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of assistance to private companies without subjecting it to complex and time-consuming bureaucratic processes.

As mentioned above, when implementing projects directly benefiting private industrial companies, international organizations must ensure that no market distortions are created. Therefore, the full costs for company-level services should be borne by the recipient enterprises which will increase their efficiency and profitability as a result of the specific assistance provided.

A further aspect in this context refers to potential competition between international organizations and domestic consultancy companies. The former—given their special reputation and mandate as unbiased neutral advisers—should not act as just another consulting firm.

First, they should concentrate on particularly demanding segments of consultancy services requiring sophisticated international expertise and access to multilateral information networks. Complex procurement services or feasibility studies involving international market assessments would be cases in point. Second, within their advisory services to the private sector, international organizations should seek to involve, to the maximum extent possible, existing domestic consultancy firms, e. g. through sub-contracting arrangements thereby extending support and training to their further development. In the case of large-scale projects, it would also appear appropriate to cooperate with big international consulting firms—a model that could be referred to as “co-consulting” in analogy with the co-financing of development projects.

Ramesh C. Garg*

The Case for Debt-forgiveness for Latin America and the Caribbean Countries

Resource transfer to Latin America and the Caribbean was negative throughout the eighties. Debt-forgiveness would benefit not only the debtor countries, however. Lending countries and institutions would also stand to gain.

The “debt crisis” still overshadows the horizon of international financial markets. It has been causing political instability and the collapse of the economies of several Latin American countries. The debt crisis has resulted in inhibiting the transfer of capital and investments from developed countries to the debt-ridden less developed countries (LDCs). At the same time, the stocks of several private international banks are under severe pressure and selling substantially below their book values due to their exposure to LDC debt, particularly in Latin America. Various proposals have emerged for finding a satisfactory resolution of the debt problem, yet the progress to date in reducing the debt burden has been very slow.¹ According to World Bank estimates, the outstanding debt of all developing countries amounts to

\$ 1.35 trillion at the end of 1991, which is unchanged from 1990's total.² A significant portion of this debt is owed to private banks. A number of Latin American countries have instituted debt-equity swap programmes, which have made a small dent in the growth of external public debt³ for the Latin American and the Caribbean countries. According to the World Bank statistics, the external public debt of Latin America and the Caribbean countries

¹ Cf. Ramesh C. Garg: Exploring Solutions to the LDC Debt Crisis, in: The Bankers Magazine, January/February 1989, pp. 46-51; Steven Miller: Coping With The LDC Debt Crisis, in: The Bankers Magazine, May/June 1988, pp. 29-33.

² Eduardo Lachica: World Bank Issues Warning on Debt Woes, in: The Wall Street Journal, December 16, 1991, p. A9A.

³ External public debt is defined as the debt incurred or guaranteed by government repayable to non-residents in foreign currency, with an original maturity of more than one year. In the paper, wherever the term “debt” is used, it refers only to the external public debt and does not include the private external debt.

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increased from \$ 130 billion in 1980 to \$ 318 billion in 1990, with a peak of \$ 342 billion in 1987 (cf. Table 1).

The purpose of this paper is to re-examine the issue of debt crisis with a view to providing its ultimate solution, i.e. to examine the strategy of "debt-forgiveness" for heavily indebted Latin American and other developing countries. Thinking along the lines of "debt-forgiveness" is neither radical nor entirely a new concept. Recently, British Prime Minister John Major announced that Britain would unilaterally push through a plan to slash the debt of the world's poorest countries.⁴ Under this initiative, Britain and any other lender nations that go along with it, would write off two-thirds of the debt owed by 20 nations categorized as the world's poorest. For Britain, that means forgiving about \$ 830 million of \$ 1.3 billion lent to the cash-strapped countries.

