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# The Case for Cancellation

by George C. Abbott, Glasgow \*

**Given the chronic and crippling impact which their mounting international indebtedness exerts on the economies of many developing countries, cancellation on a fairly comprehensive basis seems the only realistic way of coping with this problem. According to the author, the existing objections to a write-off are mainly emotional and psychological and refuse to recognise that relationships have changed.**

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**B**riefly debt consolidation can be defined as the re-arrangement of a country's external debt by agreement with its creditors on a bilateral country to country basis, or multilaterally with a group of creditor countries. Although each system has its particular attractions, the vast majority of post-war international debt renegotiations has, for a number of reasons which is not directly relevant in this context, been conducted on the basis of multilateral re-arrangements.

## Techniques of Debt Consolidation

The methods and techniques of debt consolidation can take any of the following forms, including a combination of any or all of them. Firstly, debts can be rescheduled. This is a very simple operation. All that happens is the repayment provisions of an existing loan are amended, or more usually, replaced by a new schedule of repayment. Rescheduling is intended specifically to reduce the country's debt profile by changing the timing of payment of interest and amortisation; e.g. by extending the date of repayment, reducing the rate of interest, or granting a grace period. It is not intended to reduce the total debt. That remains unchanged.

This is what might, perhaps, be called the orthodox method of rescheduling. However, rescheduling operations often apply only to the "transfer problem" of foreign debts. In other words, although debtor countries may have the local funds to service their debts, they do not have the available free foreign exchange to meet their international obligations. In such cases payments are made on

schedule by the private debtor to an intermediary in the debtor country, usually the Central Bank, which transfers the nonconsolidated portion of the debt to the creditor country's export credit insurance agency. Transfer of the consolidated portion of the debt is then deferred and paid according to the new schedule of repayment. A moratorium interest rate at normal commercial rates (or close to) is usually levied on the part of the debt which is carried forward.

Secondly, a country's external debt can be re-financed. Under this method the debtor is given a new loan or line of credit in order to continue to meet its existing service payments, or to resume repayments if these have been temporarily suspended. Basically, there are two techniques for refinancing debts depending on the conditions for disbursement of the new loan. The debtor country may either draw on a new loan to make its repayments, or it may pay its debts out of its foreign exchange balances or from short-term bank loans and later receive a refund from the creditor country for the consolidated portion of the debt paid. Of these two techniques the latter is obviously "harder".

Thirdly, debtor countries may declare a moratorium on all or part of their debt service payments, including amortisation of principal. Such a suspension may be of a purely temporary nature, or of a more permanent duration depending on the economic and financial conditions of the debtor country, the nature and causes of indebtedness, and a number of other factors. It may also be a unilateral declaration of suspension of payments, or made with the tacit approval of the creditor countries. Recent examples of countries which

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have declared a moratorium on their outstanding debts with the tacit assent of their creditors are Turkey (1959), Ghana (1966) and Indonesia (1966). Another variation of this arrangement is the inclusion of a "bisque" clause in the loan agreement entitling the borrower to postpone payments of interest and principal for limited periods of time in balance of payments difficulties. A number of post-war loans by the United States and Canada carried this provision. For example, in December 1945 the United States made a loan of \$ 3,750 mn to the United Kingdom to be repaid over fifty years (1951 to 2001). The agreement provided that under certain circumstances, the interest on this loan could be waived. In 1957 the United Kingdom decided after agreement with the United States, to forgo its right to this waiver in exchange for the right to postpone up to seven instalments of principal and interest.

Finally, debts can be written-off or cancelled. Each of the above techniques has its own merits and its suitability for any particular case depends on such considerations as the size and composition of the country's external debts, the extent of the changes required in the overall structure of debt service payments, the time pattern of debt schedules, and so on. Rescheduling, for example, provides a more manageable repayment schedule, though the levying of a moratorium interest rate on the part of the debt to be rolled over, may under certain circumstances increase the country's total debt. It is nevertheless, the most appropriate form of consolidation when only individual debts are concerned. It is also the usual procedure for providing temporary relief, where there is a bunching of debts over a short period of time (2 to 3 years), or when there is a temporary shortfall in foreign exchange earnings.

