 1986 the Fund has been the net recipient of $200 million from the problem debtors and this will increase to $1.6 billion in 1987. About $400 million is being drawn from small low-income debtors, including $200 million from sub-Saharan Africa, that is, from the countries least able to pay. The World Bank* was also close to being a net recipient of Third World repayments in 1986.

TABLE 4

Capital Flight and Gross Capital Inflows in Selected Countries, 1979-82

Country	Capital flight ($ billons)a	Gross capital inflows ($ billions)b	Capital flight as a % of gross capital inflows
Venezuela	22.0	16.1	136.6
Argentina	19.2	29.5	65.1
Mexico	26.5	55.4	47.8
Uruguay	0.6	2.2	27.3
Portugal	1.8	8.6	20.9
Brazil	3.5	43.9	8.0
Turkey	0.4	7.9	5.1
Korea	0.	18.7	4.8

a. Data are estimates. Capital flight is defined as the sum of gross capital inflows and the current account deficit, less increases in official foreign reserves. For some countries (notably Argentina and Venezuela), the estimate may overstate capital flight to the extent that unreported imports and normal portfolio investments abroad are included.

b. Defined as the sum of changes in gross foreign debt (public and private) and not foreign direct investment.

Source: World Bank data.
World Development Report 1985, page 64.

* Generally, in this report, the term "World Bank" refers to the **International Bank for Reconstruction and Development** (IBRD) and not to its affiliates, the **International Development Association** (IDA) or the **International Financial Corporation** (IFC). The three together are known as the World Bank Group. A description of the functions of these organizations, together with those of the regional development banks, can be found in Appendix A of this report.

Another factor adding to the problem of net capital outflows from developing countries is the flight of private capital and the reluctance to repatriate capital. Up-to-date figures of the size of these flows are difficult to pinpoint. However, a 1985 World Bank table, reproduced here as Table 4, provides an estimate of the size of capital flight from certain selected countries between 1979 and 1982.

Deterioration in Capacity of Problem Debtors to Pay

The full dimension of the problems facing debtor countries can only be appreciated by examining the deterioration since 1982 in their capacity to make payments on their debts. This can best be assessed by noting the trend in each of the three key debt indicators that measure the debt burden of the 57 countries having debt difficulties. These indicators are: a) the ratio of debt to GDP; b) the ratio of debt to exports; and c) the debt service ratio, that is, the interest and principal due on the debt as a percentage of exports of goods and services. All three indicators are used widely, including by the IMF and the Canadian Department of Finance, as measurements of the debt problem. All three are considered useful signs of a borrowing country's creditworthiness. Increases or decreases in the ratio of debt to GDP measures a country's ability to service debt out of the current national income. A continued rise in the ratio of debt to exports indicates an incipient liquidity problem and suggests the likelihood of additional net borrowings that will add to debt servicing difficulties. A rise in the ratio of debt service payments to exports of goods and services suggests that a borrowing country is becoming increasingly vulnerable to adverse external developments such as higher interest rates, unfavourable terms of trade or a decline in new capital inflows. Table 5 indicates how each of these ratios has worsened for all Third World debtor countries between 1981 and 1985.

The above statistics show that the countries of Latin America and the Caribbean face a particular squeeze between their requirements to service and repay their debts at floating rates and the decline in revenues from their exports due to such factors as falling commodity prices and shortcomings in their past

TABLE 5

Indices of Debt Burden

	Debt as a % of GDP		Debt as a % of exports		Debt payments* as a % of exports of goods and services	
	1981	1985	1981	1985	1981	1985
57 problem countries	36	48	180	261	31	37
Latin America/Caribbean	36	48	208	295	41	44
Sub-Saharan Africa**	43	63	169	240	18	29
Small low-income countries	41	59	269	383	18	30
Asian developing countries	18	25	71	93	9	12

* Interest, amortization or both.
** Excluding Nigeria and South Africa.
Source: IMF, *World Economic Outlook*, April 1986.

economic policies. For some of the larger Latin American countries, 40 to 50 per cent of their export revenues is going to debt servicing. The Committee heard details of the situation from the former Finance Minister of Mexico, Mr. David Ibarra, who explained that:

> By and large, the governments and countries in Latin America are, in 1986, in a weaker position to deal with the debt service than they were in 1982. The reasons for this are very many. Income per capita decreased 10 per cent between 1980 and 1985. Its level today is similar to that attained eight or nine years ago. National income must have been further depressed, to judge from the deterioration of the terms of trade and the increased external debt servicing. Most of all, there are social groups within the countries that have lost, perhaps, between 25 per cent and 40 per cent of their former income. Therefore, in terms of internal discipline, the adjustment to a harsh external environment has been enormous. In order to service the debt growth, private consumption, government spending and imports have been drastically cut. (8:6)

Mr. Horace Barber of Jamaica said that just servicing the interest on his country's external debt represented 30 per cent of total government revenues, an amount which put an inordinate constraint on Jamaica's economic growth. Mr. Sidney Dell of the United Nations Institute for Training and Research (UNITAR) told the Committee that in 1985 Argentina owed 136 per cent of its exports in debt service on interest and principal repayments, an amount which was clearly unpayable. He explained:

> Part of this problem is due to a bunching of maturities from now to approximately 1988 or 1989, and that bunching of maturities is, in turn, due to the fact that the crisis management process, so far, has only postponed a little bit of debt at a time, and it has done it in such a way as to bunch up further obligations ahead. Therefore . . . there has been a tendency to adopt what is called a short-leash approach to force the borrower to come back again and again, and the result is that countries see themselves faced with increasing obligations, year by year, which must be negotiated again and again with the creditors. (4:7)

Table 5 also makes clear the very severe problems of the sub-Saharan African countries and shows that the accumulated debts of the small low-income countries in some instances amount to four times their annual exports. While much of the debt of these latter countries has been on concessional fixed interest terms, the level of this debt in relation to the GDP and annual exports of these countries is now alarmingly high. Africa's debt-service ratio has increased at a faster rate of growth than any other area. Eleven African countries have debts equal to 85 per cent of their GDP. Had Sudan's debt not been rescheduled, it would have needed more than 100 per cent of its export earnings to deal with its debt obligations, including both interest and principal repayments.

Mr. Dell, noting that the smaller-income countries of sub-Saharan Africa owed most of their debt to governments rather than to commercial banks, observed that:

> ...the problem, essentially is very similar. It does not really matter very much to Sudan that its debt is owed to a government rather than to a commercial bank. It is faced with the same impossible burden of debt as are the others. (4:8)

The Committee does not share Mr. Dell's perception. While it is true that to a country making interest payments it matters little whether it makes its payments to a bank or to a foreign government, past experience demonstrates that foreign governments can agree to a moratorium much more readily than can the banks. For the sub-Saharan African countries recently granted a moratorium on interest payments by Canada, this distinction was clearly important. (see page 41)

For most Asian debtor governments the situation is considerably less serious. Table 5 compares the same debt ratios for Asian developing countries with those for other regions' developing countries in order to illustrate the difference in their situation. While there are exceptions, including the Philippines which has a major debt problem, many low-income Asian countries currently have better ratios than they did ten years ago, and with those that have deteriorated, the change has been relatively minor. According to experts whom the Committee met in New York, an important factor in the generally more favourable Asian situation was the more market-oriented economies and the more active entrepreneurial systems that prevail in many Asian developing countries than in the other two regions. Part of the explanation also lies in the diversity of exports from the countries of this region including more manufactured exports than from either Latin America or Africa. The particular mix of exports in Asian countries has meant they were less vulnerable to the global recession and particularly to the commodity price slump. However, they may be more vulnerable to protectionist measures in the OECD countries, the most promising market for exports of their manufactured goods.

Position of the Creditor Banks

At the time of the Mexican moratorium in 1982, there were widespread fears that a default or repudiation by large borrowing countries could lead to bank collapses or a widespread undermining of the stability of the international financial system. Several major banks were especially exposed in Latin America in 1982; loans made to Mexico by the nine largest U.S. banks, known as the "money centre banks", were equivalent to 44 per cent of the combined capital of those banks.

Overall, however, the position of the commercial banks in OECD countries has improved since 1982. Concerted efforts have been made by banks in all developed countries to increase their capital base so as to improve their capital-to-assets ratio. At the same time they have increased their loan loss reserves, while reducing their lending to Third World countries. The Canadian Finance Minister told the Committee that, while practices differed from country to country and from bank to bank, "the effect has been to strengthen the positions of the financial institutions and the system as a whole against possible defaults". (14:8)

The rate and degree of improvement has reflected several factors which highlight the fact that differing regulatory environments affect the way bank debt is handled. These include:

- the extent to which the capital-to-assets ratios of banks had been run down in the 1970s, a rather general phenomenon;
- differing tax treatment of provisions, which helps to explain why European banks are more heavily provisioned, Canadian and Japanese banks more moderately so and U.S. banks rather sparsely provisioned;

- different regulations with regard to the treatment of allowances or reserves for loan losses, so that U.S. banks are able to include such allowances in their primary capital base and thereby improve their capital-to-assets ratio, a procedure not permitted in Canada; and
- different approaches to writing down sovereign loans in Europe than in North America.

Depending on which group of countries is looked at, relative shares of bank debt vary somewhat. In 1984 the share of the bank debt of the 57 problem countries held by U.S. commercial banks was 42.6 per cent or $99.6 billion. The Canadian banks' share was 8.4 per cent or $19.7 billion. For the purposes of comparison, if the 15 "Baker" countries are examined, the share of the debt by Canadian banks is somewhat lower — 6.5 per cent in 1985 — while the U.S. share is 32.3 per cent and the share of other OECD banks based in Europe and Japan is 61.2 per cent. Taking an even narrower focus — looking at one country, Mexico — gives yet another picture, with the United States in 1985 having about 35 per cent of Mexico's debt, Japan 15 per cent, Britain 13 per cent and Germany, France and Canada all in the 7 to 8 per cent range.

The main effort of the U.S. banks has been to strengthen their capital base by increasing both their equity and their productive assets. The nine major money centre banks in the United States, which are the most heavily exposed, were able to decrease their exposure in Latin America as a per cent of capital from 177 per cent in 1982 to 105 per cent in 1985. The Committee was told by the U.S. Deputy Comptroller of Currency, Mr. Robert Bench, that, in respect of the 15 "Baker" countries, the exposure of all U.S. banks across the board had fallen from 134 per cent to 86 per cent of capital during the same period. The banks, he reported, had also concentrated on developing their capital base and had been able to improve their capital-to-assets ratio from 4 per cent to about 6.5 per cent. This ratio is derived by dividing the value of the equity held by the bank's shareholders plus retained earnings, into the assets held by that bank. The base for these assets is normally the collateral pledged for the loans made by that bank. One of the problems with sovereign debt is that there is no collateral. The capital-to-assets ratio is the traditional measure of a bank's capacity to weather a deterioration in the quality of its assets or to meet all its obligations in the event of a bank wind-up. It affects the capacity of a bank to raise new capital on the stock markets.

The Committee received relatively little statistical information on how the European and Japanese banks have responded, but it was clear that differing tax laws and regulatory frameworks determine the nature of their attitude to rescheduling proposals. A New York banker, Mr. Charles Meissner, told the Committee that some European banks were quite strongly reserved against their loans. Indeed German, Swiss and French banks are reported to have provisioned from one-third to one-half the value of their loans. One reason why they could do this more easily is because some European countries are allowing their banks to build up what are called "hidden reserves", which are untaxed. With these reserves, European banks are in a better position than Canadian banks, and in a much better position than U.S. banks, to write down their loans to Third World countries.

Third World Debt Owing to Canada

The position of Canadian banks

Canadian banks have for many years been active in international banking, particularly in Latin America and the Caribbean, and they participated vigorously in recycling petrodollars to that part of the world along with banks in the United States, Europe and Japan. As a result they built up loan portfolios in that region comparable in scale with those of the large U.S. banks. Major Canadian banks are owed over C$27 billion from debtor countries in the Latin America and Caribbean region. Figures show that Mexico owes four Canadian banks over C$1 billion each and Brazil owes one bank almost C$2 billion and two other banks over C$1 billion.

Table 6 shows the extent of the published indebtedness to Canadian banks of Third World countries by region and by country, when known. This information has been compiled from the annual reports of the banks. No public information is available as to how much of the debt is owed to the banks by either the 57 problem countries identified by the IMF or the Baker 15. The Canadian *Bank Act* requires that banks report loans to specific countries only if they represent more than one per cent of their total assets. Only the Bank of Montreal uses this standard. Four others — the Toronto-Dominion Bank, the Canadian Imperial Bank of Commerce, the Bank of Nova Scotia and the National Bank of Canada — use the threshhold of three-quarters of one per cent of assets, and the Royal Bank uses half of one per cent. In practice this has meant that only six of the 57 problem debtor countries are separately identified in some or all of the reports of the six major Canadian banks. Other non-problem countries are also listed, such as the United States, Japan and Korea. Otherwise loans are reported by region.

The Committee has been told by Canadian bankers that of the large C$27.5 billion debt from countries in Latin America and the Caribbean, on average about 90 per cent of this figure constitutes problem debt. Although six countries of the region are listed because their debt to Canadian banks is above the threshold applied by the bank, in some smaller countries, Canadian banks may be very heavily exposed without having to report the details. An indication of the extent of this exposure can be deduced from the fact that for two Caribbean countries — the Dominican Republic and Jamaica — Canadian banks act as the agent or lead bank for the international advisory consortia that negotiate debt listed because their debt to Canadian banks is above the threshhold applied by rescheduling agreements. While not always the case, the agent bank is usually the one that has the largest exposure in the country involved, and it is always drawn from among the major creditors. During its meetings in Toronto, the Committee was told that of the five major lenders to the Dominican Republic, two are Canadian banks; of the four principal creditors of Jamaica, three are Canadian banks; and that among the top 15 banks holding Mexican debt, four are Canadian. These facts highlight more graphically than the sparse published statistics the extent to which Canadian banks have accumulated loan portfolios in some Latin American and Caribbean countries that are as large as those held by the commercial banks of any other creditor country.

The Committee did not include figures on debt owed to Canadian banks by the so-called "Asia, Oceania and Australasia" region, which amounted in total to

TABLE 6

Earning Assets by Leading Canadian Banks to Latin America, the Caribbean, Africa and the Middle East, 1986
(C$ millions)

	Royal Bank of Canada	Bank of Montreal	Canadian Imperial Bank of Commerce	Bank of Nova Scotia	Toronto-Dominion Bank	National Bank	TOTAL
Brazil	1,629	1,983	1,203	955	809	525	7,104
Mexico	1,557	1,810	1,036	1,213	937	588	7,141
Venezuela	720	n.a	n.a.	539	n.a.	187	–
Argentina	479	n.a.	n.a.	n.a.	n.a.	174	–
Bahamas	669	n.a.	n.a.	479	n.a.	n.a.	–
Jamaica	n.a.	n.a.	n.a.	620	n.a.	n.a.	–
Other Latin American & Caribbean	1,753	1,609	1,851	2,855	910	374	–
Total Latin American & Caribbean	6,802	5,402	4,090	6,661	2,670	1,848	27,473
Africa & Middle East	n.a.	174	163	309	57	118	821
Total earning assets in these two regions	6,802*	5,576	4,253	6,970	2,727	1,966	28,294
Total bank assets as of October 1986	99,607	87,180	80,841	64,013	51,447	27,872	410,960
These assets as a % of total assets	6.83	6.4	5.26	10.9	5.3	7.05	688 (avg.)

* excludes Africa and Middle East.
n.a. not available
Source: The annual reports of the six largest Canadian banks for 1986.

about C$22 billion, since only a portion, less than 20 per cent, is problem debt. The principal borrowers — Japan, Australia, South Korea and Hong Kong — are quite able to service their debts. (There remains nevertheless debt probably in excess of C$1 billion with some countries in this region that is at risk, a significant addition to the total problem debt owed to Canadian banks.) Nor is any breakdown published as is the case with debt owed by African countries — where most countries are in the "problem" category — or the Middle East — where Egypt is the main problem country. The important point to note, however, is that the levels of Canadian loans to Latin American and Caribbean countries are substantial.

Comparing the position of Canadian banks to those of the United States, the exposure as between Canadian banks is somewhat more evenly distributed. Figures given to the Committee indicate that the nine large U.S. money centre banks hold over 60 per cent of the total U.S. problem debt. This represents 9.2 per cent of their assets as compared to 6.4 per cent of the assets of Canadian banks. This heavy involvement of major U.S. banks has a powerful influence on the approach taken by the U.S. Treasury on managing the debt question. However, if an across-the-board comparision of the two banking systems is made and account is taken of differences in banking regulations and accounting practices, the capital-to-assets ratios of the two countries are roughly similar.

The Canadian banks have in the last couple of years substantially increased their reserves against the problem debtor countries. In June 1984 the Inspector General of Banks directed them to set aside provisions against sovereign risk loans in 32 problem countries of between 10 and 15 per cent of total exposure.*

The minimum level was to have been achieved by October 31, 1986. To strengthen reserves still further, another directive was issued in December 1986 requiring that by 1989 Canadian banks make a further increase in their provisions — of 18 to 20 per cent — on their sovereign loans to specific countries. This percentage is likely to be increased further in the future. The list of countries is henceforth to be assessed annually with a view to possible additions or deletions.

Although it is Canadian bank practice to set aside specific provisions for non-performing loans in Canada and some OECD countries, reserves for sovereign loans to problem debtor countries are pooled and treated as a general reserve. Some banks report in the text of their annual reports the amount set aside for general provisions, and in some instances this is related to the Inspector General's list of 32 countries, whereas others give only the percentage of their general provisions in relation to the debt; the Bank of Nova Scotia limits its comments to the statement that it is "in compliance with the guidelines." The Royal Bank reports its loan loss experience by region; all the others aggregate their losses under the general category of "international" which means that non-performing loans in the United States and other OECD countries are lumped in with Third World debtors. A further limitation in the information provided is that the aggregated figures given for non-performing loans are shown net of provisions for loan losses, with no separate entry to indicate the size of the provisions taken, so that the precise amounts of international loans deemed to be non-performing cannot be identified.

Subject to these several qualifications, the annual reports do broadly show that the banks are carrying out the Inspector General's directive and making significant additions to their reserves against loan losses. The National Bank of Canada reported that its general reserves as of October 31, 1986 amounted to

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* The Inspector General's 32 countries were: Argentina, Bolivia, Brazil, Chile, Costa Rica, Cuba, Dominican Republic, Ecuador, Guyana, Honduras, Jamaica, Liberia, Madagascar, Malawi, Mexico, Morocco, Nicaragua, Nigeria, North Korea, Peru, Philippines, Poland, Romania, Senegal, Sudan, Togo, Turkey, Uruguay, Venezuela, Yugoslavia, Zaire and Zambia. When the new directive was issued for 1987-89, the Ivory Coast, Panama and South Africa were added and Turkey was removed.

C$383 million, or 15.7 per cent of its loans to the basket of 32 countries specified by the Inspector General; this represents an increase of C$97 million from the previous year. The Canadian Imperial Bank of Commerce reported having reserves of C$451 million in October 1986 against loans to financially troubled countries, representing 13.6 per cent, with C$130 million set aside during the year. The Toronto-Dominion Bank had accumulated, by the 1986 year-end, a general reserve of C$302 million, representing 10.1 per cent of outstanding loans to the 32 problem countries, an increase of C$52 million. The Bank of Nova Scotia gave no specific figures. The Bank of Montreal indicated only that its provisions amounted to 12.8 per cent of its loans to the Inspector General's basket of countries. The Royal Bank reported provisions of C$628 million or 11 per cent of its loans, an increase of C$265 million over the previous year.

Paralleling their problems with Third World loans, Canadian banks as well as those in the United States have been adversely affected by economic difficulties experienced domestically since 1980. Heavy losses in the energy, real estate, agriculture and shipping sectors have exacerbated the problems of North American banks. The sharp fall in the price of oil has both reduced the value of assets held by banks as collateral for loans to oil companies as well as reducing the earnings of the oil companies and therefore their capacity to service their debts. As a result, in 1986 the banks felt it necessary to take substantial write-downs on loans to the energy sector in Canada and the United States. The drastic decline in the price of internationally traded grains is causing a depression in parts of the farm economy, reducing the price of land and affecting the ability of farmers to make payments on their loans. In the parts of the two countries most affected by the decline in the energy and agricultural markets, the real estate market has also fallen sharply and shipping interests in the United States have suffered from the decline in international trade. In parts of the United States, smaller, regional banks heavily involved in both energy and agricultural sector declines have been hit particularly hard. Indeed, write-downs or specific provisioning by Canadian banks in these sectors in 1986 have exceeded general provisions taken on their sovereign risk loans. Taken together, the combined cost of provisions and write-downs absorbed by Canadian banks in 1986 amounted to C$3.4 billion.

According to Canadian bankers, the effort of the banks to build up the necessary funds to establish their provisions has reduced bank profits and resulted in lower dividends and lower bank stock prices for shareholders. It can also be assumed that there must have been a considerable cost to the Canadian economy and to Canadian consumers in the form of increased charges to bank customers through wider spreads in interest rates and higher service charges.

While the Committee has been able to find some gross figures on the Third World debt exposure of Canadian banks, it has been impossible to learn details of the amounts owed by all but the largest debtor countries to particular banks. As already indicated, the banks do not set aside specific provisions in respect to each country's debt. Instead, general provisions are consolidated and form a kind of self-insurance fund. Moreover, it is understandable that commercial banks do not wish to allocate provisions to specific loans, since this would compromise their bargaining position in rescheduling negotiations. So although the facts confirm that in aggregate terms the problem is very serious, the only details given relate to the largest debtor countries.

The Committee has established that the Canadian banks do make full disclosure to the Inspector General of Banks. The Committee considers that the requirements for provisioning against the basket of countries identified above are necessary and are being adhered to. However, in chapter seven the Committee examines the adequacy of the present level of provisions and recommends that the Inspector General consider raising the percentage required.

ODA Debt Owed to Canada

Total ODA debt outstanding currently to CIDA amounts to a little over C$3 billion, encompassing approximately 400 loans. Of this, C$1 billion is owed by African countries (of which C$700 million from sub-Saharan African countries), C$300 million from Latin American and Caribbean countries and C$1.7 billion from Asian countries. These sums all represent debts incurred from past official development assistance.

The Canadian government has taken steps to lighten the official debt load of a number of low-income countries. During the Conference on International Economic Co-operation in 1977 Canada forgave its outstanding loans to the least-developed countries, including eight African countries, for a total forgiveness of C$310 million of debt. Since that time all CIDA projects in these leastdeveloped countries in sub-Saharan Africa have been on a grant basis. Further, in 1986 Canada offered a 15-year moratorium on payments of principal and interest of the ODA debt of other low-income sub-Saharan African nations where Canada had continued to make concessional loans rather than grants. Debt of this nature totalled C$700 million and involved foregoing C$250 million in repayments. Initially the government offered a five-year moratorium, but announced that it was prepared to extend the measure in five-year segments until the year 2000. The government asked only that the African countries affected show their commitment to introducing economic reforms. In effect, this Canadian action amounted to almost completely writing off the debt from these countries. At the time Canada's moratorium offer was announced, the government said it hoped other countries would follow suit with similar measures that together would give a substantial measure of relief to low-income African debtor countries.

Outstanding Debt on Official Canadian Export Credits

The 1986 Canadian offer of a moratorium on its debt to poor African countries extends only to official development assistance indebtedness and not to official loans of a commercial character. There are some outstanding credits of the Export Development Corporation (EDC) to Third World "problem" countries, although at this time there is little new EDC lending to these countries. Peru, for example, has an outstanding debt of C$223 million to the EDC and has not made any payments on that obligation since early 1984, a fact that caused the EDC to stop any further credits to Peru, even for ongoing projects. Total EDC financing to high-risk regions, including Latin America, dropped from C$355 million in 1983 to C$141 million in 1985. Indeed in 1985, repayments by developing countries to the EDC exceeded new EDC export credits to these countries by almost C$200 million.

In addition to EDC credits, there are a number of countries, including Poland and Peru, with substantial outstanding debts owed directly to the Canadian Wheat Board.

The Committee's Assessment

Markedly different views are held on the seriousness of the debt problem, on the prospects for the future and on what remedies, if any, should be pursued. The success of the international financial community in averting a collapse of the world financial system at the time of the Mexican debt crisis of 1982 and in adjusting to subsequent threats as they have arisen has been interpreted quite differently by persons reflecting different points of view. Jacques de Larosière, Managing Director of the IMF at the time, told the Committee in early 1986 that "the case-by-case approach has been working reasonably well":

> Adjustment . . . has been taking place in an orderly fashion over the past three and a half years, through countries servicing their debts, the banks rescheduling their profiles of amortizations and the governments and commercial banks lending support to these actions. (6:7)

As would be expected from a person in his position — indeed it would have been destabilizing for him to have expressed any other view — he was very cautious in commenting on the future. He concluded his opening statement to the Committee with the observation that while "I am facing . . very difficult individual situations, I am not overwhelmed by pessimism". (6:8) Later, in responding to a question and in commenting on the particularly difficult problems faced by the oil-producing countries, he expressed the hope that countries like Mexico and Nigeria could manage their problems "in an orderly fashion." He concluded the thought with the comment, "I think it is possible, but it is a challenge." (6:11)

On the other hand, spokesmen for the position of debtor developing countries were, not surprisingly, much less sanguine about the success of the case-by-case approach and what the future would hold. Mr. Ibarra told the Committee that the governments and countries in Latin America were, in 1986, in a weaker position to deal with debt service than they were in 1982. He continued:

> Muddling through bilateral negotiations is not enough. A more general policy framework must be built by the borrowers and lenders... . Latin America is running out of time... . (8:10)

These views were corroborated by Mr. Sidney Dell of UNITAR, who asked the question: "How long can this austerity be maintained? At best, it is a short-run expedient. It cannot go on indefinitely. No one knows exactly where the crisis point will be reached but there has to be a crisis here". He quoted a former President of the Bank for International Settlements as saying that to adopt a policy of austerity over a long period, simply in order to service debt, "is a bomb with a built-in time fuse." (4:9)

Although there are divergent views as to how the debt problem should be managed and whether and how a breakdown in the world financial system can be averted, everyone acknowledges that there are significant costs and risks in the current situation. The size of the external debt of Third World developing countries has reached alarming proportions. It is creating severe problems for many borrowing countries, several of which have unilaterally imposed limits on the foreign exchange they are prepared to allow to be used to make interest or principal payments on their debts. The middle-income countries like Mexico, Brazil and Argentina are far from creditworthy. They are having to ask for repeated reschedulings of their bank debt and their official debts, a process that seems to postpone facing up to the problem even as the accumulated debt actually grows in size. Saddled with the heaviest debt burden, the poorer countries see little prospect of improving their condition and a few countries in Africa have virtually ceased to service their debt.