Brazil, the world's largest debtor nation, announced in 1988 that it was going to suspend interest payments on its \$ 67 billion commercial debts. This announcement sent shock waves throughout banking boardrooms across the

United States and Europe. Many of the private international banks rushed to follow the lead of Citibank, which announced an addition of \$ 3 billion to its loan loss reserves. Yet, lender banks and creditors have been carrying LDC debts at their book values. It has been taken for granted that the debtor countries would continue to honour debts at their full book values. In the secondary markets, however, the debts of some big Latin American countries are changing hands for as low as 20 cents on the dollar with very few buyers in sight (cf. Table 2). If history is to provide any precedence, it should be noted that debt crises in the past have been resolved through a partial write-off of debts.

Debt Crisis of the 1980s

Mexico's announcement in August 1982 that it could no longer service its international financial obligations signalled the start of the 1980s' Latin American debt crisis. Proposals to reduce the size of outstanding debt were emphasized during the early stages of the post-1982 debt crisis, but did not get any support from either the various lending governments of developed countries or the major private bankers. Even the IMF made its financial support for the debtor countries contingent upon their accepting an "austerity plan" and continuing to service their debts. Countries that continued to accumulate arrears in their foreign debts were made ineligible to receive the IMF's so-called "helping hand". This policy greatly increased the private banks' bargaining power in dealing with debtor countries. As the debt talks dragged on, banks became increasingly reluctant to lend new money. In the early stages of negotiations, private banks had been persuaded to offer new money in exchange for the debtors' efforts to keep up with debt service payments, but gradually this bargain looked less appealing to the private bankers. Towards the end of the decade, deals including new money became extremely rare. As a result, the accusation that the IMF was acting as a debt collector for the private banks began to sting.⁵

Data on the debt structure of Latin America and the Caribbean countries is presented in Table 3. The data indicates the percentage distribution of debt between the official and private sources for the years 1980 through 1990. The official sources include various governments and international organizations. The private sources, on the other hand, include private financial markets and suppliers' credits. As evident from column 2 of Table 3, the percentage share of official lending increased from 24 percent in 1980 to 36 percent in 1990. The share of private

Table 1
Latin America and the Caribbean:
Selected Data on External Public Debt

Year	Total debt outstanding (US\$ millions)	Total debt service (US\$ millions)	Debt service ratio
1980	129,689	45,998	37.4
1983	221,803	50,237	43.0
1984	249,850	51,627	39.9
1985	275,414	47,696	38.6
1986	309,607	47,502	44.1
1987	341,547	45,937	38.1
1988	332,524	54,601	40.3
1989	324,558	45,281	30.5
1990	317,568	44,387	27.0

Source: IBRD: World Debt Tables 1990.

Table 2
Secondary-market Debt Prices
(September 1991, % of Face Value)

Country	Bid	Offer
Argentina (Bonex '89)	79.20	79.30
Brazil (Investment Bonds)	54.00	54.50
Chile	88.25	89.25
Colombia	77.00	79.00
Costa Rica	51.50	52.50
Cuba	5.00	n.a.
Dominican Republic	28.00	n.a.
Ecuador	23.50	25.00
Mexico (Par Bond)	59.38	59.62
Nicaragua	8.00	n.a.
Panama	17.50	18.50
Peru	14.00	15.00
Venezuela (Par Bonds)	67.38	67.62

n.a. = not available.

⁴ Tim Carrington: Britain Moves to Cut Debt of Poor Nations, in: The Wall Street Journal, October 18, 1991, p. A-11.