#### **Complications Involved in Refinancing**

However, if the country's debt difficulties are more deep-seated rescheduling is unlikely to be of much use. Refinancing is a more appropriate procedure in such circumstances. By providing new loans on softer terms, it is particularly useful for a country that has substantial long-term obligations. New credits with extended maturity dates and concessional interest rates will improve the recipient country's debt structure. But if that country is forced to borrow on commercial terms to meet current amortisation and interest charges, the effect will be tantamount to a rescheduling operation with a commercial moratorium rate of interest.

There are other complications involved in refinancing. Space permits mention only of two. Refinancing involves a cost which many creditor

countries may prefer to avoid. Export credit insurance schemes are supposed to be self-supporting. However, if they lack adequate reserves they can in the short run at least, impose a severe financial strain on the creditor country's budget when the number and size of consolidations in any one year are substantial. Secondly, the real benefit of any new loan insofar as the debtor country is concerned is that it must be softer than the original loan which it replaces, and also that it must be untied. If either of these conditions is not met then the cost of the new loan may well exceed its benefits. Instead of providing relief to the debtor it could well exacerbate the debt problem.

#### **Growing Indebtedness of Developing Countries**

In retrospect, this seems to be precisely what has happened. Most refinancing operations have been of the "harder" type. In addition, creditor countries tie the vast majority of their resource flows to the developing countries. Consequently, although a substantial number of debts has been refinanced, the overall upward trend of mounting indebtedness has remained largely unaffected. During the sixties alone international indebtedness grew at an average annual rate of 14 p.c. for the developing countries. In fact the rather indifferent record of both rescheduling and refinancing in the post-war period is due as much to the inherent limitations of these techniques as to the nature and causes of the problem itself.

When the debts to be consolidated are of a purely temporary short-term nature rescheduling is the ideal procedure. But the external debts of the developing countries, the major international debtors, do not fall into this category. They are chronic, long-term, structural, and what is more, they continue to grow. They are precisely the sort of debts against which rescheduling is unlikely to make any lasting impact. Refinancing is also unlikely to make any serious inroads into the problem of chronic indebtedness facing the developing countries. There are just not enough "soft" funds available for providing the appropriate type of new loans for refinancing. Not only that, soft funds for refinancing have invariably had to be siphoned off from new development aid funds thus considerably reducing their net benefit to the debtor countries.

Indeed one could go further and argue that both rescheduling and refinancing have themselves contributed to the problem of international indebtedness in at least three respects. Firstly, they have converted short-term debts to medium and long-term debts. In so doing they have earned the debtors a brief respite which though welcome, has enabled them to avoid introducing a number of

fiscal and budgetary measures to deal with the underlying causes of the problem. Secondly, given the procedures which have been adopted, rolling over the debt has on balance, made it harder for the developing countries to meet the final bill of settlement. In other words, they have increased the terminal level of debt. In effect this means that these countries have mortgaged of a larger share of their future resources to the already developed countries. Thirdly, rescheduling and refinancing have severely jeopardised the creditworthiness of the debtor countries. The substantial debt burden with which they are saddled makes it very difficult for many of them to raise sufficient development funds in the capital markets of the developed countries.

### Conventional Thinking and Financial Orthodoxy

Notwithstanding these developments there is a reluctance to extend the range of consolidation procedures beyond these wellworn techniques. There has never really been any great enthusiasm for employing either a debt moratorium or cancellation which are themselves highly respectable and efficient techniques of debt consolidation. The reason for this is very simply that the concept and practice of debt renegotiation are still rigidly governed by conventional thinking and financial orthodoxy. The basic principles of which are that "relief afforded should be the minimum needed to ensure the early resumption of debt service payments and that the cost to creditors of any postponement of amortisation and interest payments whether by means of rescheduling or refinancing should be matched by additional interest charged at commercial rates".<sup>1</sup>

Such a philosophy rests on the rather questionable assumption that relief should not only be *ad hoc* but also negotiated against the background of an impending financial and economic crisis in the debtor country. In the golden era of *laissez-faire* and free enterprise, financial crises and bankruptcies were regarded as exceptional. Such losses as were incurred were considered private rather than public, and part of the inevitable price of economic efficiency, profitability and free enterprise. Indebtedness was regarded as an aberration of the smooth functioning of the international financial system, which had to be put right as soon as possible. Once this was done, the system would continue to function as smoothly and as efficiently as before.