The size of the debt is also creating severe strains on the commercial banks, including those in Canada. The non-payment of some debts, the repeated reschedulings and "involuntary" loans associated with others, and the continued dangerous possibility of defaults or repudiation by several major debtor countries hang like a black cloud over many of the seriously exposed commercial banks. Such developments could not only have a crippling impact on the banks' operations but could threaten the very viability of the international banking system.

In the Committee's view these are all factors that make the the debt problem an urgent topic for investigation: it is serious, complex, controversial, dynamic and of great importance to Canada.

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Chapter III

WHAT IS AT STAKE FOR CANADA?

The way the Third World debt problem develops will significantly affect the state of the world economy and thus the Canadian economy. The impact is both indirect and direct. As the economies of the world have become increasingly interdependent, the prospects for improved economic conditions in OECD countries rest, in significant measure, on the economic progress made by the developing debtor countries. One development flows from another. When the strain of servicing the debt becomes sufficiently serious to cause disequilibria in the balance of payments, economic growth in these debtor countries is constrained. As a result they are less able to import from developed countries, world trade shrinks, and declining market opportunities create protectionist pressures in OECD countries, which in turn hurt the developing and developed countries, Canada included. The effect is significant and cumulative and international economic growth experiences a severe setback.

The entire mechanism for maintaining a stable international balance-of-payments system is also threatened when the foreign exchange reserves of the debtor developing countries are run down dangerously, a position which limits their access to foreign borrowings. Moreover, there is a risk that the debtor developing countries, faced with making heavy payments to OECD banks and governments with little visible effect on their debt burden, will become alienated from the established international payments system and may choose to take unilateral radical measures that could undermine the entire system.

Strains on the Commercial Banks

The commercial banks have been subjected to continuing strain since 1982, as the indebtedness of the Third World countries to them has steadily grown. In major borrowing countries such as Mexico and Argentina, banks are still faced with the prospect of non-payment of interest unless they lend more funds for this purpose. Brazil suspended interest payments in February 1987 on loans from commercial banks and on trade credits, and early in 1987 Ecuador cancelled payments on its debt for the remainder of the year. Furthermore, few of the large debtors (with the exception of Venezuela) have been making payments on the principal of their loans.

It has been pointed out in chapter two that, quite apart from their Third World debt portfolios, North American banks are also over-exposed in some areas of their domestic lending. They are carrying a heavy load of bad debts in the domestic energy, agriculture, real estate and shipping sectors, which limits their capacity to offer debt relief. Mr. Alan Hockin told the Committee how easily depositors' confidence in the banks could be upset and with what results. He stressed that if the banks were forced to write off too high a percentage of their loans, or to make sizeable interest rate concessions or to accept interest capitalization, discount bonds or other measures that were perceived by major depositors to be more than the banks could carry, this could undermine confidence in the banks. He went on to say that this would prevent banks from continuing to lend to Third World countries because the banks would not be able to attract new deposits to replace the funds they had lost.

The risks to the banks may be even greater. Given the internationalization of capital movements there is real concern that a major bank failure in any OECD country could have a domino effect. In other words, the failure of a major bank in the United States, Canada or Europe resulting from repudiation or default by a large Third World debtor would obviously have a serious impact on the international banking system.

Trade Losses

The threat that Canadians face is not confined to possible damage to the financial system. The contraction in international trade brought about by the debt problem is causing Canadians to lose export markets and export trade financing opportunities. Developing countries with debt problems have had to make strenuous efforts to cut balance-of-payments deficits. In most instances this goal has been met by substantial import constriction on their part. As a result, Canada and other OECD countries suffer from reduced exports and higher unemployment.

Canadians do not so readily see the consequences of Third World import restraint in terms of lower exports and lost jobs because Canada's direct sales to the Third World are and have always been substantially lower than those of most OECD countries. In 1982 Canada's exports to all Third World countries represented 12.1 per cent of exports, compared to 40.9 per cent for the United States, 22.8 per cent for West Germany, 45.5 per cent for Japan and 29.7 per cent for France. When Third World countries cut imports, the direct cost to Canadians is less than to citizens of other industrialized countries. Nevertheless by 1985 Canada's share of exports going to the Third World had fallen by over one-quarter to 8.1 per cent of total exports.

More specifically, Mr. W.T. Brock, a Vice-President of the Toronto-Dominion Bank, informed the Committee that in 1983, according to his calculations, Canada's exports to about 30 countries involved in rescheduling had dropped by 40 per cent as compared to its 1981 sales to these same countries. He maintained that Canada's exports to Mexico dropped 50 per cent, to Brazil 12 per cent and to Argentina 55 per cent. Using the ratio of C$100 million in exports representing about 3,500 jobs, he calculated that the drop in direct Canadian exports of C$1.5 billion to the Third World during this two-year period could have cost Canada about 50,000 jobs. This is an area where it is extremely difficult to develop precise figures. For example, the North-South Institute estimated that Canada lost sales worth C$1 billion to Argentina, Brazil, Mexico and Venezuela alone during this same period. Moreover it is not easy to establish how much of this trade loss can be directly attributed to the plight of indebted developing countries and how much is a result of other economic or trade factors. What is clear, however, is that substantial trade has been lost due to declining demand in Third World countries.

There has also been a significant indirect impact on Canadian exports. Reduced exports by other OECD countries to the Third World have led them to cut back on their purchases of Canadian commodities and components used in the manufacture of their exports. To give some idea of the scale of this reduction, it has been estimated that in 1984 the decline in U.S. exports to Latin America alone accounted for the loss of 440,000 U.S. jobs.

There has also been increased competition in exports generally. Developing countries, desperate for foreign currency, have cut prices in an effort to increase their sales abroad. Where Canada competes with Third World producers, which is mainly in the export of commodities, the effect on Canadian producers has been serious.

Dangerous Implications for Democratic Debtor Countries

The debt crisis involves political dangers as well. During recent years a number of military governments have been displaced by democratic governments in the Third World. In Latin America, democracy has been restored and elections have been held in Uruguay, Argentina, Brazil, Ecuador, Peru and Bolivia. A number of these countries are heavily indebted, due in part to the inappropriate policies of their former leaders. For instance, in Argentina, the democratic government is faced with the problem of servicing the excessive debts incurred by previous military governments not for the creation of economically productive infrastructure but mainly for military purposes.

People in these newly democratic countries not unnaturally have higher economic and social expectations of their elected governments. When asked by their new leaders to support austerity programs, the people expect, after a year or two, to see some positive benefits for their belt-tightening. Instead, they are faced with reduced real incomes and higher unemployment rates. Already the decade of the 1980s is being termed "the lost decade" as far as economic growth of these debtor countries is concerned. In Latin America, real GNP per capita that had been growing continuously since 1950 fell by nearly 10 per cent during the first half of the 1980s. Despite economic constraints and debt-servicing efforts, the debt-export ratios in Latin America are, except for Brazil, higher in 1985 than they were in 1982. Forecasts indicate that 1980 per capita income levels will not be regained until at least 1990. In such a setting, disappointment and unrest grow, threatening the recently elected leaders.

Governments in established democracies in the Third World as well are undermined by the debt problem. Steadily mounting unemployment, high inflation, and rising consumer prices overburden their existing social welfare systems. Income distribution frequently tends to become more inequitable in economically strained situations. History demonstrates that a causal relationship exists between political change on the one hand and economic growth and social welfare on the other. Even firmly entrenched democratic leaders find their manoeuverability constrained by the pressure of debt servicing and their position becomes highly vulnerable as a result. The recent riots in Brazil give ample proof that a debtor country's fragile social and political fabric can be threatened by widespread discontent with austerity conditions. Moreover, such developments make measures of reform and restructuring even more difficult.

Mr. Cedric Ritchie, Chairman of the Bank of Nova Scotia, told the Committee that continual applications of austerity measures "have exacted a social and political cost that, in some countries at least, appears to be unsustainable". Mr. William Mulholland, Chairman of the Bank of Montreal, put it even more directly: "if we think we can convince debtor countries that it is in their interest to eat less in order to make loan repayments, we had better think again."

Canadians share an interest with other industrialized democracies in seeing democratic systems in developing countries grow stronger. The Committee urges the Canadian government to recognize that the debt burden could have an adverse effect on the stability of these developing democracies.

PART II

THE SEARCH FOR SOLUTIONS

A problem so 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. These comprise debtor countries, international financial institutions, commercial banks and creditor governments and some of the Arab OPEC countries.

In the chapters that follow, the report will consider the approach and interests of each of the principal actors and review various suggestions that have been put to the Committee as to ways to contribute to the management of the problem.

Chapter IV

THE DEBTOR COUNTRIES

The Middle-income Debtor Countries

Since 1982 the efforts of many debtor countries to pay interest on their debts, whether private or official, have necessitated difficult adjustments and painful sacrifices. Failure to make any progress in reducing the debt burden has caused an increasingly strong reaction on the part of many debtor countries.

A systematic expression of a number of these debtor countries' views is contained in the 1985 declaration of the Cartagena Group of 11 Latin American countries. Pointing to the serious decline in living standards in Latin America since 1980, the lack of economic growth and the sizeable negative transfer of real resources abroad the Cartagena ministers spoke of the resultant threats to consolidation of democratic processes in their countries. They proposed a series of measures to assist growth in their economies, including:

- the return of real interest rates to their historic levels, longer maturities and grace periods for debt servicing;
- an increase in the flow of funds and separation of present debt from future debt;
- a limitation on net resource transfers out of the debtor countries and a possible ceiling on debt service payments relative to export earnings;
- a substantial increase in the resources of the multilateral development banks along with limitation of the conditionality required by these agencies;
- for official debt, a multi-year restructuring of principal and capitalization of interest for debtors in need of such measures without creditors suspending their coverage of new export credits;
- enlargement of the IMF's Compensatory Financing Facility;
- avoidance of overly restrictive conditionality and of World Bank-IMF cross-conditionality; and
- the elimination of protectionist trade measures that restrict or bar access to developed countries' markets.

The Latin American debtor countries' ministers also called for "a political dialogue . . . in an appropriate forum" between debtor and creditor governments, a request creditor governments have steadfastly refused to agree to.

Generally, the position taken in 1985 by the governments of the Cartagena Group to continued efforts to service their countries' debts was very responsible. It stands in contrast to the Final Statement of a meeting of legislators from 15 Latin American parliaments held in Montevideo in October 1985, which took the negative position that "the external debt of Latin America is unpayable under the conditions imposed presently on the debtors." Nor did the Cartagena Ministers espouse the Peruvian reaction which limited the amount that Peru would commit to debt servicing to 10 per cent of the country's export revenues. But a disturbing feature of the Cartagena Consensus was its failure to balance the emphasis it placed on measures that the commercial banks, the international financial institutions and the creditor governments were asked to take with any acknowledgement of the substantial changes in policies that the debtor governments must themselves make to restore the health of their economies.

A recent study* of Latin America's economic plight has pointed to a number of past policies as being primarily responsible for the present difficulties of that region, namely: overvalued currencies, protectionist trade policies, a lack of the necessary incentives as well as inefficient investment of savings and "the excessive even suffocating role of the state" with the parallel weakening of the private sector.

There are important lessons to be learned from some developing countries that have managed their economies successfully. These countries, mainly in Asia and often poorly endowed with natural resources, have been careful to use capital and labour efficiently. As has been described briefly in chapter two, their economic and fiscal policies have been market-responsive. Countries as diverse as South Korea and India have been able to adjust to the successive economic shocks to the world economy and have been prudent in limiting the debt they incurred to manageable proportions.

South Korea is an example of a developing country that has strongly encouraged foreign borrowing over the past two decades. Even though its external commercial debt rose from $22 million in 1960 to $33 billion in 1983, Korea used these capital inflows efficiently, channelling them almost entirely into productive capital investments. While the country was hard hit by the two oil shocks, in both cases it applied strong and, as it turned out, effective medicine. In the wake of the 1973-74 oil price rise, Korea borrowed abroad to cushion the shock and at the same time devalued its currency, which spurred the success of its ongoing policy of maximizing the export of manufactured goods. After the 1979-80 oil shock, the country again borrowed from abroad and the exchange rate was again devalued, real wages reduced, public investment cut, domestic energy prices raised and investment to non-export sectors curtailed. Even after rapid export growth was re-established in 1981, fiscal and wage restraint policies were continued. While Korea's debt service ratio is modest in terms of its export earnings, the government is currently attempting to reduce its debt by raising domestic savings.

India is a somewhat different case; there, external borrowing has been controlled and careful. Whenever its balance of payments became troublesome in

* Institute for International Economics, "Toward Renewed Economic Growth in Latin America".

the late 1960s and early 1970s, India reduced its imports; moreover, most of its foreign borrowing was undertaken on concessional terms. Severely affected by the first oil shock, India decided against borrowing abroad and instead boosted domestic savings by raising taxes, reducing public spending and tightening monetary policy. By 1978 India had become a net lender to the rest of the world, with a small trade and current account surplus, a debt-to-GDP ratio that was quite low, and large foreign reserves. It has gradually liberalized import controls and increased incentives for investments. With its diminished dependence on imported food and energy, India's growth rate is improving, as has its flexibility in managing its balance of payments.

While Korea and India have applied quite differing policies, both have managed to avoid the millstone of disproportionately heavy debt. The critical factor in each successful case has been the adoption of an appropriate combination of effective monetary and fiscal policies.

The Committee considers that, in order to promote stable economic growth, middle-income debtor countries must be prepared to persist in sound economic 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**

Increased Investment Incentives

In addition to structural adjustment measures, debtor countries can derive some benefit from policies to stimulate foreign direct investment and so secure, by means other than borrowing, the capital inflows necessary to strengthen their economies. In some debtor countries, restrictions on foreign equity investment could be eased. External investors could be encouraged by assurances that profits from foreign-controlled enterprises could be repatriated. In this context, it is unfortunate that some large debtor countries have been reluctant to ratify the convention establishing the new World Bank affiliate, the Multilateral Investment Guarantee Agency (MIGA). Establishment of MIGA would assist in dispelling foreign investors' concerns that their investments would be vulnerable to sudden political actions.

As a way of attracting foreign investment capital and, at the same time, marginally reducing their external debt totals, debtor countries might also explore the use of debt-equity swaps, the mechanism being used by several Latin

American debtor countries including Brazil, Chile and Mexico. Under such schemes, Fiat has bought Brazilian debt at the going discount rate, for which the Brazilian central bank gave Fiat the equivalent in domestic currency, a sum it subsequently invested in Brazil. Nissan Corporation has arranged a similar deal in Mexico. In other cases, bank debt has been swapped for shares in companies, a mechanism that could make easier the privatization of some state-owned companies.

Discouraging capital flight

Capital flight, discussed earlier in chapter two, reached massive proportions in several middle-income debtor countries, notably Venezuela, Argentina, Mexico, Nigeria and the Philippines. In a number of cases it appears to be continuing. The effect of this outrush of capital is to increase a country's balance-of-payments problem and, accordingly, the difficulty of servicing its debt, to reduce external investment in the debtor countries, and to deter commercial banks from making new loans to these countries when they see the funds being siphoned right out again.

The Committee recognizes that unfortunately there are no simple actions that governments can take to prevent capital flight. It is now virtually impossible for governments, other than the state-controlled economies of Eastern Europe, to maintain effective foreign exchange controls. But much can be done to discourage the export of capital. Establishing an appropriate and competitive exchange rate is obviously extremely important and the IMF has rightly made this a condition of all its agreements with debtor countries. Effective management of the economy, including tighter money policies, a positive real rate of interest and a control on inflation can all help to create situations in which the owners of capital will not face the same inducements to invest abroad. **It is essential that developing countries introduce measures to discourage capital flight, including an appropriate exchange rate.**

More difficult than discouraging capital flight is the problem of persuading those in developing countries who have already invested money abroad to repatriate their capital. While tighter money can exert pressure on some manufacturers to repatriate capital in order to finance their operations, many people who have capital invested abroad are looking for security and lack confidence in the economic prospects of their own country. The process of providing the necessary reassurance that domestic holdings would be secure is bound to be slow and gradual and easily undermined by political instability stimulated by persisting reductions in the standard of living. Nonetheless, in 1986 the tight credit situation forced Mexican businessmen looking for working capital for their firms in Mexico to repatriate significant capital funds which they had invested abroad. If such capital repatriation were to continue and were repeated in other middle-income debtor countries, it could have a positive impact on the debt problem, although widespread capital repatriation is probably unlikely until economic conditions have improved significantly in these countries.

Population pressures

One subject that is seldom raised in the context of the debt problem is the issue of population growth and the pressure which that growth exerts on scarce resources. The case of Mexico illustrates the problem. In 1930, Mexico's population amounted to 17 million; today the population is believed to number almost 80 million and by the turn of the century it could amount to 110 million. Brazil's population is projected to rise from 130 million today to 180 million by the year 2000. The situation in some African countries is especially disturbing. Some countries, including Kenya and Tanzania, have population growth rates of over 4 per cent, which means a doubling of the population within 17 years. Even more alarming are the projections of population growth in the large cities of some developing countries. While countries with rapid population growth may double their populace in a single generation, their cities are likely to quadruple in size during the same period. Mexico City's 1980 population of 15 million is projected to rise to over 26 million by the year 2000 and that of Sao Paulo, Brazil, from 13 million to 24 million in the same period.

The Committee took note of the difficulty for any country of maintaining sustained per capita growth if the level of population expands faster than economic development.

Low-income Debtor Countries

The debt problems of low-income debtor countries, especially those in Africa, differ substantially from those of the larger, middle-income debtors whose attitudes were well reflected by the Cartagena Consensus. The heads of African governments, focussing mainly on their official debt obligations, put forth a list of specific recommendations on debt to the 1986 UN Special Session on Africa. Among other measures of relief, they urged: multi-year rescheduling with a minimum 15-year repayment period and a minimum five-year grace period with interest rates held to at least current levels; the adjustment of past ODA bilateral loans to the "softer" terms of currently prevailing loans; and total or partial forgiveness of past ODA debt by converting them to grants.

As has been described earlier, on a per capita basis, the debt of the low- income African countries is higher than that of Latin American debtors, their debt has grown faster and their debt service burden is as heavy or heavier. For many of the poorer debtor countries the outlook for the next ten years is bleak, and nowhere is it bleaker than in low-income Africa where even under optimistic assumptions, per capita incomes are projected to decline. In these countries, there is a pressing need for domestic economic policy reforms, yet many of them lack even the most basic infrastructure, as well as the cadre of trained personnel at almost every level in the government, industrial and financial sectors to put it in place.

There are, nonetheless, some actions these poorer debtor countries can take to try gradually to improve their situation. First, if emphasis were placed on agricultural production, not only would this reduce the need for certain food imports, but it would result in the most direct assistance to the majority of the population. In the past, numerous low-income developing countries have jumped too fast into poorly designed and inappropriate industrial developments at the expense of their farmers. Projects mounted by the International Fund for Agriculture Development (IFAD) have demonstrated surprisingly fruitful results in agricultural production at the most basic level with minimal resources.

Second, these countries will have to be careful about how they administer the funds they receive. Examples abound of the wasteful use of development assistance in the past. With bilateral concessional flows declining and multilateral concessional aid stagnating, these developing countries will need to use the aid they receive wisely. While the conditions for structural adjustment attached to IMF and World Bank loans may appear rigorous, the present pain may be unavoidable in order to achieve future economic stability and growth. In cases where commodity prices rise in the future, low-income debtor countries should attempt to make the best possible use of these increased revenues, turning them whenever possible into productive enterprises.

IDRC's computer program to assist the poorer debtor countries

During its hearings, the Committee heard from a number of witnesses of the difficulties experienced by the smaller, poorer debtor countries in marshalling the sort of technical capacity in terms of data and macro-economic understanding to conduct debt negotiations. Dr. Bishnu Persaud urged that more should be done "to help developing countries to develop the capacity to negotiate with the IMF". (12:12) He pointed out that in many cases these countries had to rely on the IMF prescriptions and it was unrealistic to expect that IMF officials knowing little of the political and social circumstances in particular developing countries would be able to develop policies which would be completely relevant to the needs of those countries.

The Committee was told by Mr. Ivan Head, president of the International Development Research Centre (IDRC), of the preliminary results of a computer program developed for use with small personal computers designed to help the poorer developing countries prepare for debt negotiations. The program is quite simple and offers smaller developing countries with limited financial expertise a capacity to put together and analyze basic information and statistics needed for effective debt negotiations with the World Bank, the IMF, the regional development banks and the lender governments. The Committee is impressed with this project, which represents an innovative application of the IDRC's mandate.

It would be unfortunate and undesirable if the continuing needs of the low-income debtor countries were lost sight of owing to the emphasis currently being given to the resolution of the commercial bank debt question. Regrettably there is little basis for optimism that the economies of most of these low-income countries will, in the near future, take off and become competitive and able to service their debts. While the advice given for economic restructuring by the IMF and the World Bank to middle-income countries can be of assistance to the low-income countries, the problems of the latter group are very long-term. Their most urgent requirements are for continuation of basic and traditional development assistance. The conversion of earlier government loans to grants by Canada and some other OECD countries is a most helpful action to support the internal efforts of these countries.

Uncertainties of Adjustment Policies

Although the Committee remains persuaded that debtor countries must persist in adjustment policies if their economies are to become more cost-effective and market-sensitive, it is important to recognize that progress may be uncertain and erratic. Unfortunately there is no way to guarantee economic stablization and growth. No restructuring prescriptions are universally applicable and the process has proven to be much longer term than has been recognized by some. Too many variables exist in each country, including the size of the debt, domestic policies affecting wages and prices, the rates of domestic savings, levels of domestic investment and fiscal deficits, domestic policies affecting production and the state of a country's external accounts, to name a few. Nor can it be taken for granted that all debtor countries will have the infrastructural base or the entrepreneurial expertise needed to transform their countries quickly into effective market economies.

Even when all the appropriate measures can be brought together successfully, external events beyond the control of national governments can cause them to fall short of their economic targets. Factors such as weather can drive the price of a major export commodity sharply up or down; drought or frost can destroy an important crop, or good weather can cause a glut — as is now occurring in the international coffee market — and drive down prices world-wide, affecting producers in different continents alike. New protectionist measures can also deny or limit access to important industrialized markets. Tariffs and non-tariff measures are the most obvious barriers that can be erected. But subsidies by large temperate-zone producers of agricultural commodities — notably sugar, soya beans, wheat, meat, rice and cotton — which Third World countries also produce can have disastrous effects on their balance-of-payments positions. Canadians have a keen sense of the serious consequences on the Canadian economy of the current competition in wheat export subsidies between the United States and the European Community. But for a country like Argentina whose economy is more heavily dependent on export earnings from wheat sales, the impact has been even more serious. Likewise, Brazil as well as Argentina, both large beef producers, have suffered for some time from price supports on meat in the European Community.

Brazil's recent experience illustrates, however, that internal rather than external factors tend to be the dominant influence on a country's economic development.

Lessons from the Brazilian Experience

Until the autumn of 1986, it was the perceived wisdom to look on Brazil as one of the few problem debtor countries coping successfully, particularly by comparison with Mexico. In its 1986 annual report the Royal Bank commented favourably on Brazil's "bold anti-inflation plan", and the "austere budget proposed for 1987" and it anticipated "very strong growth performance". The Toronto-Dominion Bank referred to the "healthy pace of economic expansion" and noted that Brazil enjoyed "consistently . . . good trade surpluses". But between October and December 1986, Brazil's export surplus fell by over 80 per cent, and by February 1987, it had declared a moratorium on interest payments on foreign bank debt. A careful look at the Brazilian experience is instructive.

During 1984 and 1985, Brazil had developed an annual trade surplus amounting to $12 billion, partly helped by lower-cost oil imports, declining interest rates and a fall in imports as consumer demand declined, but also due to a high level of exports. In February 1986, on its own initiative, and without the direct involvement of the IMF, Brazil instituted sweeping economic changes — known as the Cruzado Plan — to combat the country's soaring inflation. While the initial results of these measures were positive — and in fact led the creditor banks to agree to reschedule Brazil's debt — the freeze on prices brought about heavy consumer demand leading to product shortages, increased imports, dwindling savings and meagre investment levels. In July, the Brazilian government imposed certain measures including reimbursable taxes on a range of popular items designed to rein in middle-class consumer spending. The resulting National Development Fund was to be spent on transportation, electricity and other key infrastructure sectors. But the necessary strong curbs on the overheated economy in the form of serious spending cuts and higher taxes were not put in place until after the November election and only after the trade surplus had begun to plummet.

By the last quarter of 1986 the Brazilian economy had deteriorated drastically. Interest rates climbed, a voracious consumer demand continued to overheat the economy, the stock market plunged and inflation rose sharply. Brazil's favourable trade balance deteriorated dramatically, and the country's reserves were eroded. The situation generated public protests in Brazil and the government came under strong domestic pressure to postpone its debt repayments or to limit payments to a percentage of exports or of GNP.