capital has, of course, declined simultaneously during the same period. Columns 4 and 5 of Table 3 indicate the percentage distribution of the total debt service payments required to service official and private debt capital respectively. On average, 28 percent of the total debt service payments was required to service 27 percent of the total debt outstanding which originated from official sources during 1980 – 1990. There seems to be a good balance, on average, between the debt outstanding and the debt service payments required to service the debt from the respective sources. Columns 6, 7 and 8 indicate the percentage cost of total, official, and private capital respectively. As one might anticipate, the cost of financing private capital was substantially higher to begin with but declined substantially during the decade. The cost of official capital has increased. The overall weighted average cost of borrowing for Latin America and the Caribbean countries was 10.9 percent during 1980 through 1990. As the data indicate, the official creditors (the IMF, the World Bank, other multilateral institutions and governments) were the net suppliers of loans to Latin America and the Caribbean countries. The private banks started shrinking their share of lending at a rapid pace. This trend is a reversal of what had happened during the 1970s when the share of official capital declined and that of the private capital increased.⁵ It is paradoxical to note that during the 1980s the taxpayers in industrialized countries were led to believe that they would not be sharing the risk of loan defaults by Latin American countries. In fact, that is exactly what happened during the 1980s: private banks reduced their exposure, official creditors (i.e. taxpayers) were obliged to increase theirs.

Resource Transfer Analysis

Any proposal to forgive Latin American debt may be classified as a “radical” scheme at best and an “absurd” one at worst. Then why forgive the debt now? Given the historical perspective on Latin American borrowings, the forgiveness of debts is not only conceivable but is unavoidable. Simon Bolivar began the lending default cycle in 1820, followed by others in the late 19th century. The most extreme solution today – voluntary debt-forgiveness or reduction – was also implemented in the 19th century. Brazil and other post-1931 debtors also negotiated debt and interest reductions.⁷

We shall now analyze the effects of the trend in debt structure, the cost of borrowing and the increasing level of

indebtedness on the extent of the transfer of resources to Latin America and the Caribbean countries. The literature pertaining to the field of international capital movements generally outlines the concept of resource flows.⁸ There are three variations of capital flows: gross capital inflow, net capital inflow and resource transfer. Gross capital inflow is defined as all receipts on capital account, without any offsets; net capital inflow is gross inflow less the amortization portion of the loans; and the resource transfer is net capital inflow less interest charges on such loans. Resource transfer analysis provides an appropriate mechanism to ascertain the extent of resource transfer that a country or a region might realize over a period of time. The concept essentially measures how much of the gross capital inflow is left to the borrower after it has paid for the service items.

It is the transfer of real resources, then, which is of significance to the capital-importing countries. Only such transferred resources become available to supplement domestically generated savings, thus enabling the borrowing countries to achieve a relatively high rate of investment and output growth. Ratios of net capital flow and net resource transfer to debt disbursement can be calculated in order to determine the percentage transfer of net capital and real resources respectively during a given time period.

Table 4 provides the data on resource transfer for Latin America and the Caribbean countries. The World Bank compiles the data on external debt based on the reporting made to it by individual countries. The last column in Table 4 indicates the amount of net resource transfer as a percentage of debt disbursement during the year. It may be noted that the percentage resource transfer has been negative throughout the 1980s for Latin America and the Caribbean countries. On an average, they paid 87 percent more in the form of debt service payments than the amount of debt disbursements during the 1980s. During the same decade, the volume of total outstanding debt has continued to grow (cf. Table 1).

The data on resource transfer suggest a very gloomy outlook for Latin America’s and the Caribbean countries’ ability to continue servicing their external public debt. A deteriorating trend in the country’s debt structure along with a negative level of resource transfer at an alarming rate can only bring them several steps closer to the brink of

⁵ Sisters in the Wood, the IMF and the World Bank Survey, in: *The Economist*, October 12, 1991, p. 24.

⁶ Ramesh C. Garg: Latin American and the Caribbean External Debt: Problems and Prospects, in: *Economia Internazionale*, August-November 1982, pp. 449-450.

⁷ Frank Griffith Dawson: Latin America’s Debt Crisis: The Longest Running Show in Town, in: *International Financial Law Review*, Vol. 9, August 1990, p. 15.

⁸ Cf. D. Avramovic: Latin American External Debt, in: *Journal of World Trade Law*, March-April 1970, pp. 134-136; Ramesh C. Garg: Debt Problems of Developing Countries, in: *INTERECONOMICS*, March-April 1977, Vol. 12, No. 2, pp. 95-96.