However, the whole international situation is very different nowadays. The international community of nations lives in a perpetual state of crises. The

crisis of indebtedness is just one example, the world food problem is another, the oil crisis yet another. One could extend the list almost indefinitely. The point, very simply is, given the perpetual state of crisis facing the developing countries it is pointless to pretend that an *ad hoc* approach to any of these major world problems will produce an effective and long-term solution. In the specific case of international indebtedness what is obviously needed is a completely new approach which will help the debtor countries to break out of their crippling debt trap, and at the same time give them valuable breathing space for tackling the fundamental causes of the problem.

Such an approach must start from the basic premise that the nature, causes, and consequences of post-war indebtedness are very different to the traditional forms of indebtedness. It must give greater weight to the concerns and considerations of the debtor countries. It must seek to devise a strategy which will enable them to meet their international financial obligations without jeopardis-

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<sup>1</sup> Debt Problems of the Developing Countries, Report by the UNCTAD Secretariat, UN, New York 1972, p. 22.

ing their own economic and social development. It must also employ the whole range and scope of existing consolidation procedures, including a debt moratorium and outright debt cancellation.

### **New Attitude Towards International Indebtedness**

The need for a new strategy has long been recognised and advocated by a number of eminent studies, notably, the Pearson Report. More recently studies emanating from the OECD, UNCTAD and other related UN agencies clearly indicate that attitudes are slowly changing. There is no longer that basic and deep-seated antipathy to cancellation. The old doctrine of payment at all costs has been finally laid to rest. International indebtedness is no longer seen as an aberration of the smooth functioning of the international financial system, nor brought about by the financial mismanagement and irresponsibility of the debtor country. A new attitude prevails. International indebtedness is seen as a global problem, the solution for which lies in a wider scenario of international cooperation and development.

One of the most crucial elements of any new debt strategy is that it must deal with the backlog of accumulated debts. These must be scaled down considerably, and how better to achieve this than through cancellation? Whether cancellation is to be in full or partially is obviously a matter of detail and agreement between both creditors and debtors. Once the principle has been agreed, the mechanics and administration of the operation can follow later. More precisely, however, the case for cancellation rests on the very positive and immediate impact which it will make on the overall debt burden facing the developing countries. Cancellation goes directly to the heart of the problem, which is the accumulated backlog of outstanding debts, questionably undertaken in the name of development. By reducing the stream of future debt service payments of interest and amortisation, it reduces the debtors' financial obligations and releases resources for other urgent tasks, specifically promoting development.

### **Advantages of Cancellation**

This would have a major impact in terms of both the stock and the flow of resources for development. In the case of the former, a writing-off or down of outstanding development debts would represent first and foremost a substantial once-over increase of aid funds. This would immeasurably relieve the developing countries of their overwhelming preoccupation with the problem of indebtedness. Frankly, it would be difficult to exaggerate the psychological and material advantages which such a move would bring to the

debtors. As regards the creditors there is no evidence to suggest that "clearing the books" would either impede their own economic progress or precipitate any major international financial or economic crisis.

Insofar as the longer term availability and flow of funds for development are concerned, cancellation of a number of outstanding debts now would also help to increase the overall net inflow of resources in the future, especially in cases where the level of new lending is likely to be inadequate, or the terms harder than at present. In this respect it is more effective as a consolidation procedure than either rescheduling or refinancing since it does not create any additional pressure for an overall softening of the terms of new lending. It seeks instead to relieve the underlying causes of indebtedness by going straight to the problem, rather, than by attempting to compensate for the inadequacy and inability of the international financial system to provide ample soft funds for relending the debtor countries.

In fact, given the chronic and crippling impact which indebtedness exerts on the economy of the debtor countries, cancellation on a fairly comprehensive basis seems the only realistic way of coping with this problem. There is no doubt for instance, that many developing countries are having to sacrifice vital development works in order to meet their external debt service payments. This has not only led them to suspect the motives of the creditor countries but also engendered a lot of unnecessary misunderstanding and international ill-will. Cancellation would thus represent a forthright expression of the goodwill and earnest intention of the developed countries to help the poorer nations to develop. This, more than anything else, is what is urgently required. If the problem is to be tackled constructively there must be a re-establishment of mutual trust, understanding and goodwill.