In the face of both domestic and international pressures, the Brazilian government's room for manouevre became very limited. Early in 1987 it moved to relax temporarily its freeze on prices, a move that triggered an automatic pay increase. Further domestic belt-tightening was seen as threatening the stability of the government. Even when exports had been buoyant, Brazil's annual debt payments abroad of $10 to $12 billion absorbed its entire trade surplus, leaving no margin for new productive investment. As its export surplus shrunk, Brazil's external debt payments were represented by the government's critics as a roadblock to economic growth and the cause of economic recession. Consequently, the government began to press its creditors abroad for some relief, asking the banks as a minimum for multi-year rescheduling and a cut in interest rates. While formally committed to negotiation, the government's attitude toward the commercial creditor banks hardened and in January 1987 it took the unusual step of expelling a U.S. commercial bank for failing to cooperate in debt rescheduling in 1986. At the same time, Brazil maintained its opposition to IMF supervision of its economy. For their part, the commercial banks were resistant to longer-term refinancing because of the lack of an agreement between the IMF and Brazil. Paris Club creditor governments, from whom Brazil requested certain relief measures including an unfreezing of official credits on exports, also pressed Brazil for a prior IMF accord. Nevertheless, early in 1987 these governments, urged by the U.S. Treasury, agreed to reschedule Brazil's official debt without an IMF agreement, although they withheld new export credits.

Assessing Brazil's current difficulties, observers have concluded that the Cruzado Plan was kept in place too long and the necessary follow-up austerity measures were not implemented in time. The well-intentioned price freeze unleashed pent-up domestic demand, which saw a rise in consumption of products normally exported and even caused a surge of imports. For example, Brazil, normally a major exporter of beef, became an importer of beef. Factories were swamped with back orders, industrial output grew and exporters found it more profitable to sell their products in the home market. Increased demand for manufactured goods caused a 50 per cent jump in capital goods imports. Coffee and soya export revenues declined due to poor commodity prices and sales. While these declines could have been more than balanced by the almost $3 billion savings in oil imports due to low 1986 prices, Brazil's trade balance actually fell during the last quarter of 1986 from an average of over $1 billion a month to between $150 to $200 million.

With debt service amounting to between $10 to $12 billion annually, and with reserves having fallen to $4.5 billion at year-end, the situation became extremely worrisome. By late February 1987, with no improvement in sight and with reserves continuing to fall, the Brazilian government unilaterally suspended interest payments for an indefinite period on foreign bank debt amounting to almost $70 billion. A week later, it placed a moratorium on the payments on short-term credits totalling about $15 billion.

A New Crisis?

It is too early to assess the seriousness of this new development. Some comment has been relatively sanguine, suggesting that Brazil will resume interest payments if the banks will agree to reschedule their debts and provide new loans. Others warn that Brazil is looking for some linkage between export earnings and debt service, in which case it may be more difficult to reach an agreement. Moreover, several large debtors in Latin America cautiously praised Brazil's move and are watching the outcome. Ecuador, having just suffered a disastrous earthquake, announced that it would postpone interest payments on its bank debt until the end of 1987. Depending on the results of Brazil's negotiations, other countries may be tempted to emulate its moves. These prospects will cause the commercial banks to be cautious in their response to Brazil.

In fact, the Brazilian move poses a dilemma for the banks and a resolution of the situation will be significantly affected by their attitude. Coming so soon after the Mexican negotiations of 1986, how much new lending will the banks be prepared to make to Brazil? Brazil will undoubtedly seek to equal or better the terms of the Mexican package. It is the Committee's impression that resistance on the part of the banks to substantial new lending will not be easily overcome, and that this new problem may not be speedily solved.

However this latest situation is resolved, Brazil's experience has drawn increased attention to the fact that adjustment policies are slow to achieve results, especially when the economies of the countries concerned have for years been protected from competitive pressure.

The World Bank's *World Development Report 1986*, starting from a perception that "debt-servicing problems . . . would last longer than had been earlier thought" has observed that "despite the adjustment efforts" of the developing nations, these countries "seem to be as far as they ever were from reconciling growth and creditworthiness". In looking for some explanation for its depressing conclusion that "sound policies and world growth, though essential, will not be enough to restore growth", the Bank report has fixed on the debt overhang, which they regard as "so constraining that corrective domestic policies alone will not provide a viable solution". The report continues:

Because debt-servicing obligations absorb 5 to 7 per cent of GNP in many countries, domestic savings are not enough to service debt and maintain the level of investment needed to permit adequate growth. Thus, a significant amount of new private and official lending is required. (page 54)

This pervasive impact of the debt burden has been carefully analysed in a paper given by Professor Jeffrey Sachs of Harvard University at a recent Brookings Conference:

Because of the large overhang of debt, the Latin American governments did not have the creditworthiness even to borrow in their own capital markets, so that budget deficits could not serve as an automatic stabilizer . . .

The debt overhang now discourages investments by the public sector even beyond its direct budgetary burden. A fragile government riding the storm of a downward spiral of living standards cannot shift spending from current consumption to investment without justifying the shift politically on the grounds that the citizens in the country will soon be much better off by virtue of the investment. But the citizenry of the debtor countries now believes that a shift from consumption to investment will serve first, and perhaps only, to improve the capability of the country to service its debts. Unless an increase in investment spending is combined with substantial debt relief, the needed squeeze on consumption is seen as something that is done for "Citibank" rather than for the nation itself.

The overhang of the debt also encourages capital flight, which further depresses investment... . Since the private sector well understands that the public sector is starved for funds, no astute wealthholder now leaves any signs of wealth lying around to advertise a ready source of revenues for the fiscal authorities. Wealthholders hold their assets outside of the country to avoid taxation, with the result that new private savings simply spill over into capital flight, rather than into real investment... .

Private investment has been impeded even in the export sectors, which depend on foreign demand rather than domestic demand and which have gained substantially in profitability because of real exchange rate depreciations since 1982. Private-sector entrepreneurs do not feel safe leaving their money in the country, even in a temporarily profitable sector, if it appears that the rest of the economy, and perhaps the government itself, is collapsing. The investments are vulnerable not only to tax increases, but also to the possibility that the government will, at some point, abandon debt servicing, repudiate the debt, and thereafter allow a sharp real appreciation of the exchange rate once again... .

There are several more subtle ways in which the debt overhang discourages investment. Now that the ability of the debtor governments to continue to service their debts is in doubt, external private creditors have started a "grab race" to get their assets out of the country. Individually, these creditors have an incentive to call in their claims against the over-extended debtor countries, even if doing so injures the economic performance of the debtor so much that the creditors suffer collectively... .

At present, new external lenders will not make new loans to a debtor government even for investments whose returns easily exceed the market cost of capital, since those lenders rightly fear that their claims will simply become part of the enormous pool of uncollectible claims against the debtor... .

Investment rates will thus continue to be insufficient for many of the debtor countries, not because of a shortage of good investment opportunities, but rather because of the wrong financial incentives resulting from the debt overhang. (Brookings Papers on Economic Activity, 2:1986, p. 416-18).

The conclusion drawn in the *World Development Report 1986*, with which the Committee wholeheartedly agrees, is that "domestic adjustment efforts will have to be supported by additional capital inflows and growing export markets". The analysis in this report has already stressed how the virtual termination of bank lending combined with continuing debt service payments — even though the debts have been rescheduled — have caused serious capital outflows. The 1986 report of the Inter-American Development Bank has documented the extent of this outflow. (See Table 7) In the years 1982 to 1985 the net resource transfer out of Latin America amounted to $96 billion and this flow has continued in 1986.

TABLE 7

Net Resource Transfers to Latin America 1981-85
($ billions)

Year	Net capital inflow	Interests repayments and foreign profits	Net resource transfer
1981	49.1	27.8	21.3
1982	27.6	36.8	−9.2
1983	6.1	34.9	−28.8
1984	11.6	37.1	−25.5
1985*	4.1	36.7	−32.6

* Preliminary.
Source: Inter-American Development Bank, *Economic and Social Progress in Latin America, 1986 Report* (Washington, D.C.: IDB, 1986) p. 35.

The message that the recent Brazilian experience has highlighted is that adjustment measures cannot produce speedy results when the economies of debtor countries require extensive and comprehensive change. **The Committee considers that for many developing debtor countries, economic adjustment policies continue to be required, but it must be recognized that the process of achieving economic stability and growth will be unavoidably slow.** This being the case, **it is essential to find ways to limit the negative effect on problem debtor countries of the huge debt overhang and to make available to countries that have committed themselves to serious economic adjustment measures the investment capital that they need if their debts are to become manageable.**

The conclusion drawn in the *World Development Report 1986*, with which the Committee wholeheartedly agrees, is that "domestic adjustment efforts will have to be supported by additional capital inflows and growing export markets." The analysis in this report has already stressed how the virtual termination of bank lending combined with continuing debt service payments — even though the debts have been rescheduled — have caused serious capital outflows. The 1986 report of the Inter-American Development Bank has documented the extent of this outflow. (See Table 7) In the years 1982 to 1985 the net resource transfer out of Latin America amounted to $96 billion and this flow has continued in 1986.

TABLE 7

Net Resource Transfers to Latin America 1981–85

($ billions)

Year	Net capital inflow	Interest and profit payments	Net resource transfer
1981	[illegible]	[illegible]	[illegible]
1982	[illegible]	[illegible]	[illegible]
1983	[illegible]	[illegible]	[illegible]
1984	[illegible]	[illegible]	[illegible]
1985*	[illegible]	[illegible]	[illegible]

* Preliminary

Source: Inter-American Development Bank, *Economic and Social Progress in Latin America 1986 Report* (Washington D.C.: IDB 1986) p. 3.

The message that the recent Brazilian experience has highlighted is that adjustment measures cannot produce strong results when the economies of debtor countries require extensive and not merely marginal change. The Committee considers that for many developing debtor countries economic adjustment policies continue to be required, but it must be recognized that the process of achieving economic stability and growth will be at best slow. This being the case, it is essential to find ways to limit the negative effect on problem debtor countries of the huge debt overhang and to make available to countries that have committed themselves to serious economic adjustment measures the investment capital that they need if their debts are to become manageable.

Chapter V

THE INTERNATIONAL FINANCIAL INSTITUTIONS

The international financial institutions — the International Monetary Fund, the World Bank and the regional development banks — have been and will remain central to the effective management of the Third World debt problems.

The International Monetary Fund

The part played by the **International Monetary Fund (IMF)** in the recycling of OPEC oil money was relatively minor when compared to that of the commercial banks of the industrial countries. It was not until the Mexican crisis of 1982 that the IMF stepped into a leadership position in preventing a Mexican default. Through the intensive efforts of the IMF Managing Director at the time, Mr. Jacques de Larosière, and his staff and with the encouragement of the Interim Committee of IMF Governors, the IMF designed a successful rescue package for Mexico and became the catalyst for new lending by commercial banks. This was followed by similar operations for Brazil, Argentina and Yugoslavia, whose severe debt problems surfaced immediately afterwards.

The basic package included IMF financing, official bridging loans from central banks, commercial bank lending and undertakings by debtor countries to adjust their domestic policies. The Fund took a stern directive tone with the commercial banks, explicitly telling them that if they did not provide the essential new lending, no IMF funds would be made available to assist the vulnerable debtor countries. The strategy worked, dissuading many banks that had sought to withdraw from doing so.

The IMF's primary goal is to achieve stabilization of the debtor countries' economies so as to establish a solid base for future economic growth. The Fund's admonition to countries that are seeking its help due to balance-of-payments difficulties is to ask them to adopt changes in monetary and fiscal policy. Specifically, as a condition of Fund financing and of its agreement to persuade commercial bankers to reschedule debts and expand their lending, the IMF has required that a recipient government: sharply cut its fiscal deficit to reduce the government's demand on domestic savings and thereby assist new investment; strictly limit domestic credit expansion, primarily to control inflation; introduce a realistic exchange rate; and cut government spending and reduce subsidies.

The IMF has been blamed for causing the austerity associated with the strong adjustment policies it has prescribed. However Dr. Horace Barber pointed out to the Committee that conditions imposed by the IMF are measures which a country would have to take in any case. To illustrate his point he contrasted Jamaica and Guyana. Jamaica complied with IMF requests for demand management and structural adjustment, while Guyana refused to accept any IMF participation. Ultimately, however, Guyana was forced by underlying economic conditions to undertake the adjustments pointed to by the IMF.

Brazil is another country where tension between the IMF and a government in financial difficulty reached the point where the government insisted, for internal political reasons, that the IMF not be associated with the remedial package. In 1986, Brazil put in place its own austerity measures that were accepted by the commercial banks as being along the lines of a program that the IMF itself would have advocated. Even when conditions worsened in 1987, the Brazilian government persisted in its refusal to accept a formal IMF accord.

Dr. Gerald Helleiner of the University of Toronto explained that the IMF's unpopularity in many developing countries was not unusual under the circumstances:

> The IMF has traditionally been the bearer of bad news. Sometimes, certainly, it was used by governments to assist the political process of imposing the necessary belt tightening upon the citizenry. That IMF image is, perhaps, an inevitable product of the fact that the IMF is resorted to only in circumstances where times are tough and the government has not yet brought itself to impose the necessary belt tightening. (9:27)

It is, after all, difficult to recommend belt-tightening measures and remain popular. The IMF has taken the heat of criticism from debtor governments that recognized the need for IMF-prescribed programs of austerity, but yet for political reasons were reluctant to agree openly with the necessity for such measures.

Despite the criticisms the IMF strategy has recently undergone, it should be recognized that it was the swift and effective IMF response to the 1982 debt crisis that prevented a widespread international financial collapse. **The international community has been fortunate that, since the 1982 Mexican debt crisis, the IMF has taken the lead in co-ordinating the short-term management of Third World debt problems.**

Witnesses expressing the viewpoints of developing countries were concerned about the effectiveness and availability of some of the Fund's programs in the current situation. Both Dr. Bishnu Persaud, Director of the Economic Affairs Division of the Commonwealth Secretariat in London, and Dr. Horace Barber pointed out that the IMF programs tended to be too short-term to correct the kind of structural problems facing indebted developing countries. Dr. Barber thought a five-year program was preferable to a three-year program and Dr. Persaud urged more use of the Fund's Extended Fund Facility, which provides longer-term programs, as a replacement for the IMF's traditional short-term, standby stabilization programs.

Both Dr. Persaud and Dr. Helleiner urged a more liberal use of the Fund's Compensatory Financing Facility, which is designed to help compensate for the sharp decline in commodity export earnings. Dr. Helleiner regretted that this facility was no longer automatically applied if it could be shown that export earnings had dropped below a five-year moving average. Now, to receive Compensatory Financing Facility assistance, a country has to be involved in a high conditionality borrowing program with the IMF. The automatic granting of monies from the Trust Fund reflows was also gone, he observed:

> Nowadays the Fund has less sheer help, unconditional help, or low conditionality help to offer, and that which it offers seems to be on tougher terms than it used to be. This is attributable, above all, to its shortage of resources. If its member governments provided the funds and allowed it to offer compensatory financing or to offer larger first credit tranche money . . . the staff would happily do so. (9:28)

The last increase in IMF funds occurred in 1983 when total subscriptions, or quotas, were raised from $64 billion to $94.5 billion. But like the commercial banks, the IMF has been forced to extend the terms of its credits, which has in practice reduced the funds at its disposal. Making the case for increased IMF funding, Dr. Helleiner commented that there was "a perception that the short-term approaches and short-term demand-oriented finances of the Fund were inappropriate for the current needs." (9:20)

> The resources of the Fund have not kept pace with the expansion of world trade, not to speak of the increased expansion of international capital flows. It just does not have the resources to perform the role for which it was created, and there is no way that it can restore its . . . leadership short of the provision of further funds. (9:19)

However, a broader view of the IMF's current position was presented by a senior Finance Department official, Mr. John Coleman, who summed up the situation:

> By 1985, a number of government officials in various countries started to think that perhaps the IMF had been put under excessive pressure in dealing with the debt crisis; that it was dealing with the same countries year after year; that its capacity to lend more was severely constrained; that the IMF medicine, involving short-term stabilization, while important, was not getting at the underlying structures of the economies with which it was dealing; and that other players had to become more active. I think this accounts for the growing interest in the World Bank as an operator in the international financial system in conjunction with the IMF. (3:14)

This new emphasis on a larger role for the World Bank and the regional development banks was given major impetus by U.S. Secretary Baker in his Seoul speech. However, in spite of the growing importance of the World Bank, which will be discussed below, **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 to provide debt rescheduling and new money and by organizing economic adjustment programs in debtor countries to reduce their imbalances and rebuild their creditworthiness.**

The World Bank

When the debt crisis erupted in 1982, the World Bank continued to play its traditional lending role in contrast to the vigorous intervention of the IMF. In fact, one commentator, Dr. Pedro Pablo Kucyzinski, Co-chairman of First Boston

International, has accused the World Bank of sleeping through the first phase of the crisis. U.S. Treasury Secretary Baker's initiative in Seoul in 1985 has projected the World Bank into a larger, more active role in the management of the international debt problem. Mr. Baker's "Program for Sustained Growth" urged a stronger lending role for the World Bank and a 50 per cent increase in World Bank disbursements over a three-year period. Shortly afterwards, the U.S. Assistant Secretary of the Treasury for International Affairs, Mr. David Mulford, amplified this proposal when he said "We expect to see a growing stream of policy-based structural and sectoral adjustment loans from the World Bank..."

Since its establishment, the World Bank's principal focus has been on lending for specific projects for development purposes. Bank projects for funding have traditionally concentrated in the sectors of agriculture, rural development, energy and transportation. They are normally proposed by developing country governments, within agreed development strategies, and approved by the World Bank. Once approved, disbursements for the projects are made to the recipient countries over a number of years, subject to good performance.

In addition to these traditional World Bank project loans, the Bank introduced in 1980 a new type of lending, the structural-adjustment loans (SALs). These loans are designed to support adjustments or reforms in the policies and institutions of developing countries faced with unfavourable international economic conditions. Complementing the SALs have been the Bank's sector-adjustment loans, which focus particularly on ways to assist in the more efficient mobilization and allocation of resources within specific sectors.

It was these two adjustment lending programs that were given a new impetus by the U.S. Administration's proposals. In the last two years, the percentage of Bank lending in support of adjustment has risen and now accounts for almost one-third of the Bank's commitments to 14 highly indebted middle-income countries, mainly in Latin America.

Another World Bank activity of growing importance in the Third World debt context is its cofinancing program, designed to encourage commercial banks, official aid donors and export credit agencies to participate with longer-term loans in financing projects sponsored by the Bank. Almost one-half of Bank projects approved in 1986 involved cofinancing. Official bilateral aid agencies and multilateral development institutions, which contributed $2.6 billion in 1986, continue to be the largest source of funds. Since 1983, however, the Bank has put in place a number of new procedures to encourage more commercial bank participation, including a Bank guarantee on part of the principal loaned and participation by the World Bank in syndicated lending. In 1986, World Bank-commercial bank cofinancing amounted to $650 million and was used to fund projects in Chile, Ivory Coast and Turkey.

Reviewing the various Bank programs, **the Committee considers the World Bank is well placed to give leadership on the debt question at this time by increased lending to assist growth in developing countries.** While endorsing a strengthened position for the Bank, however, the Committee is aware of a number of criticisms of Bank activities and policies and wishes to add a few cautionary notes.

Dr. Kucyzinski told the Committee that the pace of the World Bank's lending had in the past been unnecessarily slow and the amounts loaned by it were too modest. Both could be accelerated, he said. Indeed, despite the increase in adjustment-type loans, the level of Bank lending was lower than expected prior to 1985. In 1984, actual lending was $1 billion less than the amounts approved for that year. In its 1986 report, however, the Bank has acknowledged the need to become more flexible, innovative and responsive in its lending and Mr. Barber Conable, the World Bank President, said in Ottawa that Bank lending was to be substantially increased.

Another question that has been raised is whether the Bank is equipped to manage successfully the expansion contemplated into policy-based or adjustment lending. Mr. Conable agreed that "lending for adjustment is going to test us", but said that the Bank was reorganizing and he was confident that a streamlined Bank structure and staff could meet the challenge. **The World Bank should take steps to reorganize its staff as quickly as possible to meet the demands of increased policy-based lending.**

The promotion of policy changes in the debtor countries involves not only a particular technical expertise but also, as the IMF has found, the risk of unpopularity and controversy in attaching conditions to loans. The World Bank will not be immune to such reactions by the borrowing countries. However, World Bank loans may involve somewhat more acceptable conditionality, since they would have a longer time-frame than IMF loans. They would also relate to economic growth issues in contrast to IMF loans, which are made in an atmosphere of crisis brought on by serious payments imbalances. Mr. Conable has made the point that "conditionality that goes beyond the moment of crisis has to be totally acceptable within the country which is seeking to recapture growth through reform".* The Committee would agree. In particular, **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.** Many of these countries cannot readily transform themselves on the OECD model nor do they have the entrepreneurial skills to do so.

A basic question addressed by the Committee was how far the Bank should go in shifting its emphasis from traditional project lending to structural adjustment lending. The Committee considers there is some risk that the Bank might be pushed into adopting a role similar to that of the IMF, but on a longer-term basis. This issue was raised with Mr. Conable during his Ottawa visit and it was reassuring to be told that he is aware of the danger. He explicitly stated that he did not expect the Bank's project lending — which he clearly believed to be necessary for future development — to fall below 50 per cent of total Bank lending. However, since project lending has in recent years represented around 80 per cent of the total, even this change represents a significant shift in the Bank's focus. If the Bank were to lose interest in its established role as a development agency it would be in danger of disregarding its mandate.

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* *Finance and Development*, December 1986, page 3.

Professor Peter Kenen of Princeton University pointed out to the Committee yet another difficulty. The new emphasis on structural loans and economic reforms will undoubtedly mean that commercial banks, which have been taking their cue from the IMF, will in future attach increased importance to the agreements negotiated by the World Bank with debtor countries in judging the creditworthiness of borrowers. However, when a debtor government undertakes domestic economic reforms and restructuring, some time is needed for results to become apparent and the degree of success likely to be achieved is difficult to predict. The World Bank cannot very well give assurances to the commercial banks regarding matters on which the Bank is not itself sure. This contrasts with IMF agreements which, being shorter-term, can be more quickly assessed, and consequently the criteria for measuring success tends to be quite straightforward.

While the Committee is in broad agreement with current proposals to expand and change the emphasis of World Bank lending, it sees a danger in the World Bank being pressed too hard from the outside to weaken, and perhaps in some instances to abandon, its traditional development lending. **The World Bank should try to maintain a judicious balance between its traditional project lending and the more recently emphasized structural adjustment lending.**

Cross-conditionality between the Fund and the Bank

Several witnesses drew attention to the difficulties faced by developing debtor countries when the conditions attached to loans from the IMF differed and even conflicted with those attached to World Bank lending. Different objectives have at times led each institution to press for implementation of policies that are at cross-purposes, and regional development banks may have different priorities as well. Speaking from the point of view of the recipient country, Mr. Ibarra said that with the conditionality imposed by the various institutions "after a while you end up with so many rules of conditionality and cross-conditionality that you give the government no leeway to decide a proper adjustment policy well adapted to their internal needs." (8:16)

The Fund's recommended policies usually concern a country's fiscal balance and involve higher taxes or lower public expenditure, whereas the Bank operates on a longer time frame, with its conditions related more to economic growth than to financial stabilization. Mr. Conable said he understood the difficulties facing the debtor country policy-makers from cross-conditionalities on loans. To illustrate the point, he described the problem of a North African country that was being urged by the IMF to reduce its deficit and, simultaneously, by the World Bank to restructure industries by removing taxes on imported components. The import taxes in question were producing revenue that would help achieve the IMF's objective of deficit reduction.

Closer co-ordination between the Fund and the Bank

At Bretton Woods, where the concept of the Fund and the Bank was worked out, the idea of establishing a single agency instead of two institutions was explored and rejected. Instead, the Fund and the Bank were each mandated to pursue important, but quite different objectives. The choice of names prompted John Maynard Keynes, one of the founders of the system to observe, "We have created a Fund which is a bank and a Bank which is a fund". However the complementarity of their functions show that the founding fathers expected a close collaboration between the two.

In Washington, the Committee discussed with Bank and Fund representatives the question of closer co-ordination between the two in the light of Mr. Baker's proposals. The Committee was told that good co-ordination already existed and that it was being improved steadily. The two organizations have put in place co-operative arrangements: World Bank staff members are included on IMF missions to examine conditions in member countries, and vice versa; IMF staff members attend consultative groups organized by the World Bank; and information is exchanged. But these practices cannot resolve different conditions based on conflicting goals or priorities fundamental to each institution. Mr. Richard Erb, Deputy Managing Director of the IMF admitted that since Latin American countries were particularly wary about onerous cross-conditionality, they had indicated they preferred to deal with the two agencies independently. For this reason, he said, it seemed likely that the Fund and the Bank would find it easier to co-ordinate more closely when dealing with the low-income debtors whose problems often involve less complexities than those of the middle-income countries.

Mr. Conable advised the Committee that he intended to work closely with the managing director of the Fund. This approach should help to make differences more manageable and avoid working at cross purposes. Nevertheless, there are bound to be some ongoing policy differences in approach between the two institutions which could cause inefficiencies and difficulties for the recipient countries.

In the final analysis such differences must be resolved by the member governments themselves although this is never easy when it involves international institutions where authority is diffuse. **The Committee recommends that the Canadian government advocate closer collaboration between the Fund and the Bank. It should instruct its executive directors at the Fund and the Bank to use every opportunity to press for complementary policies in the two organizations, while recognizing the inherently different approach of each institution. Further, the Canadian government could urge 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.**

Co-ordination between the Bank and the regional development banks

The Committee considers that the same approach should apply to relations between the World Bank and the regional development banks. With resources limited, it is desirable that all loans should be mutually-reinforcing. There is already some agreed specialization in function, with regional banks tending to concentrate on project lending. While there is a certain amount of co-operation among the respective staffs of the World Bank and the regional banks, the differences in the voting strength of larger developing countries in the regional bank for their region and in the World Bank can lead to conflicting decisions.

Representatives of the Inter-American Development Bank (IDB) told the Committee that there were ongoing attempts to co-ordinate their work with that of the World Bank in the form of periodic meetings, exchanges of information, participation in consultative groups, and representation of member governments on boards and at replenishment negotiations. However, in the past there have also been problems, particularly between the World Bank and the IDB, and it was apparent to the Committee that this was an area of considerable sensitivity. The Committee formed the impression that there is room for improvement. The need for a close, constructive working relationship between the multilateral development banks (MDBs) is unquestioned.