DEVELOPMENT STRATEGY

default. This has been perhaps the major cause of political unrest in many Latin American and Caribbean countries, where the populace realized that any "austerity" programme would solely benefit the external creditors while less and less would be available for domestic consumption.

Perhaps the most striking observation about resource transfer is that, since the early 1980s, Latin America and the Caribbean countries have been net providers of financial resources to the creditor countries, rather than being the recipients. During 1983 through 1990, Latin America and the Caribbean countries as a whole transferred \$ 168 billion to the creditor countries (cf. Table 4). A continuing trend towards negative resource transfer does not make any business sense and provides the strongest argument for debt forgiveness.

Cost of Forgiveness

As the volume of debt grows, the market begins to doubt whether it will be repaid in full. We recall that "new money" in debt rescheduling is supposed to support investment, spur growth and increase the capacity to repay. Beyond a certain stage the market thinks differently: extra debt makes reform more difficult and increases the probability of default. Each extra dollar of debt then adds less than one dollar to its *present value*. If debt continues to grow, its value on the secondary market will actually start to fall. In this extreme case the debt's disincentives are so large that they more than offset the value to the creditors of their bigger claim on the debtor.

In the worst cases, a reduction in debt will increase the amount that will be paid back, i.e. if the lenders forgive

Table 3
Latin America and the Caribbean: Total Debt, Debt Service Payment by Source and Cost of Borrowings
(Percent distribution)

Year	Debt outstanding		Debt service		Debt service as % of debt outstanding		
	Total official	Total private	Total official	Total private	Total	Official	Private
1980	24	76	14	86	20.9	12.7	23.4
1983	21	79	21	79	13.6	14.0	13.6
1984	20	80	19	81	12.6	12.0	12.8
1985	23	77	21	79	11.5	10.3	11.9
1986	26	74	27	73	10.4	11.1	10.2
1987	29	71	29	71	9.3	9.5	9.2
1988	30	70	27	73	11.5	10.3	12.0
1989	32	68	36	64	9.2	10.4	8.6
1990	36	64	43	57	9.2	10.9	8.2
Average ¹ 1983-90	27	73	28	72	10.9	11.1	10.8

¹ Average figures are based on the dollar amount of external debt and debt service payments.

Sources: IBRD: World Debt Tables 1990; calculations by the author.

Table 4
Latin America and the Caribbean: Capital Inflow, Service Payments and Resource Transfer Analysis:
1983 - 1990
(US\$ millions)

Year	Debt disbursement during the year	Debt service payments			Net flow	Net transfer	as % of debt disbursement	
		Amortization	Interest	Total			Net flow	Transfer
1980	44,515	21,722	24,276	45,998	22,793	1,483	51	-3
1983	37,557	15,477	34,760	50,237	22,080	12,680	59	-34
1984	32,570	16,398	35,229	51,627	16,172	19,057	50	-59
1985	21,842	12,930	34,766	47,696	3,830	30,936	18	-142
1986	22,559	17,599	29,903	47,502	1,517	28,386	7	-126
1987	22,301	17,661	28,276	45,937	8,115	20,161	36	-90
1988	24,277	21,317	33,284	54,601	8,309	24,975	34	-103
1989	19,836	19,486	25,795	45,281	2,945	22,850	15	-115
1990	34,955	21,148	23,239	44,387	14,208	9,031	41	-26
1983-90	215,897	142,016	245,252	387,268	77,176	168,076	32	-87

Sources: IBRD: World Debt Tables 1990; calculations by the author.

some debt they themselves will be better off. In other cases, a reduction of debt of, say, \$ 100m will "cost" the lenders less than \$ 100m; the amount of debt repayment forgone might be only \$ 50m, for example.