Cancellation means that the developed countries are prepared to let bygones be bygones. It would show even that they are prepared to relinquish their claim on the future resources of the developing countries. In the present context of lack of development and increasing indebtedness this would be tantamount to a recognition that the problem of world poverty transcends the purely legal and contractual obligations of debt repayment. By insisting on payment at all costs the creditor countries seem to place greater emphasis on the enforcement of their own legal rights than on the concept of shared responsibility, to which they as members of the United Nations have repeatedly subscribed. A write-off would help to remove much of the

conceptual confusion that has grown up around the motives for giving aid as well as the nature of aid itself. Much of what passes for aid is not aid at all, but really international capital flows taking advantage of market opportunities. A write-off would thus underline the fact that there are essential differences between aid and investment. Perhaps more important though, it would be an acknowledgment that the responsibility for amassing these debts lies with both the creditor and the debtor countries. Cancellation would also serve to reassert the moral force and relevance of humanitarianism or international altruism as a motive for giving aid. Or as the Pearson Report put it "we belong to a world community . . . and it is right for those who have to share with those who do not".

### Debt Repudiation Threatening

On a more practical plane, a write-off would solve many of the immediate problems facing the developing countries. Basically, the problem of indebtedness arises from a shortage of foreign exchange which is in fact the debtors' scarcest commodity. These countries are just not earning enough to pay their debts. No amount of special pleading in the three UNCTADs for example, has improved their trading prospects materially. The future is far from encouraging. Unless they can increase their share of world trade significantly, they will not be able to meet their international obligations. Cancellation would thus help to relieve the basic problem of lack of foreign exchange. It could also be used as the essential first step on an overall stabilisation programme for improving the export potential of these countries. Finally, one must be realistic, and ask what are the alternatives open to the debtor countries? Foreign debts are slowly strangling them. If the situation continues much longer they will in fact have no alternative but to repudiate them. One does not have to be reminded of the possible consequences of such a course of action. It is obviously not something to be entered into wantonly and ill-advisedly, one wonders though, whether some of them might not come to regard repudiation as a lesser evil to mortgaging their surplus in perpetuity.

Having said this though, one must recognise that there are a number of reasons why the creditor countries may not be prepared to write-off debts owing to them. No country likes to relinquish its just and legitimate claims without some corresponding *quid pro quo* from its debtors, or a similar assurance from other creditors. There may also be a number of legal and contractual obligations which have to be met, and so on. But these con-

ditions can be, and usually are satisfied, if the political will exists internationally. Unfortunately debt cancellation is not one of those issues on which there is likely to be much political goodwill. In fact the very idea arouses deep feelings of antagonism. Many people object to a write-off not because of the benefits and advantages which it is supposed to bring to the debtors, but rather on account of the financial and economic losses which the creditors will sustain.

Antagonism to a write-off is rooted in what the exercise conventionally symbolises. Cancellation implies defeat. It suggests condonation rather than condemnation of financial irresponsibility and economic mismanagement. Failure to meet one's legal and contractual obligations is somehow seen as a negation of natural justice and international legitimacy. There is an air of finality about it which many people find difficult to accept. It is a sort of dead reckoning, a coming to terms with reality.

### Objections Mainly Emotional

Coming as it does, at the end of the process, most people find it hard to see debt cancellation as anything more than sheer negativism. But it is nothing of the sort. Cancellation can in fact make a positive and effective contribution to international development and cooperation. Instead of being regarded as the end of the line, it can form a vital first step in a comprehensive programme of long-term stabilisation for the developing countries. By stressing the positive aspects and benefits of a write-off one can also help to bring about a complete change in the philosophy and approach to debt consolidation.

In fact the objections to a write-off are mainly emotional and psychological. As such they are firmly rooted in the past, and refuse to recognise that relationships have changed. They even refuse to admit that indebtedness is as much a problem for the creditor as for the debtor countries. Perhaps the psychological breakthrough will come when it is realised that as debts multiply and mount up they cease to be a problem for the debtors and become instead a problem for the creditors. Indebtedness is not only a problem of inability to pay. It can also be a problem of inability to collect. It would be a tragic irony of events if the latter were to happen. It would certainly not benefit anyone. In fact it could quite conceivably lead to a major confrontation between the rich developed creditor nations and the poor developing debtor countries with a number of unfortunate international side-effects.