Canadian government representatives in the multilateral development banks should be instructed to press for closer co-ordination between the World Bank and the regional development banks, having in mind the strengths and specializations of the respective institutions.

Funding for the World Bank and IDA

The World Bank's lending is restricted to the sum of its capital, both paid-in and callable, and its retained earnings. To maintain lending programs, it becomes necessary for the Bank to increase its capital from time to time, through the negotiation of what is known as a General Capital Increase (GCI). In the past, GCIs moved in pace with quota increases in the IMF. On the most recent occasion when IMF quotas were increased in 1983, however, the Bank was left behind. As of the end of June 1986, total subscribed capital amounted to $77.5 billion, of which $6.7 billion (8.6 per cent) was paid-in. The remaining "callable" capital is used by the Bank, along with its paid-in capital and reserves, as collateral for funds borrowed in various capital markets, which are, in turn, available to finance loans to borrowing Third World countries.

The United States has argued that a GCI is not needed as yet and this position may be justified to some extent on the basis of past performance. The World Bank's 1985 lending commitments declined by almost 5 per cent from 1984 levels. The declines were attributed by the Bank to the continuing economic stagnation as well as to problems with project designs, domestic resource mobilization and creditworthiness of the developing countries. Others, critical of the Bank's earlier detachment from the debt problem, maintain that a General Capital Increase is very much needed to allow the Bank to increase substantially its lending. Mr. Persaud justified an increase on the grounds that developing countries were looking for at least a doubling of the Bank's lending.

The Bank has, in fact, begun to speed up its funding and has now formulated plans for doubling its 1985 lending level by 1990. Already in 1986 it increased its lending over 1985 by 16 per cent, reaching a record $13.8 billion. A program of expanded lending totalling $50 billion has been endorsed for the next three years and an annual lending level of $21.5 billion is projected to be reached by 1990. Ministers at the April 1986 meeting of the Development Committee urged that the Bank should not be constrained by a lack of capital. Mr. Conable said that he expected to "see a virtual straight line increase in lending over the foreseeable future." If the Bank is to be in a position to increase its lending by 50 per cent in four years, it will require a substantial GCI. The last GCI occurred in 1980 although a "selective" capital increase was authorized in 1984, which drew capital from 15 countries.

It is timely for the World Bank to increase its lending for another reason. Repayments due to the Bank by Third World countries for servicing and principal of loans made in the past are now, for the first time since the World Bank opened its doors, on a par with or in excess of disbursements. In principle there is nothing wrong with this. In practice, however, this is a bad time indeed for the net capital flow to be to the World Bank rather than to the Third World.

The Committee was reminded by several witnesses that the negotiation of a GCI is a lengthy business requiring perhaps a couple of years from the time it is begun. The World Bank's 1986 annual report referred to the timing of a GCI as "increasingly crucial" and noted that it will be important for Bank shareholders to agree in principle on a GCI in fiscal year 1987, that is by June 30, 1987. Mr. Conable noted that by the time the Mexican package would be completed, the Bank would be close to the upper limit of its borrowing authority.

Generally in this report the Committee has concluded that it is critically important to find ways to increase the flow of capital to debtor developing countries that have committed themselves to adopt serious adjustment measures. In chapter four the Committee pointed to the net capital outflows from debtor countries that have prevailed since 1982 and analysed the depressing effect on economic growth of the huge debt overhang. Later in this report, in chapter eight, the Committee criticizes the emphasis on pressing the commercial banks to advance more loans. To make up the shortfall, the Committee proposes in that chapter that creditor governments increase their funding to Third World countries both through ODA and increased export credits as well as through enlarged funding of the World Bank and the multilateral development banks.

Relating these conclusions to the position of the multilateral development banks, **the Committee welcomes the World Bank's decision to increase substantially its annual levels of lending and to improve the rate of disbursement. Given the time needed to complete a General Capital Increase, a decision to negotiate a new GCI for the World Bank should be reached in 1987. The objective should be the largest attainable increase in the Bank's subscribed capital.**

For this reason, the Committee approves the indication given to the Committee by the Minister of Finance, the Honourable Michael Wilson, that Canada stands ready to contribute its share to the next GCI of the World Bank: "If the proposals set forward by Secretary Baker gel into lending activity, the World Bank will need additional capital and we would support that need as a country." (14:13) Mr. Wilson added that an announcement of negotiations of a new GCI would, in itself, "do much to reassure private lenders that governments are prepared to play an increased role." (14:10)

Despite the statement of Secretary Baker in Seoul that the United States "would be prepared to look seriously at the time and scope of the general capital increase" when the need for such funds was demonstrated, the U.S. Administration continues to urge some delay. While other countries and the Bank itself consider there is such a need at present, the position of the United States is that it must be demonstrated that the Bank's sustainable lending level will be exceeded before any attempt will be made to push the approval of a GCI through Congress, which at present is geared to Gramm-Rudman budget cuts.

The Committee recommends that the Canadian government press the United States to agree to begin negotiations for a substantially increased General Capital Increase for the World Bank as soon as possible.

There are rumours to the effect that the United States may propose that the next GCI, when it occurs, should be composed entirely or very largely of callable capital, rather than the 8.75 per cent in the form of paid-in capital as at present. The World Bank borrows on capital markets where it has traditionally maintained the highest credit ratings. Should the Bank get into riskier areas of lending and especially if borrowers are unable to service the Bank's loans, it might lose some of its preferred access to capital markets and, as a result, not be able to borrow on as favourable terms as in the past. The possibility of this happening would be greater if the proportion of paid-in capital resulting from the next GCI were to be reduced from the present level to zero, as some in the United States are proposing. The net effect could be higher interest charges on World Bank loans.

The idea of reducing the percentage of paid-in capital or of eliminating the paid-in portion entirely for the next GCI is apparently designed to achieve a capital increase without the U.S. Administration having to seek Congressional approval for a substantial appropriation. There are conflicting opinions as to the wisdom of the idea and some countries even consider it would be prudent to increase, not decrease, the ratio.

Whether the paid-in portion of capital for the next GCI could be lowered without undermining the Bank's borrowing advantage, and by how much, is a technical financial question that needs to be carefully reviewed by member governments. An important consideration to be borne in mind, however, is whether the United States would agree to a substantially larger GCI if the percentage of paid-in capital were to be maintained at its present level.

The Committee considers, however, that a major reduction in the ratio of paid-in capital could send a wrong signal to the borrowing countries. If the paid-in portion were to be lowered too far, or eliminated, it might appear that the donor countries were not honouring their commitment to the developing world. **The Committee recommends that the government should instruct its executive director to resist proposals for any significant reduction in the proportion of paid-in to callable capital in the next General Capital Increase of the World Bank.**

In testimony before the Committee, the Honourable Michael Wilson had emphasized the urgency of the eighth replenishment for the **International Development Association (IDA)**, the World Bank's soft loan affiliate, and expressed support for its early conclusion. The Committee has been made aware of concerns that the dominant position of the United States has had a constraining effect on both the policy directions and the funding levels of the international financial institutions, and particularly of the World Bank and IDA. On a number of occasions the perception of the U.S. Administration as to appropriate lending policies has lagged behind those of other OECD countries. The United States has appeared to many to have reacted negatively to innovative proposals, with the result that Bank and IDA programs have become unnecessarily inflexible. Furthermore, the reluctance of the United States to lose its dominant voting position in the Bank and the accompanying management control has caused it to block increases in funding of the institutions considered necessary by other donors.

Negotiations for the seventh IDA replenishment in 1983 were a case in point. Early in the negotiations, the original objective of $15 billion was reduced to $12 billion, a sum considered a minimum by most donors including Canada. However, the United States not only insisted on limiting its contribution to $750 million, but at the same time it refused to agree to increased contributions by other donor countries wishing to reach a larger funding objective because this would have had the effect of reducing the percentage of U.S. voting shares and influence in the management of IDA. The outcome of this U.S. resistance was a severely reduced replenishment, amounting to only $9 billion and an inadequate level of funding for IDA. In order to make up some of the difference, the World Bank established a Special Facility for sub-Saharan Africa, to which donor countries were invited to make additional contributions.

Similar difficulties also arose in 1986 during negotiations for IDA's eighth replenishment. The original minimum target had been $12 billion but the October negotiations concluded with only $11.5 billion. Special additional contributions were requested from a number of the donor countries to raise the total to $12 billion or more. Japan was willing to contribute more but as a condition for doing so requested an increase in its voting shares in the Bank, a change that would have had the effect of reducing the 20 per cent U.S. share. Below a 20 per cent level, the United States would normally no longer have the right to veto major policy changes and again U.S. objections stalled the negotiations. In this case, an agreement was eventually worked out to enable Japan to have an increased voting share and to allow the United States to retain its veto, but this change has yet to be confirmed by an amendment to the Bank's charter.

Canada was among the donor countries asked by the World Bank to make an additional contribution of $30 million to meet the $12 billion IDA target. This request caused vigorous debate within the Canadian bureaucracy and the Cabinet. Those opposed to the supplementary contribution argued that the funds should be retained in Canada's bilateral aid budget where they could be better spent; they also contested the principle of special funds. The counter-argument involved giving increased priority to multilateral aid at this time, with some emphasis on the fact that, had Canada refused to contribute, its ranking among the donors to the multilateral aid agencies would have declined. In the end, the government decided to accede to IDA's request.

The Committee considers the Canadian government's decision to commit an additional $30 million to IDA in addition to its commitment negotiated at the eighth replenishment as justified by the need to increase multilateral aid at this time.

The Committee notes, however, that even the $12 billion level is in real terms substantially less than the level agreed to in the sixth replenishment six years ago and will hamper IDA's response to Third World requirements. The World Bank has estimated there will be a shortfall of $1.5 billion a year in the capital needs of sub-Saharan African countries over the period 1986-90. Moreover, the United States is still in arrears for the seventh replenishment and there remains some doubt that the U.S. Congress will approve the Administration's commitment of funds for the eighth replenishment.

Another unfortunate development that flows from the difficult situation at the recent IDA replenishments is the subsequent resort to establishing special funds or special appeals as a way to attract additional funds. These arrangements undermine the principle of international responsibility and render more difficult the future raising of additional funds for the international financial institutions.

The Committee recommends that the Canadian government instruct its executive director to work with other representatives in support of the largest attainable capital increase for the World Bank and IDA. Further, Canada should resist arguments by the United States or any other state that advocates a limit on increased contributions in order to maintain their particular voting shares.

Decisions as to the appropriate scale of capital replenishments of international financial institutions should be reached through international agreement. The Committee has been distressed to learn how the determination of the United States to retain a veto in the international financial institutions has constrained their capacity to raise new capital at a time when additional funds are desperately needed. **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. It is in the common interest that these countries be able to increase their contributions without constraint. The attempt of the United States to perpetuate that special status discourages other states from assuming increased responsibilities.**

The Role of the International Financial Corporation

What Third World countries need urgently at the present time is non-debt-creating capital to help them stimulate their economies. **The International Financial Corporation (IFC),** the second affiliate of the World Bank, concentrates its efforts on mobilizing domestic and foreign capital for the larger middle-income developing countries in order to promote investment. The underlying objective is to produce the needed economic growth by stimulating productive enterprises. The IFC aims to invest mainly in privately-owned enterprises but it also puts money into some mixed public/private undertakings. Much of the capital it currently channels to the developing countries is still in the form of loans but increasingly a growing percentage is going into equity investments. The IFC is encouraging private direct and portfolio investments through its own example; in 1986, it invested $1.2 billion and succeeded in attracting an additional $2.4 billion of investment from private sources.

Some developing countries such as Malaysia and Brazil already have significant stock markets and those elsewhere — including Korea, Chile and Mexico — are growing. According to IFC data, some of these emerging markets, including Brazil, India, Korea and Mexico, have achieved high rates of return. One obstacle which the IFC has faced in helping develop such markets has been resistance in a number of developing countries to foreign portfolio investment, although their reception of foreign direct investment has improved somewhat in recent years. An added complication, Mr. David Gill of the IFC informed the Committee, is the fact that some OECD countries discourage the exportation of portfolio equity through taxation measures or foreign exchange restrictions.

In order to encourage more portfolio investment, especially by large institutional investors who show an interest in diversifying a small proportion of their funds in countries outside the major OECD markets, the IFC has established a series of closed-end mutual funds that invest in shares in developing country companies. The first such fund, the Korea Fund, now trades at a substantial premium on the New York Stock Exchange. The success of the Korea Fund led to the establishment of the Brazilian, Taiwanese and Mexican funds as well as the Emerging Markets Growth Fund, which was launched in 1986 to invest in a number of developing country markets.

The Committee commends the goal of the IFC, which is designed to alleviate the debt burden of developing countries by providing them with a method of increasing the supply of equity and enhancing the confidence of foreign investors in those markets. This is an aspect of the development process that had been overlooked as a means of improving over a period of time the foreign debt situation in a number of middle-income debtor countries.

The Committee agrees with the thrust of the IFC that increased private sector equity investment in certain large or middle-income developing countries could benefit the peoples of those countries and promote development, especially if this can be undertaken in partnership with local investors. For this reason, **the Committee recommends increased emphasis on the work of the International Finance Corporation, on its promotion of investment in Third World countries and on its initiative in creating equity mutual funds for investment in developing countries.**

The Multilateral Investment Guarantee Agency

Not surprisingly, some would-be investors in Third World countries are deterred by the risk that they might not be able to convert their money into other currencies, that they might be suddenly expropriated or nationalized or that civil unrest or war might overtake their investments. To minimize or remove these and other non-commercial concerns, the World Bank is trying to establish another facility, the proposed **Multilateral Investment Guarantee Agency (MIGA)**. MIGA would have its own share capital derived from the paid-in portions of subscriptions from member countries including developing countries. It would supplement the coverage of national insurance programs such as Canada's Export Development Corporation.

If MIGA were successfully established, it has been estimated that by 1990 about $2 billion worth of MIGA-guaranteed projects could be in place, much of which would not have been undertaken otherwise. The prerequisite number of developing and developed countries (including Canada) have signed the draft convention to set up MIGA and the final convention will be submitted to the governments of the World Bank for ratification in 1987. However, a few large debtor developing countries in Latin America have been resistant to the idea of

MIGA, apparently fearful that relaxed rules for foreign investment could lead to an infringement of their sovereignty.

The Committee is of the opinion that the establishment of the World Bank's Multilateral Investment Guarantee Agency could be a positive factor in encouraging needed private investment capital into Third World enterprises.

The Regional Development Banks

While the Committee did not receive much testimony on the regional development banks' role in the debt problem, it did meet with representatives of the **Inter-American Development Bank**, the oldest and largest of the three such banks.

Because U.S. commercial banks are particularly exposed in Latin America, Treasury Secretary Baker's 1985 initiative placed most emphasis on the debt problems of that region. In his Seoul speech he specifically proposed the expansion of IDB lending by 50 per cent over three years. Mr. Baker himself was implicitly critical of the past lending practices of the IDB when he spoke of "strengthening the IDB's policies to enable it to be a more effective partner in support of growth-oriented structural reform." He suggested that U.S. support for its next GCI be dependent on the implementation of such improved lending methods. He emphasized the need for the IDB to introduce targeted non-project lending based on "well-defined economic and country strategies" and suggested that "such lending could be associated with World Bank programs, until the IDB has implemented the necessary reforms."

The Committee has some questions regarding IDB lending: whether there has been adequate conditionality attached to past IDB loans; whether, if the ratio of non-project loans (that is, balance-of-payments or sectoral loans) to total loans rises sharply over the next three years, the IDB would be prepared to apply stiff macroeconomic conditionality so as to reinforce the thrust of the Bank and the Fund; whether, if it does so, its borrowing members will reject the stringent conditionality on the grounds that they consider it an infringement of their economic sovereignty; whether the IDB is ready and able to implement sufficiently quickly the necessary in-house operational reorganization involving country programming and project preparation; and finally, whether the IDB would be able to increase by 50 per cent over three years its disbursements in quality programs.

Further, despite Canada's significant contributions to, and interest in, the work of Inter-American Development Bank, there is some doubt as to whether Canada has the degree of influence in its direction that is commensurate with its financial stake. In view of the major debts from this region owing to Canadian banks and the potentially effective role of the IDB, the Committee considers that a stronger manifestation of interest by the Secretary of State for External Affairs in the workings of the IDB would enhance the position of the Canadian executive director on its board. It could, for example, strengthen the position of the Canadian representative on the question of financial management of the IDB.

In respect to the next funding of the IDB, similar concerns arise as for the World Bank. With this regional bank there has been a steady decline in the ratio of paid-in to callable capital. Paid-in capital now represents only 4.5 per cent of the total, and the possibility of a reduction to 2.5 per cent is being discussed. As with the World Bank, this may accentuate the risk that the IDB's credit rating — resting increasingly on the security of callable capital — will fall, although admittedly this is a technical question and should be assessed by financial experts. However, again, too low a level of paid-in capital could constitute an inappropriate model for borrowing countries were they to see donor countries not honouring their commitments with an actual allocation of funds. On this basis, **the Committee recommends that the Canadian government instruct its executive director at the Inter-American Development Bank to resist the reduction in the ratio of paid-in to callable capital in the next general increase of resources.**

Parliamentary Authority for Funding

It has come to the Committee's attention that there is a gap in the authority from Parliament with respect to Canada's funding of some of the international financial institutions. The problem involves the reporting to Parliament of Canada's subscriptions to the regional development banks. When the paid-in portion of Canada's subscriptions is requested annually of Parliament through the Estimates, there is no procedure for obtaining Parliament's approval for the 'callable' portion. The "callable" portion represents a guarantee of payment on request of the government but it is not given parliamentary sanction. Under the consolidated Bretton Woods and Related Agreements Act, passed by Canada in 1985, the government is required to report to Parliament by March 31 of each year the full amount of Canada's subscription to the World Bank, including both the "paid-in" and the "callable" portions as well as its obligations in respect to its IMF quotas.

No such reporting is required for Canada's funding of the regional development banks. At a time when the regional development banks may be entering new and perhaps riskier forms of lending, the Committee foresees the possibility that donor governments might be asked to put up amounts of the 'callable' capital committed in past subscriptions. In such cases, the Canadian government could be faced with the prospect of honouring international commitments to which Parliament had not given prior approval.

The Committee considers that a reporting to Parliament should be instituted for the regional development banks, possibly in a statement in the Public Accounts, where Canada's full commitments, including its obligations to provide "callable" capital would be stated clearly and explicitly.

The Committee's concern related to the IDB's shift away from more traditional project loans to program or balance-of-payments loans raises the same issue in respect to the other regional development banks. Two other development banks — the Asian Development Bank and the African Development Bank — are well equipped for project lending and have built up an expertise in this field. They are now being pushed to shift their resources to policy-based lending. These banks lack the staff to design or administer such loans. Nor do they have the necessary weight to insist on and monitor the adoption of broad conditionality.

Mrs. Margaret Catley-Carlson, President of CIDA, put the issue succinctly:

> The regional banks' specialty lies primarily in specific project lending. Moreover the conditions attached to their loans focus on efficient project implementation and give less attention to sector policy reform such as pricing, tariffs, and subsidies, or macro-economic issues. These policies, if inappropriate, can undermine or nullify the positive

development impact of a project loan and work to the further detriment of the intended beneficiaries. (11A:22)

The Committee concludes that the shift in emphasis toward program lending by the regional development banks is unwise. In development terms, project lending continues to be much needed. **The Committee considers that project lending should remain the central activity of the regional banks.**

The International Fund for Agricultural Development

Canada has contributed to the first two replenishments of the **International Fund for Agricultural Development (IFAD)**, the modestly financed institution concentrating on helping the poorest people in developing countries to grow more food. The Committee has been much impressed by the exceptional effectiveness of IFAD and by its lean, no-frills organization. For every dollar provided by IFAD, other donors and governments concerned have contributed three dollars or more. The level of last year's second replenishment of IFAD was almost one-third less than the first one. In order to supplement this reduced funding IFAD established a special Programme for Africa, with a funding target of $300 million for sub-Saharan African countries affected by drought and desertification. In 1986 it asked the OECD countries for a modest contribution to help reach the objectives in Africa. IFAD President, Mr. Idriss Jazairy, told the Committee that Canada was one of very few industrialized countries not to have participated in this special program, presumably because Canada already has a special bilateral program for Africa.

Earlier in this chapter the report voiced its disapproval of the principle of special appeals and special funds. IFAD's special appeal for Africa follows on the heels of the establishment of a World Bank Special Facility for Africa to make up for a shortfall in the seventh IDA replenishment and very soon after the additional request for a supplementary contribution to the eighth IDA replenishment. If the practice of "special fund soliciting" by international financial institutions were to continue to expand, the Committee is concerned there would be a danger that the principle of burden-sharing by developed countries would be undermined.

Nonetheless, since IFAD's special fund for Africa has been established, the Committee urges the Canadian government to rethink its refusal to contribute to it. The Committee finds it difficult to understand that out of a total Canadian ODA budget of C$2.2 billion, the government is not able to allocate C$10 to $15 million to IFAD for this African program, especially since there is widespread agreement that IFAD has been extremely effective in its "grassroots" approach. If famine in Africa is to be overcome, the surest way to do so is to assist the people of that continent to produce their own food.

Chapter VI

THE ARAB OPEC COUNTRIES

The massive increase in oil prices in the 1970s created both a need for increased borrowing by developing countries importing oil and an accumulation of available funds for lending. Increases in the cost of imported oil quickly produced large balance-of-payments deficits among oil-importing developing countries which had to be financed from external sources. The equally large surpluses of the OPEC countries generated by oil price rises found their way into international placements.* By 1982, however, the OPEC countries were beginning to withdraw more money from commercial banks than they were depositing and by 1983 their deposits in OECD countries were negative. These developments were discussed more fully in chapter one. Table 8 shows how the OPEC placements of funds fluctuated with changes in oil prices until 1983.

TABLE 8

OPEC International Placements, 1974-83
($ billions)

Type of placement	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983
Placements in the United States										
Bank deposits	4.2	0.6	1.9	0.4	0.8	5.1	−1.3	−2.0	4.6	0.9
Other	7.3	7.3	9.2	6.9	−0.4	1.9	18.4	19.8	8.1	−10.4
Eurocurrency bank deposits	22.0	8.7	11.2	16.4	6.6	33.4	43.0	3.9	−16.5	−11.9
Other bank deposits	2.4	0.6	−0.9	1.2	0.0	2.0	2.6	0.5	−0.4	0.0
Other placements*	20.3	26.0	21.0	20.9	18.6	19.7	37.5	40.7	18.2	11.6
TOTAL	56.2	43.2	42.4	45.8	25.6	62.1	100.2	62.9	14.0	−9.8
Bank deposits as a percentage of total	50.9	22.9	28.8	39.3	28.9	65.2	44.2	3.8		

* Other placements include those in OECD countries, international organizations, and developing countries. The last include net flows of concessional assistance, syndicated Eurocurrency credits, bond issues and direct investment.

Source: World Bank, *World Development Report 1985*, p. 89.

* Approximately 40 per cent of the cumulative OPEC surplus funds was placed in the United States and the United Kingdom, although considerable sums also went to France, Germany, Japan, Switzerland and Canada. While initially preferring bank deposits, OPEC members increasingly favoured Treasury securities, bonds and stocks although they also purchased real property.

By 1986, in the face of falling oil prices, very few OPEC states were generating surplus revenues. It is assumed that only working capital is now being deposited in OECD commercial banks. Most of the funds that were earlier deposited in banks have either been repatriated or used for the purchase of equities and real property. Detailed figures on what must have been very large transactions are not however available.

While the OPEC countries were content initially to have the OECD commercial banks lend to developing countries the huge sums they had deposited, gradually, as Arab banks grew in size and experience, they also began to participate in international commercial bank lending. By 1981 Arab bank lending was quite substantial and most of these loans were to developing countries. While this lending declined absolutely in 1983, the percentage of international lending provided by Arab banks remained around the 10 per cent level (see Table 9). However, since Arab banks were late in the game, the totals of their loans outstanding are low in comparison with OECD banks, and their participation in debt renegotiations has been quite limited.

TABLE 9

Arab-led Syndicated Bank Lending, 1977-84
(\$ billions)

Type of lending	1977	1978	1979	1980	1981	1982	1983	1984
Total market lending	34.0	74.0	79.0	81.0	91.0	91.0	60.0	52.0
Arab-led syndications	1.0	2.3	2.5	3.6	9.1	9.8	6.3	5.3
to industrial countries	0.1	0.3	0.7	1.1	2.6	1.9	1.6	
to developing countries	0.9	2.0	1.8	2.5	6.5	7.9	4.6	
Arab-led syndications as a percentage of total lending	2.9	3.1	3.2	4.4	10.0	10.8	11.5	10.2

Source: World Bank, *World Development Report 1985*, p. 113.

Because Arab commercial banks are not heavily involved in direct lending to Third World problem debtor countries, the risks they face in the event of a default are minimal, and for this reason they could probably dispose of much of this debt by swaps or selling at a discount. Nevertheless, it is desirable in view of their potential financial strength that attempts be made to maintain the involvement of the Arab banks in future rescheduling negotiations, so that the practice of co-operative action between the industrialized and Arab lending institutions and governments develops some roots.

The very large fluctuations of oil prices which occurred in the 1970s and the 1980s had aggravating effects on the debt problems of oil-importing countries when prices increased sharply and on some oil exporters when prices fell no less precipitously. Market forces clearly had a bearing on these fluctuations, but OPEC decisions were the determining factor in setting the price of oil. In view of the large impact of energy trade and particularly trade in hydrocarbons on the world economy, several attempts were made in the 1970s to bring the management of world energy resources within the scope of international consultation and co-operation. These efforts failed, however, and to this day there is no forum in which oil-importing and oil-exporting countries can discuss the effects of price and production decisions relating to this most strategic and important commodity.

There is no reason to believe that the world economy will be less vulnerable to wide oil price fluctuations in the future and that OPEC price decisions will be any less disruptive. OPEC will be tempted to regain the position of strength it enjoyed in the 1970s. In these circumstances, **the Committee believes that 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.**

In spite of reductions in the price of oil, a number of Arab OPEC countries have maintained an impressive accumulation of assets; with the current recovery of oil prices and prospects for further increases in the longer term, the financial resources of a number of Arab OPEC countries can be expected to grow again. These countries should exercise a degree of responsibility in the management and eventual solution of the debt problem, in keeping with their financial strength.