Debt Prices in Secondary Markets

Given that the debts of many Latin American and Caribbean countries are selling at a substantial discount to their face values in the secondary markets (cf. Table 2), the real cost of debt-forgiveness would also be minimal to the lending banks. In some instances, private commercial banks may in fact choose to donate outright part of their Latin American and Caribbean countries' debt assets to an educational or non-profit institution. There are several advantages to the banks in doing so. Banks may be motivated to donate their external debt holdings partly because of the "public relations" value associated with such donations. A study prepared by the US Department of Commerce highlights the tax merits of issues associated with outright donations by commercial banks vis-à-vis the selling of debt in the secondary markets.⁹ According to the study, the Internal Revenue Service (see Ruling: Rev. Rul. 87-124, issued in November 1987), increased the incentives to donate debt. By donating, a bank can receive a tax deduction of the full face value of its loan rather than on the loan's "fair market value" only. Prior to this ruling, deductions were limited to the "fair market value" of a loan, i.e. to the discounted market price at which the loan could be sold in the secondary markets. Ruling 87-124, in effect, made it possible for a bank to sell its external loan to the host central bank; exchange it for local currency; claim a tax deductible loss on the difference between the face value of the loan and the dollar value of the local currency received for it; contribute the local currency to a US non-profit organization; and claim a tax deduction on the contribution. In other words, the donated amount of the loan can be completely written-off for tax purposes.

Private Banks' Stocks

The debt overhang has been playing havoc with the market valuation of several money-centre banks. The uncertainty and the lack of substantive progress in resolving the debt crisis has created a sort of "debt fatigue". Stocks of several private banks exposed to the debts of Latin American and Caribbean countries are selling well below their book values. Large banks, such as Britain's Midland Bank, with the largest exposures and the smallest reserves, have been hardest hit by investors.¹⁰

⁹ Michael R. Czinkota and Martin J. Kohn: Improving U.S. Competitiveness: Swapping Debt for Education, US Department of Commerce, International Trade Administration, A Report to the Secretary of Commerce, Washington D.C. 1988.

Once this debt of doubtful value is taken off their balance sheets, a surge in the valuation of their stocks can be anticipated. The cost of debt forgiveness may, in fact, be more than offset by the benefits accruing to the lenders through increased valuations of their equity. In fact, when Citibank initially announced that it would set aside a \$ 3 billion to its loan loss reserves, the reaction in the stock market was swift and favourable to its stock price.

Increased Investments

A study by Borensztein on the Philippines supports the theory that a country's external debt burden adversely affects the rate of private investment.¹¹ According to the study, the poor investment and growth performance of the highly indebted countries in the past few years is frequently attributed to the burden of their foreign debt (a high ratio of external debt to GDP), a phenomenon known as the "debt overhang". According to the debt overhang hypothesis, the accumulated debt acts as a tax on future output, discouraging productive investment plans by the private sector. It goes without saying that debt reduction of a sizeable magnitude will spurt private investments in Latin American and Caribbean countries.

The debt crisis has ballooned to such mammoth proportions that the international financial community can no longer afford to ignore it. Debt crisis management techniques calling for debt rescheduling and debt-equity swaps have had very limited success. These short-term solutions are doomed to failure because they do not address the fundamental cause of the problem. The debt overhang, in fact, is a structural problem that damaged the growth prospects of Latin American and Caribbean countries' economies as well as exports from the West. What is needed is a lasting solution to correct the structural imbalance in the world economy. Efforts to pursue debt-forgiveness can be channelled through multilateral agencies like the World Bank, the IMF, the Inter-American Development Bank etc. so that the rewards are shared equitably by all the parties concerned. Debt-forgiveness is a win-win situation. Creditor nations will benefit far more from debt-free economies in Latin American and Caribbean countries which will then be able to increase their imports and private investments. Debt-forgiveness is needed by Latin American and Caribbean countries whose economies have been jeopardized by fruitless efforts to service debt and by the industrialized countries that want them as their markets.

¹⁰ Suzanna Andrews: Debt Forgiveness Gains Ground, in: Institutional Investor, April 1988, pp. 220-224.

¹¹ Eduardo Borensztein: Will Debt Reduction Increase Investment?, in: Finance and Development, March 1991, pp. 25-27.