In this context, it is interesting to recollect that in the wake of the first oil shock in 1973, the possibility of increased Saudi Arabian funding to the IMF was considered but ultimately dismissed because some major established members were reluctant to see their voting rights reduced by transferring them to Saudi Arabia. The Committee believes that the position taken by the Canadian government in subsequent IMF replenishments supporting an increase in Saudi Arabia's voting rights in exchange for increased funding was correct and reflected a recognition of the growing financial significance of Saudi Arabia and some of the other Arab OPEC states.

Some of the Arab OPEC countries were signficant providers of development aid. Indeed, during the period 1974-77, net disbursment by OPEC for official development assistance averaged more than $5 billion a year, almost 30 per cent of ODA from all sources. Until a pipeline of projects had been built, the ODA largely took the form of fast-disbursing assistance such as budgetary support. After reaching a peak in 1980, OPEC ODA declined by over 40 per cent in 1983. Over three-quarters of their bilateral disbursements go to Arab countries. About 15 to 20 per cent of OPEC ODA disbursements is channelled through multilateral institutions, including the international financial institutions.

Of the funds that OPEC members contribute to multilateral organizations, the largest proportion goes to Arab funds. Of the remainder, the International Fund for Agricultural Development and IDA are the main recipients. IFAD is uniquely and jointly funded on a proportionate basis by 20 developed (OECD) countries, 12 oil-exporting (OPEC) countries and 109 non-oil-exporting countries. During the 1986 replenishment of IFAD's resources, a reduced contribution from the OPEC group effectively capped the commitments of OECD countries at a lower-than-expected level in order to maintain the established relationship between OECD/OPEC commmitments. The result of OPEC's diminished funding was therefore a severe drop in IFAD's lending potential.

The Committee considers that IFAD has demonstrated remarkable results in assisting Third World development, particularly given its relatively low budget. It is understandable that contributions to IFAD from certain OPEC countries, such as Nigeria and Venezuela, are currently constrained by their serious external indebtedness. **In the Committee's view, the Canadian government should urge those Arab OPEC states which have the financial resources to endeavour to increase their funding to IFAD in order to bring total OPEC contributions up to a commensurate level.** Such a move would automatically result in higher matching contributions by OECD countries.

The World Bank has pointed to the enormous gap of $1.5 billion a year in the funds available for the needs of low-income sub-Saharan African countries until 1990. **Increased OPEC support for IDA as well as for the African Development Bank could help to bridge important multilateral funding gaps.** For their part, industrialized countries must be prepared to give appropriate recognition to the place Arab OPEC countries should occupy.

Chapter VII

THE COMMERCIAL BANKS

The major commercial banks continue to view the Third World debt situation with grave concern. They agree that rescheduling will continue to be necessary. Sceptical of certain generalized solutions, most banks maintain that each country's problems are unique and must be tackled on a case-by-case basis. They are generally of the opinion that creditor governments should be more actively and financially involved in working out a solution. The Canadian banks consider that efforts to resolve the problem have so far been insufficient and that new initiatives are needed urgently.

In practical terms, there are important differences as well as similarities within the international commercial banking community in their perspective on the debt problem. Hundreds of banks from all the industrialized countries are involved and, as has been noted in chapter one, some of the regional banks in the United States, many of which are not heavily involved, have been tempted to dispose of their existing loans at a discount. While nearly all the banks with loans to developing countries indicated general support for the Baker initiative when it was first proposed, many hedged their support by saying they expected assistance from governments and international institutions. Representatives of the Canadian banks whom the Committee met with took a similar position, stressing their reluctance about lending new monies unless the prospects for repayment improved. These comments were subsequently illustrated by the banks' reactions to the pressure to make substantial new loans as part of the Mexican negotiation of 1986. It has proved to be enormously difficult to secure the participation of the small U.S. regional banks and the whole experience has certainly stiffened bank resistance to making new loans to their debtor countries.

An indication of how the attitude of bankers may be evolving was the decision in January 1987 by the Republic National Bank of New York, one of the larger U.S. banks, to write down — by about 15 per cent — its loans to Mexico. While some small U.S. regionals with insignificant loans outstanding have sold them at a discount, the Republic National Bank is the first major commercial bank to accept the consequences of an across-the-board write-down of a substantial debt. So far it remains an isolated incident.

The commercial banks were aggressive in seeking to make loans to Third World 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. Unsatisfactory loans remain on their books and are likely to stay there for a long time — a situation that affects their earnings. Moreover, in most countries they have had to increase substantially their provisioning reserves against loans to particular developing countries, a process which has inevitably been costly.

Governments have an interest in making sure that the continuing viability of their commercial banks and the international banking system is not placed in jeopardy. Should this happen, it would have drastic implications domestically and internationally. As was explained in chapter two, if the system were stretched too far, the banks would not be able to maintain, let alone increase, their lending. Even more serious, a major bank failure in one country would have a dangerous spill-over effect on banks in other countries including Canada. An official of a major U.S. bank speculated to the Committee that in the event that Mexico and Brazil both repudiated their debt, there could be alarming consequences for his bank.

From the perspective of the banks, the troubling element in the current situation is that the improvements in the balance sheets that have been achieved through provisioning and efforts to increase equity have not in any way lessened the pressure from the problem debtor countries to reschedule their existing debts and to provide new funds. They recognize that, short of debt forgiveness, only so much encouragement can be offered by consolidating loans, extending maturities, and reducing spreads. It should be noted, however, that depending on the regulations in force in different countries, the added costs of provisioning associated with new lending may discourage banks from making new loans to problem debtor countries.

Provisioning and Interest Rate Capping

One of the difficulties the international banking system has to contend with in responding to pressures from debtor countries is the substantial differences that exist in provisioning regulations and in the tax treatment of reserves. Since commercial banks in OECD countries find themselves in substantially different positions, it is very difficult to work out a co-ordinated response.

It was noted in chapter two that banks in some European countries have set aside provisions and "hidden reserves" amounting to as much as 50 per cent of their problem debt with Third World countries. Canada and Japan appear to be in a middle position, whereas U.S. banks have only been required to set aside provisions against the debts of seven minor countries. It is true, however, that U.S. banks have compensated to some degree by improving their capital base and some larger banks have been provisioning voluntarily.

The way that reserves are treated for the purposes of calculating tax has a significant effect on the cost of provisioning. In Canada, approximately one-fifth of each year's provisions may be treated as an expense on a bank's income statement. Moreover banks secure a considerable additional tax benefit through the transfer of funds indirectly derived from provisions according to a complex formula, known as the PAR (prescribed aggregate reserve) formula, from retained earnings to appropriations for contingencies. While the actual benefit varies from bank to bank, on average banks are able to treat a substantial portion of the annual cost of provisions as a business expense.

In the United States, the attitude toward provisioning is substantially different. American banks are not allowed to treat reserves as a business expense, a fact that adds considerably to the tax cost of provisioning. The result is that the U.S. government is inhibited from requiring commercial banks to set aside provisioning because without tax relief it can be a very costly process for the banks. Bank regulators must exercise their powers with care because misjudgment could have serious consequences for the economy. While commercial banks are legally liable for the loans they have made, it would be in no one's interest to handle the world debt problem in such a way as to bankrupt the banks. Nonetheless, the banks should not be freed from the consequences of their earlier lending decisions. **The banks must carry an appropriate share of the cost of handling the bank debt problem**, but maintaining the health of the domestic and international economies justifies governments in relieving them of some of that burden. This is most easily done through the tax system.

Banks that have substantial general provisions are in a position to contribute to reducing the debt burden of problem debtor countries. This can be done through negotiating an actual write-down of the principal, in effect forgiving a portion of the loan. However, this is a step that both creditors and debtors are normally loathe to take. A less drastic approach, but one offering comparable relief to debtor countries, is for banks to accept a lower interest rate for their debts. Banks that are adequately provisioned can afford to do so without weakening their income-to-assets ratio, which is an important measure of a bank's financial strength.

While the Canadian banks deduct provisions for losses from the consolidated statement of income, they continue to use the original face value of loans in calculating interest payments due from debtors. Accordingly, a lower rate of interest spread across the face value of loans to a particular country can generate a total interest payment which, when divided by the reduced value of the loan carried on the bank's books, produces an income-to-assets ratio that is undiminished.

It is this set of calculations which would make it possible for banks that are provisioning on a regular basis to consider capping* or reducing interest rates. As Mr. W.T. Brock of the Toronto-Dominion Bank commented in a speech in 1984:

> It is far from certain that all countries can continue to service their debts — the precedent-setting decision of interest concessions may still have to be faced. Those banks which have established general reserves are reasonably positioned to bear the burden of such concessions.

Even with provisioning and favourable tax treatment of reserves, reducing interest rates could be costly to banks. However, it can be argued that the banks will be better off in the long term if debtor countries were able, as a result of such reductions, to manage their debt.

* Interest rate capping means a commitment not to raise floating interest rates even if rates rise. It does not normally mean reducing 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 interest rate reduction or capping by the commercial banks. Effective provisioning, however, enlarges the capacity of banks to reduce the burden of debt service on problem debtor countries. Since it is the inadequacy of U.S. provisions that represent the main constraint on a co-ordinated resort to cap or reduce interest rates, **the Committee recommends that the Canadian government should press for international agreement on a reasonable level for general provisioning by banks in OECD countries**. It must be understood, however, that this would have to be a long-term goal, since it would take time for the United States to modify its present practice.

Swapping Debt for Equity

Among several marginal mechanisms for reducing Third World debt, a certain amount of attention has been focussed internationally on the potential benefit of swapping of bank debt for an equity interest in corporations in the debtor countries. As mentioned in chapter four, some swaps have already been arranged privately between creditor banks, corporations in Latin America and interested third parties. There are numerous variations to this scheme, but the Chilean practice seems to be working most effectively and is estimated to have reduced Chile's external debt by $1 billion or 5 per cent in the last nine months of 1986. To illustrate, under a typical Chilean debt-equity swap plan, a creditor bank sells its Chilean debt on a secondary market at a discount. The purchaser, perhaps a multinational company with a subsidiary already in Chile, then takes the dollar-denominated note to the Chilean government where it is then redeemed for Chilean pesos at its face value. These pesos can then be used by the purchaser to buy equities or expand existing investment in Chile. After four years the investor is free to repatriate 25 per cent of past dividends and all future dividends and after ten years the entire capital can be repatriated.

After Brazil's declaration in February 1987 of a moratorium on its debt payments, the Chairman of the Bank of Montreal, Mr. William Mulholland, announced that his bank would convert up to $100 million, or about 5 per cent, of its Brazilian loans into high-grade securities listed on the Brazilian stock exchange as well as into direct investments in Brazilian companies. The International Financial Corporation of the World Bank is discussing the possibility of setting up a fund which would acquire some debt owed by Mexico and convert the liabilities into an interest in Mexican corporations.

The Committee favours debt-equity swapping arrangements as a means to alleviate somewhat the commercial debt problem. In some debtor countries, newly privatized enterprises could be attractive investment prospects. The benefits of the debt-equity swap mechanism will 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.

Cofinancing

World Bank cofinancing has already been discussed as a way for the Bank to promote increased capital flows to debtor countries. This mechanism could be used more widely by the commercial banks to furnish loans in parallel to World Bank loans. The banks are able to avail themselves of the evaluations of projects made by World Bank staffs, and bank risk-taking is reduced by the Bank's guarantee on part of the principal loaned and by the Bank's participation itself. Not surprisingly, the enthusiasm of the commercial banks for cofinancing has been related to the assessment of the creditworthiness of the borrowing country. They may also consider that the lower interest spreads on these loans are not sufficiently attractive even with the reduced risk. So far, European and Japanese banks have tended to use this procedure more than North American banks, but the latter have participated in cofinancing programs that have been incorporated into recent reschedulings for Chile, Uruguay, Mexico and Ivory Coast.

The Committee urges the commercial banks to increase their use of the World Bank cofinancing mechanism as a means of increasing the necessary capital flows to debtor countries.

Other Proposals for Debt Relief

One alternative that is vigorously discussed and has taken various forms is the possibility of partially writing down the debt of problem debtor countries. Among those who are opposed to proposals to have the commercial banks write down the debt are Mr. Fred Bergsten and Mr. William Cline of the Institute for International Economics in Washington. They argue that, while most options of this sort would have a favourable impact on the debtor countries, the banks would in the main suffer reduced liquidity, future debtor access to the capital markets would be jeopardized, and there would be a substantial "moral hazard", the term used to indicate that the granting of debt relief to one problem debtor country could create a precedent and could undermine the likelihood that other debtor countries would feel obliged to honour in full their foreign debt.

In addition to these proposals for bank write-downs, there have been a growing number of proponents of some form of debt relief involving public funding or public guarantees. This group includes, among others, Professor Peter Kenen of Princeton University, Mr. Felix Rohatyn, a prominent New York investment banker, U.S. Senator Bill Bradley, Congressman Charles Schumer and Lord Lever, a U.K. Chairman of a group of Commonwealth financial experts. A common element in a number of these proposals would have a new entity of the World Bank purchase developing country debt held by the banks at a discount on its face value, paying the banks in long-term bonds against itself and thus becoming the creditor of the developing countries. The banks would have a government-guaranteed asset, although they would experience losses to the extent the loans were discounted, and the debtor countries would receive some debt relief.

Reactions to the write-down option are mixed. As mentioned earlier, Mr. Alan Hockin was worried that confidence in the banks could be upset easily by actions such as major debt write-downs or sizeable interest rate concessions. This loss of confidence would, he said, prevent the banks from increasing or even maintaining their current lending levels because they could not attract new equity funds to replace the funds they lost.

Mr. Paul Volcker, the Chairman of the Board of Governors of the U.S. Federal Reserve System, argued in a letter to Senator Bill Bradley that:

> the adoption of a policy of providing broad-scale debt relief would inevitably operate to reduce the valuation of banks' remaining claims on all debtor countries, including claims on countries that were not granted debt relief.

On the other hand, Mr. John Lipsky, a vice-president of Salomon Brothers, New York, had a provocative observation to make about how the banking and financial communities might react if writing down the problem debts were seriously considered:

> I have gone not to the banks but to funds managers and institutional investors, and have asked this question: What if major commercial banks were all allowed to take, let us say, a 25 per cent write-down on all of their developing country debt and write it off over five years? What would happen to the value of the bank stock? I have yet to have the funds manager tell me that the bank stock would not go up... .
>
> I would submit that, if the banks themselves come to the conclusion that there is no light at the end of the tunnel for some of these debtor countries, then their attitude, if offered an opportunity, would be quite favourable. (6:27)

Advocates of a debt write-down contend that it is anomalous for commercial banks to show the full value of a borrowing country's promise to repay on their books when that debt may be heavily discounted on an outside market. In fact, the face value of the foreign debt of most of the Latin American debtor countries is already trading at substantial discounts in secondary markets. Prices in 1986 ranged from about 75 per cent for Brazilian debt to about 20 per cent for Peruvian debt. However, this would appear to be a very thin market, which one banker said was closer to "a custom swap market" than a true discount market. In practice, if Latin American debt could be traded freely, the price would probably be at an even greater discount than it now is.

The Committee recognizes that resorting to across-the-board write-downs by the banks would involve enormous practical difficulties. Within OECD markets, banks dealing with corporate debtors that are in trouble follow a procedure prescribed by the state regulatory authorities for handling non-performing loans. Normally at a certain point the creditor may sue for bankruptcy and the debt will then be written off on the best terms possible. There are also precedents for voluntarily reducing the face value of a loan. However, it is difficult to treat sovereign loans similarly. The Inspector General of Banks in Canada requires a bank that has written down a sovereign loan to apply the same rate to all other sovereign loans to the same country on its books. U.S. regulatory authorities take a similar position with their banks. Moreover, it is difficult for banks to differentiate between debtor countries; if they agreed to forgive loans to one Third World country, most other debtor countries would press for similar treatment. Even deciding on a discount value would be enormously difficult and would generate competitive pressure among Third World debtors, each of which would be pressing for the best possible terms.

In these respects the positions of banks and governments differ substantially. A creditor government can reduce or even forgive loans to Third World countries without affecting its viability. Banks are limited in the amounts that can be written off from year to year. General write-downs would damage the debt-to-equity ratios of banks that were not heavily provisioned and could potentially undermine their very existence.

A major problem with simply discounting loans to developing countries is that the discounted debts retain their full face value in the hands of their new owners. Unless the discounting is associated with debt forgiveness or interest rate capping, nothing is done to reduce the amount owed by the borrowing countries and the main problem continues unaddressed.

Japanese Banks and Third World Debt

Japanese banks, estimated to hold over $50 billion in Third World debts, are experimenting with a novel method of dealing with their problem loans to Latin America. Twenty-eight banks are establishing a debt-clearing agency, called JBA Investments, to be registered in the Cayman Islands. The banks will subscribe capital to the new agency roughly in proportion to the size of their loans. From the subscribed capital, the agency will buy Latin American debt of Japanese banks at market discount rates, allowing the banks to write-down loans on their balance sheets. The banks will be able to claim a tax loss equivalent to the amount of the discount. Any interest or principal the agency might collect on the loans is to be distributed as dividends to the 28 shareholder banks. Since dividends are taxed at a substantially lower rate than interest payments, the banks will enjoy an additional tax benefit.

For the Japanese banks, apart from these substantial tax advantages, their balance sheets will also be strengthened. At this stage, however, there is no discernible benefit to the debtor countries since the face value of the debt will not, at least initially, be reduced. The Japanese Foreign Ministry is claiming that the Japanese banks will, as a result of this innovation, be able to lend more new money to the debtor countries, but this is a statement that can only be demonstrated through the future performance of the Japanese banks. Nonetheless, the banks may be in a position in future rescheduling negotiations to offer lower interest rates on some problem debt.

According to early press reports, the initial capital subscription for the new agency will amount to between $100 and $300 million, which means that when the doors of the agency open it will only have the capacity to purchase a relatively small proportion on the estimated $30 billion of Japanese banks' exposure in Latin American countries. Around $6 billion of Mexican loans will probably be sold first.

Since this initiative was only revealed publicly early in March 1987 following Brazil's decision to suspend interest payments on its commercial bank debt and details of how the agency will work are still vague, there is insufficient information even to speculate on its efficacy. It would seem probable, however, that it will strengthen the competitive position of the Japanese banks, and it may increase the difficulty of maintaining international solidarity among the creditor banks.

The Committee had an opportunity to question Professor Peter Kenen about an idea he had put forward in 1983 to establish a new international financial institution, the International Debt Discount Corporation. The Corporation would be authorized to buy back Latin American debt at a discount and reissue these notes at longer maturities and lower rates. Professor Kenen said he still felt the idea could offer the best solution to the commercial bank debt question, but there was no political support for it in the United States, where it was perceived as "bailing out the banks". Moreover, it was probably not feasible in view of the Gramm-Rudman budgetary restrictions, he said.

The Committee received an interesting proposal from the Chairman of the Bank of Nova Scotia, Mr. Cedric Ritchie. His plan linked a cap on interest rates and extensions on repayments with the establishment of an international agency that would offer the banks a partial guarantee for their existing debt as an inducement to go on lending. The proposed agency would be a World Bank affiliate with initial capital from the World Bank, the commercial banks and the creditor governments. The existing debt of qualifying Third World countries would be rescheduled to achieve sustainable debt service ratios while permitting new borrowing for structural adjustment. The Bank of Nova Scotia's approach has the attraction of being fairly easily accommodated within the regulatory regimes governing the operations of banks, especially in Canada and the United States. The new agency would guarantee a portion of the restructured loans, but would not guarantee new lending. An initial capital of $40 billion was suggested for the agency to support the guarantees, the same amount proposed by U.S. Secretary Baker over three years, but in this case only a portion would be paid-in capital. The guarantee, it was argued, would both give some relief to the developing countries debt burden and limit the risk to the capital base of the banking system inherent in the existing debt. It would not "bail out the banks" but without it, the banks would be very unlikely to be able to risk new "voluntary" lending to the Third World.

The U.S. investment banker, Mr. Felix Rohatyn, has proposed a somewhat similar plan to the Bank of Nova Scotia proposal. His suggested package includes reduced interest rates for the borrowers — he argues that even a few percentage points would provide billions in new capital annually to major debtors like Mexico, Brazil or Argentina — and some form of total or partial government guarantees to the banks in exchange for reduced interest rates and stretched maturities. These guarantees would preserve the banks' loans and allow them to continue to carry these loans at face value on their books. Alternatively the guarantees could be provided by an international organization such as the World Bank. Mr. Rohatyn has also suggested that the banks' existing loan loss reserves could be released over a period of years and credited to future earnings. Finally, he looked to Japan as a source of large supplies of capital to be channelled to the debtors through long-term commitments of capital to the multilateral development banks.

These represent only a few of the many proposals for supporting with public funds some write-down of the accumulated debt, each with special features which make them attractive to different countries. No single plan has attracted general support and it would be imprudent for the Committee to try to single out any one proposal for particular commendation. Complex international negotiations will be required to determine which approach could attract the widest support. But in chapter nine the Committee has concluded that the ongoing problems of Third World debt, exacerbated by the recent events in Brazil, have reached the point where creditor countries must modify their strategy for dealing with that debt.

Chapter VIII

THE CREDITOR GOVERNMENTS

Since the eruption of the debt crisis in 1982, the governments of the industrialized lending countries have been supportive of efforts to resolve the problem, but have generally preferred to remain in the background. These governments have encouraged the efforts of the IMF and the multilateral development banks. They have rescheduled their official debt through the mechanism of the Paris Club once agreements between the debtors and the IMF have been worked out; they have supported the case-by-case approach of the IMF. They have urged the commercial banks to reschedule their existing loans and to lend more money to problem debtor countries; some, including Canada, have pressed their banks to reduce their vulnerability by increasing their reserves and improving capital-to-assets ratios. They have urged debtor countries to adjust their economic and fiscal policies. OECD governments have generally welcomed the thrust of the 1985 Baker proposals, while eschewing radical remedial suggestions such as massive debt write-offs. Some creditor governments like Canada have forgiven in varying degrees the official debt of low-income African countries.

Access to Creditor Countries' Markets

Of all the alternatives for dealing with the debt problem, none would be more effective in the long run in reducing it to manageable proportions than a decision by the OECD countries to dismantle trade barriers. In order to increase their debt servicing capacity, the borrowing countries require high export growth to garner the foreign exchange with which to service their debt.

It is true that to some extent, the failure of Latin American and African debtor countries to increase their export earnings and establish a diversified export base is due to their own inward-looking, protectionist trade policies. By contrast, borrowing countries in Asia, such as Korea, which had built up strong export industries had room to manoeuvre when faced with repayment problems. As well, some problems are undoubtedly due to domestic policies such as inappropriate currency valuations. However, at the very time developing countries are in urgent need of earning foreign exchange through trade surpluses, industrialized countries faced with recessionary trends, higher unemployment and declining trade surpluses — and in the case of the United States, a massive trade deficit — are erecting imposing protectionist barriers around their markets.

An illustration of this protectionism has been the renewal of the Multi-Fibre Arrangement on textiles, under which increased protection has been provided to an already highly protected industry and one in which developing countries have a comparative advantage. Farm subsidies, quotas, import levies and export restitutions restrict Third World agricultural exports. Many industrialized countries protect themselves against imports of sugar, copper and other commodities from developing countries. An enormous variety of non-tariff barriers have proliferated across a wide range of products.

Mr. Conable commented that it was extremely difficult for the World Bank to press debtor countries to open their economies, reduce domestic subsidies and lower import controls when developed countries were moving in the opposite direction to restrict access to their markets. Mr. de Larosière referred particularly to textiles, footwear and a number of other products produced competitively by debtor developing countries and told the Committee:

> If they do not find markets for those products, it is extremely difficult to see how the debt situation can be managed. It is very important because if . . . the markets where they could sell are not really open, it is very difficult to ask them to open up. (6:12)

The developing countries have an important stake in a successful outcome of the new GATT round of multilateral trade negotiations. For more than 35 years, the GATT has worked through successive negotiations to reduce barriers to international trade and to establish a framework of rules for multilateral trade relations. The result has been an enormous expansion of world trade. During the past decade, the GATT has been increasingly preoccupied with the emergence of developing countries and their trading problems. In the new round, its objective will be to build on and enlarge past achievements in the face of a proliferation of new protectionist measures. If these discriminatory measures instituted by industrial countries can be significantly reduced or eliminated and better access to OECD markets obtained, world trade will continue to expand and the prospects for developing countries will brighten enormously.

The Committee concludes that, in the long term, the most constructive step that the creditor countries, including Canada, could take would be to improve the access of developing countries to their markets. This action would parallel the economic adjustment measures that debtor countries are being asked to make. It stands to reason that the debtor countries would find it easier to service their debts if they could increase their exports.

Interest Rates

Reductions in interest rate levels have the potential for significantly easing the burden of debt for Third World countries. The extent of the potential benefit can be appreciated by the fact that a reduction in short-term interest rates of 1 per cent represents a reduction of $2 billion per year in interest charges on debt owed by the ten largest Latin American debtors. In Mexico's case it has been estimated that a 1 per cent drop in interest rates would be equivalent to a $5 increase in the price of exported oil per barrel. During 1985, interest rates in fact fell by a little over 2 per cent, but real interest rates still remained high by historic standards.

The Committee recognizes the difficulties facing the major OECD governments in attempting to lower international interest rates and appreciates that no one country could effect the change alone, although obviously the impact of financing the huge U.S. fiscal deficit has a major effect. Nevertheless, the goal of reducing interest rates should be a priority for the OECD countries and would greatly benefit debtor and creditor countries alike.

The Committee considers it important to stress that any improvement in economic performance that the OECD countries can achieve will indirectly benefit developing countries. Success in lowering interest rates, reducing domestic deficits and generally in expanding their economies would improve the prospects for developing countries.

Denominating Debt in Dollars

Mr. W.T. Brock of the Toronto-Dominion Bank drew the attention of the Committee to the disadvantage of linking the debt to a single currency. He provided members with copies of a speech he gave in 1985, in which he noted that the developing countries "bear a crippling burden when they entered the global recession with a single currency floating rate debt":

> Virtually all of the debt has been, and continues to be, predominantly in one currency — U.S. dollars. In retrospect, the U.S. dollar has proved to be the worst possible foreign currency for these debtors. Because of the incredible strengthening of the U.S. dollar in the past few years, foreign debt in local currency equivalents has escalated far more rapidly than would have been the case if a mix of currencies had been used.

The conclusions he reached were that the creditor countries "must endeavour to introduce changes that enable debtor countries to diversify their currencies and the interest rates they pay." Working toward the goal of denominating the debt in a mix of currencies has the merit of reducing the risk for debtor countries of an unexpected rise in the debt level. However, while in the early 1980s the link with the U.S. dollar was detrimental, the Committee notes that since the autumn of 1985 the U.S. dollar has been substantially devalued and debtor countries have cause now to be grateful their debt is denominated in dollars rather than yen or D-marks. Moreover, the Committee is unsure whether a link to a basket of currencies is a realistic option since the international financial system treats the U.S. dollar as the lead currency.

Harmonization of Banking Regulations

Several Canadian bankers emphasized to the Committee how the extensive variations in bank regulations, controls, provisioning requirements and tax treatment in different OECD countries make it more difficult to secure a positive co-ordinated response from commercial banks to the rescheduling process. For example, as indicated in the preceding chapter, U.S. authorities have directed U.S. banks to make loan provisions only in respect to loans to seven relatively small countries, whereas in Canada the Inspector General of Banks requires provisioning against loans to a basket of countries including major debtors. The accounting and tax treatment of loan losses can also vary significantly. U.S. regulators permit provisions to be counted as part of a bank's capital base, whereas in Canada they are deducted from consolidated assets. Canadian banks can allocate some of the cost of provisions as a pre-tax expense, whereas some European banks can treat all general reserves as a business expense.

Although an exchange of information on these differences and their implications could help to ensure the adoption of policies that would work equally well in different countries, **the Committee considers that it would be desirable for creditor governments to** go further and **try to achieve a greater degree of harmonization of their bank regulations and their tax treatment of banks** and to reach agreement on a reasonable level of general provisions to be attained by all banks in OECD countries. But this should not be done by simply accepting "the lowest common denominator" of the current provisioning practices, as one banker warned might be a danger.

Fortunately, the process seems to be already underway. A tentative agreement was reached in January 1987 between the governments of the United Kingdom and the United States to establish a common regulatory system for the capital requirements of the banks, based on the risk involved in each bank's loans. Under this system, the greater the percentage of high-risk loans, the higher would be the requirement for increased capital holdings by the banks. Initial reactions by several Canadian banks were favourable to the proposed capital requirement and the Office of the Inspector-General of Banks welcomed it. The Committee considers that OECD governments should pursue this initiative by holding intergovernmental consultations with a view to concluding harmonization of banking regulations as soon as possible.

Increased Funding for Middle-income Debtor Countries

In chapter four the Committee concluded that **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.** The problem is to find a way to do this. The classical model would call for private investment to provide the major source of external funds required by the middle-income developing countries, with poorer countries continuing to look to ODA. But the overhang of bank debt, the lack-lustre performance of the world economy and the unpromising outlook for many debtor countries have created an atmosphere in which very little private investment is coming forward. This situation is not likely to improve greatly until the debts of the commercial banks have been reduced to manageable proportions. It is this gulf that must somehow be bridged and governments are best able to provide the funding needed, either directly or through the international financial institutions.

There has been a natural tendency for OECD countries to focus on the large problem debtors. For example, the Baker initiative has concentrated on 17 debtors, including many of the largest. These countries get the most attention because default or repudiation by one or two of them could threaten the international financial system. This means that the smaller debtors may be neglected, even when — as is often the case — their needs are relatively greater. Since there are limits to the amount of resources that OECD countries are prepared to put forward to alleviate the debt problem, there is a danger that too high a proportion of those resources will be concentrated on the largest problem debtors.

The current rescue package for Mexico illustrates this concern. It provides for substantial funding from the World Bank, the IMF and the IDB, concessional financing from U.S. government agencies and very considerable new monies from commercial banks on relatively favourable terms. (See page 26) It is of central importance to help Mexico resolve its debt problems; Mexico must not be allowed to collapse. But in the process Mexico will receive a high proportion of the monies which governments, the international financial institutions and commercial banks have been prepared to devote to the debt question. The financial package negotiated with Mexico in July 1986, represented almost one-third of the capital called for by the Baker initiative. This does not mean that Mexico is getting too much. Rather, the Committee concludes that lending countries are going to have to devote more funds than they anticipated to dealing with debt problems on a world-wide basis.

The commercial banks have been widely criticized for lending too much to Third World countries in the past. This report has detailed how the banks came to make such large loans and how, in the case of Mexico, they eventually became trapped holding 80 per cent of that country's total debt. Bearing this recent history in mind, **the Committee questions whether it was wise to push the banks to put up so much new money for Mexico** — more than 50 per cent of the package — particularly since repayment is spread over a relatively long term: 20 years with a seven-year grace period for principal. The traditional role of commercial banks should be short-term lending to grease the wheels of commerce. Investment funds should come from capital markets. At this juncture, **the Committee believes that the 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 to lending by the creditor governments and the international financial institutions.**

In the past, developing countries have often discouraged private investment, particularly from abroad. However, attitudes are changing and this report has described some new mechanisms being developed within the World Bank to promote private investment in developing countries. A number of middle-income developing countries are now showing considerable interest in securing foreign direct investment, particularly since the kind of investment being proposed caters to local and regional markets and would not involve large-scale commodity developments intended for export to developed country markets. Unfortunately, at this time, only relatively few countries are able to attract such funds. However, as this kind of change can only develop slowly, in the Committee's opinion more support should be given by the governments of industrialized countries to the new instruments being put in place by the World Bank's International Financial Corporation for promoting private investment in Third World countries. To the extent that this additional private investment occurs, the commercial banks could gradually reduce their exposure and return to their traditional role of short-term lending.

For most debtor countries, however, such sources of financing are likely to be inadequate and slow in coming. There is an immediate need for increased funding from sources other than the banks and private investors. Export credits represent about 18 to 20 per cent of developing countries' long-term debt and have been a signficant source of project finance for many developing countries. The level of official or officially-supported export credits from OECD countries to developing countries dropped by almost half between 1981 and 1983. The World Bank has noted that there have been many cases where export credits supported poorly designed projects and led to overpricing of goods or to corruption. It has also pointed out that some countries have no machinery for reviewing or controlling the use of export credits. Nonetheless, whether or not some earlier export financing is judged to have been appropriately and wisely spent, the decision of OECD government agencies to restrict or cease export financing has added to the debt service burdens of debtor countries.

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, the Committee considers that the governments of the 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 serious economic adjustment programs endorsed by the IMF or the World Bank.

While creditor governments are in a position to increase the funds available to their export credit agencies to finance trade flows, it is not appropriate for them to become involved in longer-term lending directly to middle-income Third World countries for development purposes. OECD governments might sometimes be tempted to use such lending to promote their own exports. Furthermore governments individually are not in a position to negotiate conditionality for their loans. Instead **the Committee thinks that governments should greatly enlarge their funding of the World Bank so that the Bank 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.**

In the Committee's opinion this increased funding to permit substantially increased lending by the World Bank has the attraction of simplicity. No new institutions need be created, debtor countries would be assisted in servicing their debts and the exposure of the banks could be gradually reduced. The main difficulty would be the anticipated opposition of the U.S. government, which is meeting Congressional resistance over a modest GCI for the World Bank. The obstacle should not be underestimated; it would be regarded by some U.S. critics as "bailing out the banks". But the Committee sees this increased funding of the World Bank as a feasible and useful step and urges the Canadian government to advocate such a move.

In looking for additional funding sources, there have been a growing number of suggestions that Japan, currently in the strongest position financially of any creditor country, should increase its financing to debtor countries, both through bilateral and multilateral channels, thereby helping to fill the funding gap. It is commendable that Japan has begun to respond. In October 1986 it increased its share in the most recent IDA replenishment and in December it agreed to lend the

IMF 3 billion of special drawing rights to help the Fund's support of adjustment programs. The Committee considers that the international financial institutions could be strengthened further by the provision of additional contributions by Japan and other creditor countries that have strong balances of payments.

Assisting Low-income Countries

Mrs. Catley-Carlson, President of CIDA, pointed out that creditor governments have the possibility of offering poorer debtor countries relief on their ODA debts in three ways: easier terms for debt reschedulings, including moratoriums on debt payment for extended periods; increased financial assistance to help service existing ODA debt while leaving a margin for investment; and forgiveness of the debt by transforming past ODA loans into grants. Only one of these approaches depends on additional ODA funds. Most debt relief by creditor countries has been offered by rescheduling on a case-by-case basis within the Paris Club context. The exceptions are actions by countries including Canada that in 1977 offered forgiveness of the outstanding debt of eight of the poorest African states, the 1986 decision by several countries including Canada to provide all future ODA in the form of grants, and the 1986 offer by Canada and several countries of a 15-year moratorium on debt interest payments. Official debt reschedulings have increased dramatically in the last few years and debtor countries are having their debt rescheduled a second and third time. However, at no time have Paris Club schedulings reduced, written off or forgiven official debt obligations, although they have stretched maturities and, in the case of Ecuador in 1985 and Ivory Coast in 1986, offered a multi-year rescheduling agreement.

The Committee endorses the announcement in the 1986 budget of the Canadian government 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. The Committee also commends the 1986 Canadian offer to low-income African countries of a 15-year moratorium on debt interest payments for Canadian ODA. These are positive steps to relieve the burden of official debt repayments from the low-income developing countries. As a way of softening the rescheduling conditions for these countries, **the Committee would like to see other OECD governments adopt, as a minimum, policies similar to the 1986 Canadian offer of a 15-year moratorium on the interest payments on their official loans.** So far the Netherlands has taken similar action and a number of other countries are looking favourably at this initiative. Further, those OECD countries that have not yet done so, should be encouraged to emulate the 1977 action of some countries including Canada that wrote off or converted to grants all existing loans to the least developed countries. Several countries have gone even further and are working toward debt forgiveness to low-income countries on a broader scale. The Committee has learned that the U.K. government, on a case-by-case basis and subject to a prior IMF agreement, has forgiven the debt of eight hard-pressed countries in Africa and Asia. Germany has introduced an intermediate scheme involving partial forgiveness, by which interest payments on official debt may be written off under certain conditions. Another alternative device to relieve the low-income debtor countries is being applied experimentally by the United Kingdom, which is permitting these countries to repay their debt in their own currencies. The result is that they avoid a drain on scarce foreign exchange.

These approaches could, if implemented, offer some breathing space to hard-pressed, low-income debtor countries.* At the time Canada announced its offer for a debt moratorium, the responsible Minister, the Honourable Monique Vézina, suggested that the offer might also eventually be extended to others of the poorest countries in areas beyond those in sub-Saharan Africa. There are a number of other severely disadvantaged countries in the Caribbean, for example, that could benefit from a similar moratorium. The Committee urges the Canadian government to examine the cost of these and similar proposals with a view to possible implementation where appropriate. In the Committee's opinion, the general approach reflected in these actions and suggestions realistically faces up to the fact that loans to the poorer countries are unlikely to be repaid.

Increased Share of ODA through Multilateral Channels

In order for Canada to fund increased multilateral disbursement out of the existing appropriation, it would be necessary to increase the share of ODA being directed to this channel. In the past, around 1978-79, Canada used to disburse almost 25 per cent of its ODA through multilateral development banks. The Committee proposes that Canada revert to this goal, in line with its recommendation that funding for the World Bank should be substantially increased. In making this proposal, the Committee does not intend to imply any criticism of CIDA's effectiveness in disbursing bilateral development assistance, which is a subject not included in this study. Rather, the decision reflects a judgment that at the present juncture, the Bank must be given the means to increase its lending to problem debtor countries that are prepared to make structural adjustments to their economies. This recommendation for increased funds applies not only to the World Bank proper, but to its subsidiary, IDA. Accordingly, **the Committee recommends that 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.**

It would be possible for the Canadian government to divert sufficient funds from the bilateral aid program to achieve the increased funding of the multilateral financial institutions that this report recommends. However, it would be preferable if the government could find the means to accomplish a small real growth in Canadian ODA each year.

In the budget of May 1986, the Canadian government announced that it was postponing the undertaking made only a year before to raise the share of GNP devoted to ODA to 0.7 per cent by 1990. As part of its campaign to cut the deficit, the government decided to postpone the date for reaching the 0.7 per cent target to the year 2000 and to hold ODA to the present share of about 0.5 per cent of GNP until 1990.

A troubling feature of this decision in the Committee's judgment is the fact that the real level of Canadian development assistance will remain static until

* The Committee notes that on April 2, 1987, the Secretary-General of the United Nations sought advice on new ways to assist low-income African debtor countries when he appointed a ten-person Advisory Group on Resource Flows for Hard-Pressed African Countries.

1990. Even more troubling, however, is the prospect, if past history is a guide, that come 1990 the government of the day is likely once again to decide to postpone any increase in the proportion of GNP going to ODA. Even though in 1975 the government had committed itself to the 0.7 per cent target, no date had been specified for reaching it, and in fact the per cent of GNP declined for five successive years. As Table 10 indicates, the per cent of ODA peaked at 0.53 in 1975-76 and has not yet regained the 1975-76 level. With a continuing large deficit and so many other demands on the government's revenues, the risk remains that history will repeat itself in 1990 and a real increase in ODA would again be postponed.

TABLE 10

Canada's Official Development Assistance

Fiscal Year	Volume (C$ millions)	Per cent of GNP
1974-75	750	.49
1975-76	910	.53
1976-77	972	.49
1977-78	1,045	.49
1978-79	1,149	.48
1979-80	1,219	.45
1980-81	1,227	.40
1981-82	1,403	.41
1982-83	1,563	.43
1983-84	1,814	.46
1984-85	2,087	.49
1985-86	2,174	.48

To ensure that this does not happen, **the Committee recommends that the government in its next budget commit itself to increase the funds devoted to official development assistance by annual increments, spread over 13 years, to achieve the 0.7 per cent of GNP target by the year 2000.** Not only would such an approach be easier to manage financially, since the annual increments would be small, but it would also put the government in a position to urge other governments to increase their real contribution to development assistance. While it is not possible to calculate the increments precisely because the growth of GNP cannot be accurately predicted, the goal of small annual increments should be accepted.

Involvement of Creditor Governments

Apart from the exceptions relating to the poorest sub-Saharan African countries all OECD governments have resisted any suggestion that debt forgiveness and direct creditor government involvement could be policy options. It is instructive to review some inter-war experience involving sovereign debts. After unsuccessful efforts following the onset of the great depression to collect the debts built up by allied governments during World War I — efforts which failed, although they did bring down the Herriot government of France — the United

States government finally gave up the attempt in 1933. Similarly the efforts to collect reparation payments from Germany during this same period had disastrous economic and political consequences. Unfortunately that policy was only abandoned after Hitler had risen to power. These two episodes illustrate the consequences of insisting on the payment of obligations beyond the economic capacity of debtors to pay.

As has been pointed out in chapter four, the effect of the huge debt overhang has been to discourage entrepreneurs in problem debtor countries from proceeding, even with clearly profitable investments, for fear that the economy will collapse around them. The psychological effect of the debt burden is to create an environment of pessimism which nullifies many of the potential advantages of the adjustment policies that these countries have adopted. It is now evident that the Baker initiative, by failing to address the issue of debt overhang, has not generated the climate of hope and optimism which is the necessary foundation for any successful adjustment policies.

Indonesia's relatively successful experience in recovering during the late 1960s and early 1970s from the disastrous economic conditions and substantial intergovernmental debts left by President Sukarno shows what appropriate policies can achieve, even though the scale of its debts did not compare with current debt loads. The successor Indonesian government was offered loans on generous terms with a low interest rate, several years of grace on interest and principal payments and no compounding of interest. Subsequently under a long-term rescheduling arrangement negotiated in 1970, Indonesia was given the right, in the event of a shortfall in export earnings, to postpone up to three annual payments. This was an approach borrowed from an earlier Anglo-American loan agreement of 1946. The Indonesian economy has since performed well, combining low inflation with high economic growth.

In the cases noted above, the obligations were all held by governments. Payment problems can be much more easily handled where sovereign debt is involved, as governments can decide either not to press their claims or even to forgive them; further, governments can absorb the consequent losses.

The current problem facing the international financial community is much more serious than any similar situation faced previously, not only because of the size of the accumulated debt, but also because so much of it is held by commercial banks. Banks operate within highly regulated environments, which limit their freedom of action. Moreover, being commercial institutions, their capacity to absorb losses is limited, if their financial viability is not to be dangerously weakened and public confidence in them undermined.

It would be possible for states to intercede and to assume, in any one of a number of ways, all or part of the debt of the commercial banks or, alternatively, to support the banks with guarantees. The difficulty with such an approach is that it could open the door to the criticism that governments were "bailing out the banks", that is, rescuing them from the consequences of past errors. However should the debt problem deteriorate to the point where the viability of banks was at risk, the Committee believes that government intervention would be preferable to massive bank failures and that such action would receive public support.

It would be a calamity if conditions reached the point where government intervention were required to prevent major bank failures. Responsible governments should take timely corrective action to ensure that such a situation never occurs. Fortunately there are ways in which governments can act that would support the position of the banks without directly raising the issue of bank "bail out". For example, increasing funding for the World Bank so that it could lend more would relieve some of the pressure being experienced by the banks to make new loans available. Governments could also modify the tax treatment of banks' general reserves so as to encourage them to make provisions.

The current difficulties between debtors and creditors are capable of threatening the underpinnings of the world financial system. To avoid serious disruptions to their own domestic economies, the Committee considers that creditor governments will have to participate more directly in the management of the debt problem.

Dialogue with Debtor Countries

Despite the relatively low profile role the creditor countries have played, it is to them that the borrowing countries are now increasingly turning because ultimately they control the banks and the international financial institutions. To make their case, they maintain there is a need for an international conference on the debt question. As mentioned in chapter four, in 1985 the ministers of the heavily indebted Latin American countries called for:

> a political dialogue . . . between the creditor and debtor countries, a dialogue that must be structured and pursued in an appropriate forum so that the specific problems posed to both sides by the crisis of development of the developing countries can be addressed.

Generally, OECD countries have resisted this idea of an international conference with debtor countries, largely out of concern that developed-versus-developing country confrontations in such a forum might render the resolution of problems more, not less, difficult. They may also fear the formation of a debtor "cartel", although it must be pointed out that, in the main, debtor countries have acted responsibly. They have recognized that it is not in their interest to combine in a confrontational way or to organize a concerted debt repudiation, an approach advocated by Fidel Castro of Cuba which Latin American governments appear to have rejected as mischief-making.

The Committee considers that the time may have come for creditor governments to lift their objections to direct dialogue with debtor governments. The position of a number of democratic debtor countries is becoming immensely difficult, and their governments are being strongly criticized. Opposing groups are pressing for radical unilateral action against the creditors, whom they blame for slow growth, falling standards of living and rising unemployment. Recently, in several debtor democracies, riots have broken out when groups demanded better food conditions and economic assistance. In certain instances, the creditors, the banks and the OECD governments, as well as the IMF, are popularly perceived as uncaring, complacent recipients of huge outflows of funds from the Third World.

This report has concluded that creditor governments should become more active and direct participants in the management of the debt question. Too much is at stake for matters to be left solely to negotiations between the commercial banks and the debtor countries, with the IMF acting both as an intermediary and a support system. While each debtor country's position has unique features, there are many common elements that should be aired in a dialogue between debtor and creditor governments. Some likely subjects for review would be the increased use of multi-year reschedulings of official debt and bank debt, experiences with structural adjustment policies, the possibility of interest rate capitalization, the economic consequences of debt overhang, the prospects for a reduction in interest rates, the role of export credits, and the implications of making interest payments in local currency or of linking debt payments to export revenues or to commodity prices.

The Committee believes that discussions between debtor and creditor governments would serve a useful purpose. Debtor and creditor governments represent two solitudes. Discussions could make possible increased understanding of the difficulties at the highest political levels on both sides. They could lead to the building of a consensus that could strengthen commitments on both sides for an agreed debt strategy. Under severe political fire at home to take drastic action, some debtor governments are feeling isolated and uncertain as to which way to turn. Discussions would help them hold to a more moderate course. Some established democratic debtor governments are coming under very sharp attack and several new Latin American democracies appear vulnerable. Evidence that creditor governments understood their plight could help these debtor governments to stand up to pressure.

The Committee considers that such discussions might be organized by the Interim Committee of the IMF with the World Bank also involved. Possibly a special committee could be established within this body that could structure the creditor country/debtor country debt dialogue on a regional basis, since the Latin American debt problems are so different from those of low-income Africa.

The Committee recommends that the Canadian government publicly endorse and advocate the principle of a dialogue within the IMF's Interim Committee involving creditor and debtor governments.

An Advisory Group on International Indebtedness

In addition to meetings between creditor and debtor countries at this time to try to discuss the various dimensions of the debt issue, the Committee sees a need for an ongoing source of advice on these problems. It is with this purpose in mind that the Committee recommends the creation of a small group of distinguished persons from North and South which might be known as the Advisory Group on International Indebtedness. They would be appointed in an advisory capacity, perhaps by the Interim Committee of the IMF or by the Development Committee of the World Bank and the IMF acting jointly. The tasks of this Advisory Group would be: to monitor the evolution of debt problems; to relate them to other aspects of the world economy; to comment on the performance of the IMF and the World Bank and their shortcomings; to strengthen the commitment of debtor countries governments to better management and adjustment; to increase the awareness of the problems of debt particularly of the poorest countries; and to help focus the attention of creditor countries on remedial measures.

This Advisory Group on International Indebtedness would not be expected to produce a single report, as the Pearson and Brandt Commissions on development assistance had done, nor to become a party to individual rescheduling exercises. It would advise both on official debt as well as debt to the commercial banks. Its function would be international facilitation and mediation between the public and private interests that are implicated in the debt question. The Interim and Development Committees are precluded by their membership and their mode of operation from playing this role and there is no other international institution able to perform such a function.

An Advisory Group with such a mandate and composed of prominent and knowledgeable persons drawn from the various interest groups in a number of countries could, through the quality and detachment of its advice, help to build a better perception of the commonality of interests as between the principal actors. It could also place issues and specific cases in a broader and longer-term perspective. For a problem with such potentially grave implications for the future health of the world economy, an Advisory Group on International Indebtedness could provide the new synthesizing approach that is needed.

The Committee urges the Canadian government to press on its six Summit partners and at OECD Council meetings the need to create an Advisory Group on International Indebtedness.

This Advisory Group on International Indebtedness would not be expected to produce a single report as the Brandt and Pearson Commissions on development assistance had done; nor, on the other hand, would it be a party to individual rescheduling exercises. It would engage both the official debt as well as debt to the commercial banks. Its function would be to improve cooperation and information between the public and private interests that are implicated in the debt problem. The Interim and Development Committees are precluded by their membership and their mode of operation from playing this role and there is no other international institution able to perform such a function.

An Advisory Group with such a mandate and composed of prominent and knowledgeable persons drawn from the various interest groups in a number of countries could, through the analysis and dissemination of its advice, help to build a better perception of the wide spectrum of interests as between the various parties. It could also place issues and specific cases in a broader and longer-term perspective. For a problem which potentially carries grave consequences for the future health of the world economy, an Advisory Group on International Indebtedness could provide this much needed dimension to this issue.

The Committee urges the Canadian government to press on its G7 partners and at OECD Council meetings the need to create an Advisory Group on International Indebtedness.

Chapter IX

MANAGING THE DEBT PROBLEM: THE COMMITTEE'S APPROACH

For almost five years the Third World debt problem has been a dominating feature of the international economic landscape. A series of rescheduling negotiations, almost all led by the IMF, have to date succeeded in averting a breakdown of the international financial system with the devastating consequences that would result from such a development. Over time, the commercial banks have slowly been able to reduce, to a greater or lesser degree, their exposure by increased provisioning and improving the ratio of their capital to their assets, that is, to their outstanding loans. However, Brazil's decision in February 1987 to suspend interest payments is recent evidence of the continuing seriousness of the Third World debt problem.

During this period, developing countries have had to operate their economies without the huge transfusions of loans that became such a feature of their economic activity in the 1970s. In spite of some success in reducing imports and even in generating balance-of-payments surpluses, most of the 57 problem debtor countries have not been able to pay interest on their debts on a steady, ongoing basis, let alone achieve any substantial reduction in the principal owing. Most of them have been seeking some form of relief.

The hope is not being fulfilled that the combination of restraint measures undertaken by debtor countries with rescheduling arrangements and some additional loans made available by the commercial banks and the international financial institutions would create conditions under which the debt problem would become manageable for most Third World countries. Instead, debtor countries are becoming increasingly insistent that they cannot manage their debts without some relief or further assistance. What has been needed are some success stories, some kind of light showing at the end of the tunnel, and for a while it seemed that Brazil would serve that purpose. In these circumstances it was hardly surprising that the sharp deterioration in Brazil's export performance, followed quickly by the decision to suspend interest payments on most of its huge debt, should have caused the mood with respect to the debt problem to become even grimmer. With current payments of principal and interest of Latin American debtors projected at over \$94 billion for the years 1987 and 1988 alone, the view that a new approach to the problem is needed has been gaining strength.

The outcome of the new round of negotiations that will be required with Brazil cannot be anticipated. It is uncertain, for example, whether the banks can be persuaded to put up new loans in addition to agreeing to rescheduling outstanding debt on the scale they did with Mexico. It was nine months after the first announcement of an agreement with Mexico that the final terms with the commercial banks were worked out. Furthermore, some of the steps taken by Brazil, such as stockpiling wheat and recalling oil tankers to avoid sequestration, suggest a determination by that country to gain longer-term relief than Mexico achieved, which could result in tougher and more protracted negotiations.

The Committee understands that ministers responsible for public finance in OECD countries must always weigh their words very carefully. They cannot make public statements that would indicate anything other than that the debt situation is manageable and in hand for fear of worsening the present situation. By contrast, financial writers and columnists in the daily press very often and quite casually refer to Third World debt as something that "everyone knows will never be repaid" or words to that effect.

The Committee stands somewhere in the middle. It is not in a position to be as casual as some in the media, nor are its responsibilities of the same nature as those of ministers. It is from this vantage point that the Committee's observations are addressed.

Some Basic Policies

At this difficult period when hard bargaining between the several actors can be expected, it is important to reaffirm the need to pursue a few basic policies.

The lower levels of economic activity that have prevailed since 1980, reflected in diminished international trade and reduced commodity prices, constrain every effort to resolve the debt problem. The Committee has already asserted in chapter eight that the most helpful action that creditor governments could take to support the efforts of the problem debtor countries to meet their obligations would be to adopt measures to improve the performance of the world economy. Specifically what is needed are sustained and co-operative efforts to lower interest rates or at least keep them at present levels, to control inflation, to reduce deficits and generally to promote growth.

Debtor countries would also benefit enormously from improved access to the markets of the OECD countries rather than facing increasing protectionism as has been the experience in the recent past. The Committee has stressed in the preceding chapter the need for creditor countries to open their markets to developing countries' imports. If the indebted developing countries are to grow and be able to service their debts, they must be able to export. It needs to be recognized that the preferential tariffs granted in the past are losing their beneficial effect for the developing countries in the face of a growing array of quotas, subsidies and other non-tariff barriers. Canada is by no means a shining example of open access for developing country exports, as exemplified by its participation in the Multi-Fibre Arrangement governing textiles and clothing, which will result in continued barriers against these Third World imports.

The Committee urges the government of Canada to recognize the mutual benefit that can be derived from further measures it might take to increase market access to indebted developing countries. In addition to improving the prospects for repayment of debt to Canadian commercial banks, such steps could strengthen the economies of these countries and possibly open markets for Canadian exports.

The problem debtor countries must, for their part, persist in their own efforts to improve their economic performance. This report recommends in chapter four that an essential element of any debt strategy must involve significant adjustments in the economic and fiscal policies of these countries.

Need for a Modified Debt Strategy

Beneficial as policies such as those cited above can be, the effects of structural adjustment measures by debtor countries and trade liberalization actions by creditor countries are long-term. Action is needed in the shorter term to improve the situation of the peoples and governments of the debtor countries, on whom the current approach to debt management strategy has placed great strains. By comparison, although the commercial banks remain very vulnerable, provisioning and increased capitalization have reduced their exposure considerably in the past five years; while the total debt has not been diminished, they have generally continued to receive substantial interest payments. (See Table 7, p. 61) Creditor governments for their part, have found the debt strategy acceptable so far, in that they have largely succeeded in avoiding direct involvement. Indeed, the initial reaction early in 1987 of the U.S., British and Japanese governments to the efforts of the Brazilian foreign minister to enter into direct discussions with them on his country's debt problem was to reject his proposals for government intervention and to insist that he deal directly with the commercial banks.

Dissatisfaction with the current approach has been voiced primarily by debtor countries, which see that five years of restraint on their part have not reduced the size of their debt burdens. At the same time, real living standards have declined. In this difficult situation, debtor governments which may be contemplating discontinuing the payment of interest on their debts, face the risk of a cut-off of credits in the future or the threat of possible retaliatory action by creditor governments in the form, for example, of reduced aid. Will these risks persuade debtor countries to continue to make efforts to adjust their economies, while struggling to maintain an export surplus sufficient at least to keep paying interest on their debt?

In 1987 Brazil, having experienced a sharp decline in its reserves from $9 billion to $4 billion in six months, chose arbitrarily and unilaterally to suspend interest payments as a way of strengthening its negotiating position. The question that Brazil has posed by its actions is whether a debtor government in serious financial and political difficulties can be persuaded to reimpose strict limits on domestic consumption and resume debt service without some agreement by its creditors to make its debt load more manageable.

The situations of debtor countries vary enormously, ranging from the countries — mostly in Asia — that have strong export sectors and whose debt is generally manageable to the other extreme, the poorer developing countries, which are concentrated in sub-Saharan Africa. Many of the latter are simply unable even to pay interest on their debt, which is largely sovereign. The decision of Canada and other countries like Sweden and the Netherlands to forgive the debt of the poorest countries and offer aid in the form of grants is the most enlightened response to their desperate needs. Most of the debt of sub-Saharan Africa must be treated as an aid problem and new capital must be channelled through the international financial institutions.

This leaves the middle-income debtors, most of whom are Latin American countries whose debt is large and owed principally to commercial banks. Providing interest payments are made regularly, the banks will undoubtedly be reasonably accommodated. OECD governments and large corporations carry substantial debt, much of which is never retired but simply rolled over at regular intervals. Given an average inflation rate of 4 per cent, the real value of loans would be halved every ten years, and with regular provisioning at the rate of 3 to 4 per cent of problem debt, the banks can look forward within a decade to being in a much improved situation.

The crucial question that the international community must resolve relates to what will happen to the middle-income debtors during that decade. Can they be persuaded to restrain demand, limit imports, and make steady interest payments? Did the debt strategy, adopted during the 1982 negotiations with Mexico, facilitate or encourage the adjustments in the economies of the debtor countries? Will new capital, as proposed in the Baker initiative, be sufficient to promote growth? Will capital be forthcoming in the necessary amounts? Or is the debt burden itself an impediment to growth and, if so, what can be done to reduce that burden?

These are the questions that the Committee has debated at length during its hearings and in the extended discussions that ensued as it prepared this report. In general terms, the Committee's position is that **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 through international agencies and creditor governments to debtor countries.** Fatigued by the effort of five years of restraint, how can the governments of the debtor countries be expected to find the will to carry on for another decade? Even if they were prepared to try, the Committee is concerned that their economies would be savaged in the process, which would ultimately result in great harm to the world economy as a whole. Further, who can foresee what damage to emerging democracies would result?

It was these uncertainties that caused the U.S. Administration in 1985 to propose the Baker initiative. The intention of the proposal was to achieve an increase in the flow of capital to debtor countries to make up in part for the vital fluids being drawn out of those countries through debt service. The assumption behind Secretary Baker's proposal was that private capital could be persuaded to flow back to those countries that had adopted effective adjustment programs. But neither has happened.

The reasons for the shortcomings of the Baker initiative highlight the key element in the Committee's analysis. The problem that the Committee has identified as being absolutely central results from the huge debt burden which is so pervasive that it seems to discourage all investment and to make growth virtually impossible, even in debtor countries that have adopted effective adjustment policies. It is essential to find ways to reduce the debt overhang in order to provide encouragement to problem debtor countries to persist in economic adjustment policies and to create conditions in which private investment might be resumed. The simple truth is that without hope there will be no growth, and the present size of the debt burden is so great that it is extinguishing all hope.

Governments must face up to this situation and draw the appropriate inferences. In the Committee's judgment, **an effective debt strategy for middle-income debtor countries must have two broad thrusts.**

First, a substantial flow of new funds must be generated to debtor countries that have committed themselves to effective economic adjustment policies. The Baker initiative recognized the need, but it was deficient in relying too heavily on funding from the commercial banks. This report recommends that a larger proportion of new funds for middle-income debtors must come through the World Bank, IDA and the multilateral development banks.

The international financial institutions are the major vehicle by which such transfusions of fresh capital could be made and to this end the role of these institutions should be enhanced and their resources significantly increased. Only these organizations have the independence, the standing and the technical capability to make loans to debtor countries conditional on their making meaningful structural adjustments.

The poorer debtor countries, whose debt stems predominantly from official assistance rather than bank loans, cannot aspire in the short-term to become internationally competitive. Creditor governments should provide new aid to these countries in the form of grants, as well as forgive earlier aid or at least offer a moratorium on debt service.

Second, an effective debt strategy must provide some way to reduce the debt burden of middle-income countries to more manageable proportions. Since the funds that can be made available through the multilateral financial institutions to debtor countries are likely to be insufficient, they have to be supplemented by some form of debt relief.

As was pointed out in chapter seven, there is the possibility of "ad hoc" write-downs of debt in specific circumstances, either directly or through the deferral of payments or the reduction of interest rates. **Banks that have substantial provisions could achieve such write-downs without lowering their capital-to-assets ratios.** However, since banks in OECD countries find themselves in very different positions, the Canadian government should press for agreement among its OECD partners for a reasonable level of reserves so as to make it possible for the banks in creditor countries to defer payments or reduce interest rates.

The Committee strongly supports the steps taken by Canadian banks to strengthen their capital bases and to increase their loan-loss provisions. Should the Canadian banks continue over the next few years to add to reserves and capital at a rate comparable to that at which they have been doing so during the last couple of years, their vulnerability to default abroad would be progressively reduced. Also, as has been mentioned, even moderate inflation can be expected to erode the real value of the debts. So convinced is the Committee of the importance of substantial reserves that it considers that **the Inspector General of Banks should raise the targets for Third World debt provisioning by banks, which were established in the autumn of 1986**.

The Committee recognizes, however, that Canadian banks are already suffering from having to write down substantial losses on farm, real estate and oil industry loans in Canada and the United States. Any increase in the target established by the Inspector General would of necessity add to the banks' costs. To make it easier for banks to absorb the extra cost of provisioning, **the Committee recommends that 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.**

Government Participation in Negotiations

Increased provisioning represents a concrete and uncontroversial step toward making possible some eventual debt relief for debtor countries. In the event that conditions should deteriorate to the point where more drastic action by creditor governments might be required, this report has referred to a variety of proposals involving the participation of creditor governments in arrangements designed to achieve some measures of debt relief. (See chapter 7) Extensive negotiations among creditor governments, debtor governments and the commercial banks would be required to reach agreement on which measure to adopt. While the Committee does not intend to recommend any particular proposal, it is convinced that **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. Furthermore, to avoid 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 Committee judges that there are some principles regarding possible write-downs of bank debt that the Canadian government should bear in mind in any negotiations that might ensue:

- Any proposal either to create a new international institution or to modify the Articles of Agreement of one of the existing international financial institutions in order to manage a debt write-down option has the serious disadvantage that it could take a year or two to secure international ratification at a time when urgent action might be required and therefore it may be necessary to use existing institutions as presently constituted.

- Partial, as distinct from comprehensive, guarantees to the banks by governments or by a World Bank agency could be justified if, in return, banks would agree either to significantly reduce the principal owed by problem debtor countries, or to cap interest rates at levels which are more compatible with historic levels.

- The acquisition of some bank debt at a discount either by existing international financial institutions or even by governments has an advantage over guarantees in that it makes some debt forgiveness easier should this option be judged to be necessary.

A More Prominent Canadian Role

Canada has a very substantial stake in the good management and ultimate resolution of the Third World debt problem. Canadian banks are heavily involved and, as a major trading nation, Canada suffers from the diminished levels of trade and prosperity to which the debt burden directly contributes.

As one of the seven countries participating in the annual Economic Summit meetings, Canada has an opportunity to contribute actively to the responsible management of the world economy. The Committee urges the Canadian government to ensure that the Third World debt question occupies a central place on the agenda of the 1987 Venice Summit. The government should encourage its Summit partners to take a realistic and enlightened approach to debt problems.

While not seeking to exaggerate Canada's influence in this field, the Committee considers that in the past Canada has had too low a profile. **It urges the Canadian government to 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 lending role for the World Bank.** The health of the Canadian economy and the viability of the Canadian banks are closely tied to a favourable resolution of the debt problem.

Chapter X

CONCLUSIONS AND RECOMMENDATIONS

By 1986, external debt of Third World countries had risen to over $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 meeting 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 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

- In order to promote stable economic growth, middle-income debtor countries must be prepared to persist in 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 (page 53)

- It is essential that developing countries introduce measures to discourage capital flight, including an appropriate exchange rate. (page 54)

- The Committee took note of the difficulty for any country of maintaining sustained per capita growth if the level of population expands faster than economic development. (page 55)

- The Committee considers that, for many developing debtor countries, economic adjustment policies continue to be required, but it must be recognized that the process of achieving economic stability and growth will be unavoidably slow. It is essential to find ways to limit the negative effect on problem debtor countries of the huge debt overhang and to make available to countries that have committed themselves to serious economic adjustment measures the investment capital that they must have if their debts are to become manageable. (page 61)

The International Financial Institutions

- The international community has been fortunate that, since the 1982 Mexican debt crisis, the IMF has taken the lead in co-ordinating the short-term management of Third World debt problems. (page 64)

- 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 to provide debt rescheduling and new money and by organizing economic adjustment programs in debtor countries to reduce their imbalances and rebuild their creditworthiness. (page 65)

- The Committee considers the World Bank is well placed to give leadership on the debt question at this time by increased lending to assist growth in developing countries. (page 66) However, the new role thrust on the World Bank will face its management with problems and pressures to which it will have to respond carefully:
    - The World Bank should take steps to reorganize its staff as quickly as possible to meet the demands of increased policy-based lending. (page 67)
    - 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. (page 67)
    - The World Bank should try to maintain a judicious balance between its traditional project lending and the more recently emphasized structural adjustment lending. (page 68)

- The Canadian government should advocate closer collaboration between the IMF and the World Bank and should press for complementary policies in the two organizations. The government could urge the establishment of a formal co-ordinating body, a joint Bank-Fund committee, to formulate adjustment and lending policies and to co-ordinate their joint concerns with those of the commercial banks. (page 69) The government should also press for closer co-ordination between the World Bank and the regional development banks. (page 70)

- The Committee welcomes the World Bank's decision to increase substantially its annual levels of lending and to improve its rate of disbursement. Given the time needed to complete a General Capital Increase, a decision to negotiate a new GCI for the World Bank should be reached in 1987. The objective should be the largest attainable increase in the Bank's subscribed capital. (page 71) The Canadian government should press the United States to agree to begin negotiations for a substantially increased GCI for the World Bank as soon as possible. (page 72)

- The Canadian government should resist proposals for any significant reduction in the proportion of paid-in to callable capital in the next General Capital Increase of the World Bank. (page 72). Similarly, the government should resist a reduction in the ratio of paid-in to callable capital in the next general increase of resources of the Inter-American Development Bank. (page 77)

- The Committee recommends that the Canadian government instruct its executive director to work with other representatives in support of the largest attainable capital increase for the World Bank and the International Development Association. (page 74)

- Canada should resist arguments by the United States or any other state that advocates a limit on increased contributions in order to maintain their particular voting share. It is in the common interest for all countries to be in a position to increase their World Bank contributions without constraints. The attempt of the United States to perpetuate the special status associated with its veto power discourages other states from assuming increased responsibilities. (page 74)

- The Committee recommends increased emphasis on the work of the International Finance Corporation, on its promotion of investment in Third World countries and on its initiative in creating equity mutual funds for investment in developing countries. (page 75)

- The Committee considers that project lending should remain the central activity of the regional development banks. (page 78)

The Arab OPEC Countries

- The Committee believes that 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. (page 81)

- In the Committee's view, the Canadian government should urge those Arab OPEC states which have the financial resources to endeavour to increase their funding to the International Fund for Agriculture Development in order to bring total OPEC contributions up to a commensurate level. Such a step would automatically result in higher matching contributions from OECD countries. (page 82)

- Increased OPEC support for the International Development Association, as well as for the African Development Bank, could help to bridge important multilateral funding gaps. (page 82)

The Commercial Banks

- The commercial banks must carry an appropriate share of the cost of handling the bank debt problem. (page 85)

- The Committee recommends that the Canadian government press for international agreement on a reasonable level for general provisioning by banks in OECD countries. (page 86)

- The Committee favours debt-equity swapping arrangements as a means to alleviate somewhat the commercial debt problem. In some debtor countries, newly privatized enterprises could be attractive investment prospects. The benefits of the debt-equity swap mechanism will 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. (page 86)

- The Committee urges the commercial banks to increase their use of the World Bank cofinancing mechanism as a means of increasing the necessary capital flows to debtor countries. (page 87)

The Creditor Governments

- The Committee concludes that, in the long term, the most constructive step that the creditor countries, including Canada, could take would be to improve the access of developing countries to their markets. This action would parallel the economic adjustment measures that debtor countries are being asked to make. It stands to reason that the debtor countries would find it easier to service their debts if they could increase their exports. (page 92)

- The Committee considers it important to stress that any improvement in economic performance that the OECD countries can achieve will indirectly benefit developing countries. Success in lowering interest rates, reducing domestic deficits and generally in expanding their economies would improve the prospects for developing countries. (page 93)

- The Committee considers that it would be desirable for creditor governments to try to achieve a greater degree of harmonization of their bank regulations and their tax treatment of banks. (page 94)

- 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. (page 94)

- The Committee questions whether it was wise to push the banks to put up so much new money for Mexico. The Committee believes that the 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. (page 95)

- Without export credits it may not be possible for problem debtor countries to import 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, the Committee considers that the governments of the 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 serious economic adjustment programs endorsed by the IMF or the World Bank. (page 96)

- The Committee thinks that governments should greatly enlarge their funding of the World Bank so that the Bank 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. (page 96)

- The Committee endorses the announcement in the 1986 budget of the Canadian government 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. The Committee also commends the 1986 Canadian offer to low-income African countries of a 15-year moratorium on debt interest payments for Canadian ODA, in effect, a writing-off of the debt. These are positive steps to relieve the burden of official debt repayments from the low-income developing countries. The Committee would like to see other OECD governments adopt, as a minimum, policies similar to the 1986 Canadian offer of a 15-year moratorium on the interest payments on their official loans. (page 97)

- The Committee recommends that 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. (page 98)

- The Committee recommends that the government in its next budget 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. (page 99)

- The current difficulties between debtors and creditors are capable of threatening the underpinnings of the world financial system. To avoid serious disruptions to their own domestic economies, the Committee considers that creditor governments will have to participate more directly in the management of the debt problem. (page 101)

- The Committee recommends that the Canadian government publicly endorse and advocate the principle of a dialogue within the IMF's Interim Committee involving creditor and debtor governments. (page 102)

- The Committee urges the Canadian government to press on its six Summit partners and at OECD Council meetings the need to create an Advisory Group on International Indebtedness. (page 103)

Managing the Debt Problem: the Committee's Approach

- 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 through international agencies and from creditor governments to debtor countries. (page 108)

- An effective debt strategy for middle-income debtor countries must have two broad thrusts. *First*, a substantial flow of new funds must be generated to debtor countries that have committed themselves to effective economic adjustment policies. The international financial institutions are the major vehicle by which such transfusions of fresh capital could be made. *Second*, an effective debt strategy must provide some way to reduce the debt burden of middle-income countries to more manageable proportions. Since the funds that can be made available through the multilateral financial institutions to debtor countries are likely to be insufficient, they have to be supplemented by some form of debt relief. (page 108)

- The Committee considers the Inspector General of Banks should again raise the targets for Third World debt provisioning that were a set for Canadian banks in late 1986. (page 110) Banks that have substantial provisions could write-down debt or reduce interest rates without lowering their capital-to-assets ratios. (page 109) To make it easier for banks to absorb the extra cost of provisioning, the Committee recommends that 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. (page 110)

- 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. Furthermore, to avoid 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. (page 110)

- The Committee urges the Canadian government to 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 lending role for the World Bank. (page 111)

Appendix A

The International Financial Institutions and Canada's Participation in these Institutions

The international financial system that is referred to in the Committee's terms of reference includes the countless participants in international trade and finance, both public and private, from street merchants to private and central banks. The relationships among them, while often loose, are sufficient to justify referring to the totality as a system.

In addition to the private financial sector and the governmentally controlled sector, the international financial system is capped by a number of multilateral institutions. Principal among these from the perspective of this report are the International Monetary Fund and the World Bank which were created at the 1944 Bretton Woods Conference and established in 1945 in order to bring greater stability and order to the system.

The designated missions of the IMF and the World Bank pertain to the operation of the system as a whole. The Fund was initially charged with the stabilization of international currency exchanges on a short-term basis. The World Bank is organized to transfer capital to the Third World to assist in economic development on a longer-term basis. There is a third multilateral organization which plays a strategic role in the international economy, the General Agreement on Tariffs and Trade (GATT), but it is not directly involved in this study.

There are four other multilateral development banks (MDBs) that parallel the World Bank and are regional in character, namely, the Inter-American Development Bank (IDB), the Asian Development Bank (AsDB), the African Development Bank (AfDB), and the Caribbean Development Bank (CDB).

For each of the six institutions — the IMF, the World Bank and the four regional development banks — the senior directing body is the board of governors, composed in most cases of either ministers or central bank governors. These ministerial — level boards, which meet once a year, have delegated most of their powers to executive boards responsible for directing the business of the institutions. The executive boards comprise some representatives appointed by the largest "shareholder" countries and others elected by groups of member governments from among their numbers. In the latter case, the representatives speak not only for their own country but must also reflect the opinions of the other countries in their group. Voting powers are apportioned according to each country's financial contributions although most decisions are taken by consensus.

One other relatively new international financial institution, established in 1977, is the International Fund for Agricultural Development (IFAD). The unusual tripartite structure of IFAD gives equal voting rights to three different groups of member countries. The executive board consists of representatives from six OECD countries, six OPEC countries and six non-oil-exporting developing countries, plus alternates.

In addition there are two continuing ministerial-level committees. The *Interim Committee* of the IMF is a 22-member advisory group* established in 1974 with no formal powers. It is the main policy-making body of the Fund, advising the much larger board of governors on the supervision, management and adaptation of the international monetary system. The board of governors meets annually and its membership comprises ministers or central bank governors, appointed by each member country.

The *Development Committee* is a joint Committee of the Fund and the Bank, also established in 1974 to advise and report to the two boards of governors on broad approaches to development issues. It is formally known as the *Joint Ministerial Committee of the Boards of the Bank and the Fund on the Transfer of Real Resources to Developing Countries*. It consists of 20 members, usually ministers of finance, appointed in turn for successive periods of two years.

The International Monetary Fund

The **International Monetary Fund** is designed to help make monetary relationships between member countries work smoothly. At present its membership includes 149 countries, the main exceptions being the U.S.S.R. and a number of countries in Eastern Europe. The day-to-day operations of the Fund are carried out by the managing director and an executive board comprised of six members appointed by the six major contributing countries,* and 16 elected by the remaining 143 member countries. The IMF holds the funds or "quotas" that member countries subscribe. These quotas provide the Fund with its main resources and form its financial base. If a member country has a balance-of-payments problem, the IMF can make a loan, normally referred to as a credit, to provide financial liquidity. Eligibility for drawing credits is based on a member's quota and members may draw on a portion of their quota, known as a "credit tranche" or slice, at will. However, access to upper "tranches" is conditional on a country agreeing with the IMF to adjust its economic policies in order to improve its balance-of-payments position.

The IMF makes financing available on what is intended to be a temporary, revolving basis. But carrying out this role with limited resources has become increasingly difficult, especially when debtor countries are experiencing long-term debt servicing problems as contrasted with short-term liquidity difficulties. To cope with new demands on its resources the IMF has organized a number of programs and has developed new ones. The principal programs are the following:

* In 1986 the countries on the Interim Committee were: Algeria, Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, India, Iraq, Italy, Japan. Mexico, Netherlands, Saudi Arabia, Sierra Leone, Sweden, Thailand, United Kingdom, United States and Zaire.

* United States, United Kingdom, Federal Republic of Germany, France, Japan and Saudia Arabia.

- *The General Arrangements to Borrow*, an arrangement by which the Fund can borrow from member governments to meet exceptional circumstances, such as a perceived threat to the international monetary system arising from the financial needs of members.

- *The Compensatory Financial Facility*, a special facility introduced in 1963 to ease the problem faced by developing countries heavily dependent on primary commodity exports whose earnings tend to fluctuate dramatically year-to-year.

- *The Extended Fund Facility*, established in 1974 to give financial assistance to members to meet their balance-of-payments deficits for longer periods and in amounts larger than normally applicable.

- *A Trust Fund*, established in 1976 and financed by profits from the sale of some of the IMF's gold, was used for highly concessional loans to developing countries with balance-of-payments difficulties until 1981, when the final disbursements under this program were made.

- *The Structural Adjustment Facility*, a successor to the Trust Fund, was set up in 1986 to use the reflows on loans made under the Trust Fund to assist low-income member countries with serious balance-of-payments problems in implementing medium-term structural adjustments.

The World Bank

The World Bank Group consists of the original *International Bank for Reconstruction and Development (IBRD)*, generally referred to simply as **the World Bank**, together with its two affiliates, the **International Development Association (IDA)** and the **International Finance Corporation (IFC).** The IBRD provides administration and staff for IDA. The president of the IBRD is the president of IFC, although the latter agency has its own staff.

The World Bank, despite its name, is not a central bank, but is the principal international institution that lends money to Third World countries for development purposes. It has become a centre for expertise and research on development matters. It is by far the largest of the multilateral development banks (MDBs), accounting in 1984 for 70 per cent of total MDB lending.

The World Bank has the same member governments as the IMF and they provide it with its capital. Each member country subscribes funds on the same formula as used for IMF subscriptions and voting powers are also the same as for the IMF. The Bank borrows on commercial terms from the world's capital markets and lends the money to developing countries at a slightly higher interest rate to cover administrative costs. Its resources are also augmented by retained earnings and the flow of repayments on its loans. The current subscribed capital is approximately $77 billion. While commercial banks operate on a fractional reserve principle, World Bank lending is restricted to the amount of its subscribed capital by the Articles of Agreement. Member governments actually pay in only a small proportion — 8.7 per cent — of the capital they subscribe, with the balance remaining "on call"; the Bank is currently contemplating lowering this ratio even further. The World Bank is able to borrow at advantageous rates up to the full amount of its subscribed capital.

World Bank loans are directed toward developing countries at relatively more advanced stages of economic growth. The loans generally have a grace period of five years and they are repayable over 20 years or less. In June 1986, the Bank's outstanding loans totalled $61 billion.

Traditionally the Bank has concentrated on project loans to enhance development in sectors such as agriculture or for basic infrastructure such as electricity. Increasingly, the Bank is being pressed to increase its "program" loans, which are designed to assist the developing countries with needed policy reforms. These latter loans can be either structural adjustment loans or sectoral adjustment loans. Sectoral adjustment loans are designed to support policy and institutional changes in specific sectors and to increase the mobilization of resources in those sectors. Structural adjustment loans are aimed at helping developing countries carry out difficult adjustments in their economies in the face of unfavourable international economic conditions. Whereas previously, the World Bank's lending had been disbursed slowly, more and more it is turning to quick-disbursing loans for balance-of-payments support.

The International Development Association is the concessional funding arm of the World Bank. IDA's funding is concentrated in the very poor developing countries. Those with an annual per capita GNP of less than $790 are eligible, but 80 per cent of IDA's recipient countries have per capita incomes of less than $400. As a result, IDA is the largest multilateral source of concessional assistance to these countries. IDA was established in 1960 with the same objective as the Bank, but it is empowered to make loans on "soft" terms that bear less heavily on the balance-of-payments of borrowers. IDA credits have previously been made on terms of 10-year grace periods, 50-year maturities and no interest but the most recent replenishment negotiations reduced the maturities to 40 years. In effect, these credits amount to a grant, not a loan. Small annual service fees are charged.

IDA obtains its funds mainly from special contributions from IDA's richer members and transfers from the net earnings of the World Bank. Replenishments are arranged every three years through negotiations among IDA's donors. IDA's disbursements have been increasingly constrained in the past six years due to lower-than-anticipated levels of the last two replenishments. The most recent, eighth, replenishment of October 1986 of $12.4 billion was still less in real terms than the sixth replenishment six years earlier.

The increasingly severe problems in sub-Saharan African countries have led IDA to concentrate more of its lending to that region. In 1985 a Special Facility for African countries was established, administered by IDA, to help maintain an adequate level of concessional assistance.

The International Financial Corporation, the second affiliate of the Bank, was established in 1956. Its function is to promote policies in less-developed countries that will increase investment, both domestic and foreign. It seeks to identify and structure good investment opportunities in developing countries that could be attractive to foreign investors and to help foreign companies interested in direct foreign investment to reduce the risks involved.

Membership in the Bank is a prerequisite for membership in the IFC, currently at 122 countries. With a capital base of $1.3 billion, the IFC plans to invest $4.5 billion over the next five years in projects with a total value of about $30 billion. In 1984, the IFC approved a capital increase over five years in the amount of $65 million, which is entirely paid-in.

While the bulk of the IFC's participation is in the form of loans, the IFC also uses part of its resources to take equity positions where private risk capital is scarce. The IFC's ability to share the investment risks has been instrumental in putting together joint ventures and in helping investors obtain loans from commercial sources. An added benefit is that since the IFC is an active, if minority, investor in the various countries, it is well placed to advise the Bank on how the Bank's policies affect investment decisions in the countries concerned.

By June 1984 the IFC had financed over 770 projects in 84 countries representing a total investment cost of $27 billion; it was able to add to its own investments of $3.7 billion $2.5 billion syndicated from other lenders. Further, it helped attract to these projects about $1 billion in direct foreign private investment.

The IFC is attempting to encourage portfolio investment as well as foreign direct investment in developing countries. It has set up mutual funds in Mexico, among other countries, and is about to launch a diversified Third World fund. As a result of predicted growth in the international capital market, the IFC estimates that by the 1990s foreign equity portfolio investment available for developing countries could be in the $2 to $4 billion range annually. The IFC is hoping to stimulate such investment in Third World countries.

Currently the World Bank is in the process of launching another facility for stimulating international investment in the Third World, the **Multilateral Investment Guarantee Agency.** MIGA is designed to operate as an autonomous affiliate within the World Bank Group although closely allied in its objectives with the IFC. As proposed, it would aim to improve the investment climate in developing countries through issuing guarantees for foreign investment against non-commercial risks, such as political uncertainty, and by supplementing the activities of the Bank and the IFC in promoting investment. MIGA would set standards governing international investment and reimburse investors for any money they lost as a result of member countries breaking the agreed rules.

The Regional Development Banks

As mentioned earlier in this report, there are four regional development banks in which Canada is involved:

- The Inter-American Development Bank
- The Asian Development Bank
- The African Development Bank
- The Caribbean Development Bank

As their names imply, the regional banks were established to foster economic growth and contribute to the economic development of the developing member countries in their particular regions. All four are organized along the lines of the

World Bank and their capital replenishments and funding practices proceed similarly. Each of them has a soft-loan affiliate similar to IDA in the World Bank.

The largest and oldest regional bank is the **Inter-American Development Bank** established in 1960. It accounts for 16 per cent of total MDB lending. Initially set up to stimulate economic development in its member countries of South and Central America, its operations now extend to much of the Commonwealth Caribbean as well. Its membership comprises 43 countries — 26 Western Hemisphere states including Canada and the United States, and 17 non-regional (mainly other OECD) countries. In recent years IDB lending accounted for about 5 per cent of the total net external financing to the whole region. The IDB's concessional funding arm is called the Fund for Special Operations.

Since its operations began IDB loans have amounted to over $32 billion. In recent years, Bank lending has accounted for 4 to 5 per cent of the total net external financing of the region. Loans generally have maturities of 15 to 30 years and a current interest rate of 8.75 per cent. Loans from the IDB's Fund for Special Operations carry interest rates of about 2 to 4 per cent with grace periods of 10 to 15 years and maturities of 20 to 40 years.

The ratio of paid-in to callable capital of the IDB has been 8.6 per cent but at the last replenishment the paid-in portion of the increase in funding dropped to 4.5 per cent.

The Asian Development Bank was established in 1966. It is made up of 32 regional and 15 non-regional member countries including Canada which was a founding member. With resources of approximately $28 billion, the AsDB carries out a lending program designed to foster economic growth in the region. By the end of 1985 it had loaned $17.5 billion for over 700 projects in 27 developing member countries. These loans have maturities of 10 to 30 years and a current interest rate of about 9 per cent. The ratio of paid-in to callable capital for this bank is relatively high, at 12.5 per cent.

Like the World Bank, AsDB lending commitments in 1985 showed a decrease, attributable to external debt burdens, domestic resource constraints and economic slowdowns in the borrowing countries. In 1985, 23 projects were co-financed, with co-financers (both official and commercial) contributing $640 million and the AsDB another $1,024 million to these projects.

The African Development Bank began operations in 1966. Its membership was originally confined to African independent states but since 1982 25 non-regional countries including Canada have become members. Associated with the AfDB and managed by it, the African Development Fund provides funding on concessional terms for development. As of 1985 the total subscriptions to the Fund were approximately $4.8 billion.

The Caribbean Development Bank, the smallest regional bank, was established in 1969. Its membership comprises 20 regional members and three non-regional members, (Canada, the United Kingdom and France). Canada was a founding member and is the third largest member of the Bank (together with the United

Kingdom) with 12.5 per cent of the voting shares. The CDB's subscribed capital is $347 million of which $80 million is paid-in.

Table 11 indicates the scale of operations of these multilateral development banks from 1984 to 1986.

TABLE 11

Multilateral Development Bank Lending
($ millions)

	Loan Commitments		
	1984	1985	1986
World Bank			
IBRD	11,947	11,358	13,179
IDA	3,595	3,028	3,140
IFC	696	937	1,156
IDB			
Ordinary Capital	3,215	2,766	2,706
Fund for Special Operations	352	295	331
AsDB			
Bank	1,551	1,271	1,368
Asian Development Fund	684	637	633
AfDB			
Bank	494	709	1,034
African Development Fund	385	439	584
CDB			
Bank	17	23	29
Special Development Fund	33	19	22
Total	**22,696**	**21,482**	**24,182**

The International Fund for Agricultural Development is a lesser-known organization. Founded in 1977, it is often called "the poor man's bank" and is the only international financial institution exclusively concerned with increasing Third World agricultural and food production by the poorest people living in rural areas and subsisting on incomes of below $100 a year. IFAD's loans are provided at very concessional rates, some as low as 1 per cent over 50 years. For every dollar provided by IFAD, other donors and the governments concerned contribute more than three dollars. IFAD divides roughly two-thirds of its financing between Africa and Asia, while the remaining third goes to Latin America, the Near East and North Africa. In 1986 the IFAD launched a three-year Special Programme for sub-Saharan African countries affected by drought and desertification with a funding target of $300 million.

In the eight years of IFAD's operations, it is estimated that its work has brought 70 million people above the poverty line. IFAD's work is doubly beneficial. Not only is desperate rural poverty being alleviated, thereby in the long run reducing the need for ODA, but food production is increased, which in turn reduces the need of debtor countries for foreign exchange with which to import food supplies.

Canada's Participation in the International Financial Institutions

Canada has provided long-standing and active support for the family of international financial institutions, and in most instances played a part in their founding. There are a number of specific reasons for Canada's interest and support, ranging from an appreciation of the developmental effectiveness of the multilateral development banks to the opportunities for Canadian business which the International Financial Institutions present. There is a more fundamental Canadian interest, however, which embraces all of these particular interests. In a paper presented to the Committee as a supplement to his testimony, Mr. John Coleman of the Department of Finance summarized the point:

> As a middle power with a large open economy not incorporated in any trading bloc, Canada has a particularly strong interest in a stable and resilient international financial system that is effectively supported by multilateral institutions.

Canada's interest in the international financial institutions has been translated into significant financial support. The Canadian pattern of funding for the MDBs has been in the range of 3 to 5 per cent of general total contributions and up to 10 per cent for their concessional funds. The Caribbean Development Bank is the exception, where Canada provides about 13 per cent — a level of support equal to the United Kingdom and second only to Jamaica and Trinidad-Tobago — and double that percentage to its Special Fund.

Canada's financial support for the multilateral development banks accounts for just under 20 per cent of total official development assistance or some $490 million in fiscal year 1986-87 Estimates. While the absolute level of Canada's support is within the average range of OECD donors, the percentage of ODA funds allocated to the development banks is below average. Canada's contribution to IMF quotas is in the 3 to 4 per cent range. Table 12 summarizes Canada's position with respect to the international financial institutions.

Corresponding to members' financial burden-sharing in the IFIs is their participation in the decision-making of the institutions. Due to its significant level of support, Canada has its own director on each executive board of the IFIs except IFAD which has a different structure. In this agency Canada serves as an alternate director.

It is not surprising, given the shared regional relationship, that Canada's stake in the Inter-American Development Bank and the Caribbean Development Bank is considerable. As of December 1984, Canada had committed $1.5 billion to the 43 member IDB, giving it 4.4 per cent of the total shares. Canada and the United States are the only two non-regional countries that hold their own separate seats on the 12-member board of directors. Canada also has a separate seat on the Caribbean Development Bank's board of directors due to its large contribution and its role as a founding member.

TABLE 12

Canada in the International Financial Institutions

	Canada's percentage of shares	Rank	Constituency*
International Monetary Fund(1)	3.3	7	Canada, Ireland, Antigua and Barbuda, Bahamas, Belize, Dominica, Grenada, Jamaica, St. Christopher and Nevis, St. Lucia, St. Vincent
World Bank Group(1)	3.3	8	Same as IMF constituency except Guyana is also included
IBRD	4.6	6	
IDA	3.5	6	
International Finance Corp.			
Inter-American Development Bank(1)	4.4	6	Canada alone
Fund for Special Operations	5.5	6	
Caribbean Development Bank(1)	12.9	3	Canada alone
Special Fund	26.5	1	
African Development Bank(2)	3.2	9	Canada, Yugoslavia, Spain, Korea, Kuwait
African Development Fund	9.5	3	
Asian Development Bank(3)	5.0	7	Canada, Netherlands, Denmark, Norway, Finland and Sweden
Asian Development Fund	8.3	5	
International Fund for Agricultural Development(4)	3.2	10	(Canada serves as an alternate to Japan)

(1) as of June 1986
(2) as of December 1985
(3) as of April 1986
(4) as of October 1986

* "Constituency" is the term used to denote the countries that the Canadian executive director speaks for, in addition to Canada, on the executive boards.

In the World Bank, IMF, Asian and African Development Banks, Canada has the unusual position among industrialized countries of also representing a "constituency" of other, mainly developing, countries. These constituencies provide Canada with a very special vantage point from which to assess and appreciate the extreme economic pressures bearing on developing countries. Given its significant but minority status in the IFIs, Canada must obviously work through persuasion, not through power.

A question related to the Inter-American Development Bank that has come to the Committee's attention concerns the charge of political interference by the United States in the allocations of IDB loans to certain Latin American countries, notably to Nicaragua. On this question the Committee does not hesitate to agree with Canada's representative at the 1985 annual IDB meeting in calling for "an end to political interference in the operations of the Inter-American Development Bank." The Canadian government has taken the appropriate position that the primary objective of the international financial institutions should be economic development, whereas the most effective channels for registering concerns about political policies are bilateral or through the United Nations.

Appendix B

Acronyms and Glossary of Terms

AfDB	African Development Bank
AsDB	Asian Development Bank
CDB	Caribbean Development Bank
CIEC	Conference on International Economic Cooperation — 1977
GAB	The General Arrangements to Borrow is an agreement between the IMF and the larger industrial countries (G-10) including Canada; Switzerland is a full participant and Saudi Arabia has a parallel arrangement with the Fund. The GAB is a mechanism whereby the participating countries may lend their currencies to the Fund to help it finance drawings by any member country.
GCI	General Capital Increase of the World Bank — a capital assessment due from all members in order to increase the capital of the World Bank
IBRD	International Bank for Reconstruction and Development — commonly referred to as the *World Bank* or the *Bank*
IDA	International Development Association — the concessionary arm of the World Bank
IDB	Inter-American Development Bank; sometimes referred to as the BID, the initials of its name in Spanish
IFAD	International Fund for Agricultural Development
IFC	International Financial Corporation — the private investment affiliate of the World Bank
IFIs	the international financial institutions, including the IMF, the World Bank and the regional development banks
IMF	International Monetary Fund — often referred to as the *Fund*
LIBOR	the London interbank offering rate is the short-term rate for inter-bank deposits; i.e., the rate banks offer each other. It serves as a benchmark against which other rates are calculated.

MIGA	Multilateral Insurance Guarantee Agency — an agency which would be under the auspices of the World Bank when it becomes operational, probably in 1987
ODA	Official Development Assistance
OECD	Organization for Economic Co-operation and Development
OPEC	Organization of Petroleum Exporting Countries

Glossary of Terms

Ad hoc consortia of commercial banks (or the London Club as it is sometimes referred to)	a counterpart of the Paris Club but dealing with bank debt and composed of the leading creditor banks. Their meetings are not necessarily in London but in the country of the leading creditor bank. This informal group negotiates debt rescheduling with the country concerned and tries to sell the package to other banks involved in the loan syndicate
Bretton Woods Conference	the international conference held in Bretton Woods, New Hampshire in July 1944 at which the IMF and the World Bank were created
Canadian Inspector General of Banks' list of countries for which provisioning is required	Argentina, Bolivia, Brazil, Chile, Costa Rica, Cuba, Dominican Republic, Ecuador, Guyana, Honduras, Jamaica, Liberia, Madagascar, Malawi, Mexico, Morocco, Nicaragua, Nigeria, North Korea, Peru, Philippines, Poland, Romania, Senegal, Sudan, Togo, Turkey, Uruguay, Venezuela, Yugoslavia, Zaire, Zambia. (When the new directive was issued for 1987-89, the Ivory Coast, Panama and South Africa were added and Turkey was removed.)
Cartagena Group or the Consensus of Cartagena	Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Uruguay and Venezuela
Concessional lending	loans on terms more favourable to the borrower than those obtainable through normal market channels
Debt overhang	a term used as a synonum for debt burden
Debt refinancing	either a rollover of maturing debt obligations or the conversion of existing or future debt service payments into a new loan usually of longer term
Debt rescheduling	the deferment of debt service payments. New maturing dates are applied to the deferred amounts
Debt service	the sum of principal and interest payments due on a loan
Debt service ratio	total debt service divided by the sum of a country's exports of goods and services

Debt write-down	as used by banks, a reduction of the value of a loan shown on a bank's financial statements. However, normally there is no forgiveness of the loan as far as the debtor country is concerned
Development Committee	Joint committee of ministers of finance or someone of comparable rank representing the member countries of the IMF and the World Bank, whose mandate is to seek ways to improve the flow of financial assistance to developing countries
Developing countries	as defined by the Development Assistance Committee of the OECD, all countries and territories in Africa (except South Africa); in America (except the U.S. and Canada); in Asia (except Japan); and in Oceania (except Australia and New Zealand). In Europe the list comprises Cyprus, Gibraltar, Greece, Malta, Portugal and Turkey
Export credits	finance provided by lenders, usually government agencies, in a country for facilitating the export of specific goods and services
Eurodollar or Euro-currency markets	usually refer to dollars deposited in banks outside the United States, including in the Caribbean and Asia, but can also refer to other currency balances deposited in banks outside their currency area. The market operates somewhat like an international money market, facilitating the rapid transfer world-wide of capital
Interest rate capping	agreement not to raise floating interest rates even if rates rise. It does not normally mean reducing interest rates
Interim Committee	Committee of IMF ministers of finance, central bank governors or someone of comparable rank; an advisory group with no formal powers, it is the main policy-making body of the Fund
Low-income countries	Afghanistan, Bangladesh, Benin, Bhutan, Burkina Faso, Burma, Burundi, Cape Verde, Central African Rep., Chad, China, Comoros, Equatorial Guinea, Ethiopia, Gambia, The, Ghana, Guinea, Guinea-Bissau, Haiti, India, Kampuchea, Dem., Kenya, Lao People's Dem. Rep., Madagascar, Malawi, Maldives, Mali, Mauritania, Mozambique, Nepal, Niger, Pakistan, Rwanda, Sào Tomé and Principe, Sierra Leone, Somalia, Sri Lanka, Sudan, Tanzania, Togo, Uganda, Viet Nam, Zaire (IMF classification)
Low-income developing countries	countries with a gross national product in 1984 of less than $400 (World Bank definition)
Middle-income developing countries	countries with a gross national product in 1984 of $400 or more (World Bank definition)

Multiyear restructuring agreement	(MYRA) — a debt restructuring agreement where the consolidation period covers more than two years beyond the date of the signing of the agreement
Official debt	debt owed to, or guaranteed by, the governments or official agencies of the creditor countries. Rescheduling of official debt is usually undertaken under the aegis of the Paris Club
Paris Club (The)	a group of creditor countries, chaired by the French Treasury, that meets to reschedule debts to governments (official debts) as opposed to bank debts
Problem debtor countries (57)	an IMF classification for statistical purposes of developing countries that have incurred external payments arrears or rescheduled their debts since 1982
Provisioning or loan loss provisioning	the setting aside by commercial banks of funds to cover potential losses on loans to a group of countries as opposed to write-downs on specific loans
Spread on interest rate	the difference between the rate used in borrowing and lending money. In the context of Third World debt, the spread is usually the difference between the LIBOR rate and the rate at which the funds are lent to final final borrowers
Sovereign debt	amounts owed abroad by national governments or by their decentralized agencies or by private firms with public guarantees; by the same token sovereign loans are amounts loaned to these same entities
Special drawing rights	the currency-equivalent unit issued by the IMF to its members from time to time in proportion to their fund quotas and comprising part of any IMF loan. SDRs can be exchanged through the Fund for national currencies or held by a country as a reserve asset but they are not used in commercial transactions
Sub-Saharan Africa	all 39 developing African countries south of the Sahara excluding South Africa
Third World	is a general term referring to developing countries. In certain recent usage it seems not to include the least-developed countries, which some are referring to as the Fourth World
U.S. Treasury list of 15 problem debtor countries, often referred to as the "Baker 15"	Argentina, Bolivia, Brazil, Chile, Colombia, Ivory Coast, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia; Jamaica and Costa Rica were subsequently added to this list

Appendix C

List of persons who appeared before the Committee

Issue Number	Date	Witnesses
2	January 28, 1986	*Special Advisors to the Committee* Dr. Claude Isbister Professor David Pollock
3	February 4, 1986	*Department of Finance Canada* Mr. John C. Coleman Assistant Deputy Minister International Trade and Finance Branch Mr. Yves Fortin Assistant Director International Finance and Development Division
4	February 11, 1986	Mr. Sidney Dell Senior Fellow United Nations Institute for Training and Research New York, N.Y.
5	February 25, 1986	Mr. Horace Barber Alternate Executive Director World Bank Washington, D.C.
6	March 4, 1986	Mr. Jacques de Larosière Managing Director International Monetary Fund Washington, D.C. Mr. John P. Lipsky Vice-President Salomon Brothers Inc. New York, N.Y.
7	March 25, 1986	Mr. Marcel Massé Executive Director (Canada) International Monetary Fund Washington, D.C.

8	April 15, 1986	Mr. David Ibarra former Mexican Minister of Finance Mexico City, Mexico
9	April 22, 1986	Dr. Gerald Helleiner Professor of Economics University of Toronto Toronto, Ontario
10	April 29, 1986	Mr. Ivan Head President International Development Research Centre Ottawa, Canada
11	May 6, 1986	Mrs. Margaret Catley-Carlson President Canadian International Development Agency (CIDA) Ottawa, Canada
12	May 13, 1986	Dr. Bishnu Persaud Director and Head Economic Affairs Divison Commonwealth Secretariat London, England
13	May 20, 1986	Mr. Alan Hockin Dean Administrative Studies York University Toronto, Ontario
14	June 10, 1986	*Department of Finance* The Honourable Michael Wilson, P.C., M.P. Minister of Finance Mr. John C. Coleman Assistant Deputy Minister International Trade and Finance Branch

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Washington, New York and Toronto Study Visit, June 2-5, 1986

The objective of the Committee's meetings in Washington, New York and Toronto was to hear the viewpoints of officials in the U.S. Administration, the U.S. Congress, the Federal Reserve Bank, the international financial institutions, as well as from a number of U.S., Canadian and Latin American bankers, U.S. business figures and academics who have been closely involved in subjects related to this study, particularly the international debt crisis. The opinions heard were not officially recorded. The information and views expressed were nevertheless of significance coming as they did near the conclusion of the formal hearings in Ottawa.

The Committee met its interlocutors in the following order:

Washington

Monday, June 2, 1986

His Excellency Mr. Allan E. Gotlieb
Canadian Ambassador to the U.S.A.

Mr. A.F. Burger
Counsellor
Canadian Embassy

From the Department of the U.S. Treasury

Mr. Richard Darman
Deputy Secretary of the Treasury

Mr. Ciro DeFalco
Director of Developing Nations' Finance

Mr. Robert Bench
Deputy Comptroller
International Banking

The World Bank

Mr. Ernest Stern
Senior Vice-President
Operations

Ms. Anne Krueger
Vice-President
Economics and Research

Mr. David Hopper
Vice-President of South Asia
Regional Office

Federal Reserve System

Mr. Paul Volcker
Chairman of the Board of Governors

* * *

Mr. William Cline
Institute for International Economics

Mr. Alfred Watkins
Joint Economic Committee of the Congress

Mr. Ernest Bernstein
The Brookings Institution

Mr. Horst Schulmann
Institute of International Finance

Tuesday, June 3, 1986

The International Monetary Fund

Mr. Richard Erb
Deputy Managing Director

Mr. William Hood
Director of Research

Mr. J. Abramovich
Alternate Executive Director

U.S. Congress

Representative Dante Fascell (*Florida*), Chairman, House Committee on Foreign Affairs; and Senator Charles McC. Mathias *(Maryland)*, Chairman Sub-committee on International Development of the Senate Foreign Relations Committee were Co-Chairmen with Senator George C. van Roggen at the working luncheon meeting in the U.S. Congress

Representative William S. Broomfield *(Michigan)*
Represenative Lee H. Hamilton *(Indiana)*
Representative Don Bonker *(Washington)*
Representative William Frenzel *(Minnesota)*
Representative Lawrence J. Smith *(Florida)*

The Inter-American Development Bank (IDB)

Mr. Miguel Urrutia
Manager of Economics

Mr. Marian Czarnecki
External Relations Advisor

Mr. Henry Constanzo
Manager, Finance Department

New York

Wednesday, June 4, 1986

Mr. Robert Johnstone
Canadian Consul General

* * *

Mr. Charles Meissner
Senior Vice-President
Chemical Bank

Dr. Pedro Pablo Kuczynski
Co-Chairman
First Boston International

* * *

Professor Peter B. Kenen
Walker Professor of Economics and International Finance
Princeton University

Mr. Robert D. Hormats
Director
Goldman Sachs International Corporation

* * *

Mr. Manuel Medina Mora
Executive Vice-President
Banco Nacional de Mexico

Mr. Humberto Carvalho
Regional Director
Banco Real of Brazil

Mr. Rodney Wagner
Vice Chairman
Credit Policy Committee
Morgan Guaranty Trust

Toronto

Thursday, June 5, 1986

The Royal Bank of Canada

Mr. R.G.P. Styles
Vice-Chairman of the Board

Mr. John Cleghorn
President

Mr. Keith Talbot
Vice-President
Sovereign Loans

The Bank of Montreal

Mr. W.D. Mulholland
Chairman and Chief Executive Officer

Mr. John Bradlow
Sr. Vice-President
Government and Banks

The Bank of Nova Scotia

Mr. C.E. Ritchie
Chairman and Chief Executive Officer

Mr. W. Scott Macdonald
Vice-Chairman

Mr. David Hilton
General Manager
International Corporate and Government Banking

Mr. Peter J. Nicholson
Executive Assistant to the Chairman

The Toronto-Dominion Bank

Mr. W.T. Brock
Executive Vice-President
North-American Credit

Mr. K.H. Dowd
Senior Vice-President
International Banking Services

Mr. P.C. Noonan
Senior Vice-President
Credit Department International Banking Group

The Canadian Imperial Bank of Commerce

Mr. A. Flood
President

Mr. Gerald Beasley
Senior Vice-President
International Credit

Dr. Ben Gestrin
Senior Vice-President and Economic Adviser

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The Committee also received written material from the following:

Canadian Hispanic Congress, Toronto, Ontario

J. Quittner, P.Eng., Toronto, Ontario