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ABSTRACT

Arguing that the benefits from borrowing abroad exceed the costs recently imposed on countries through debt-servicing difficulties, this paper defines debt as an engine of growth, forcing the borrower to produce goods efficiently, export them, and function competitively in the international market. Debt-servicing difficulties of developing nations have a complex history and the assessment of the 1986 conditions seems no less complicated. Countries continue to gain access to foreign resources even as recent growth trends and long term borrowing plans cause problems. U.S. Treasury Secretary James Baker's contribution to the lending and debt management processes continues as does the discussion of direct U.S. investment in developing countries. Developing nations must reduce the growth of debt relative to the rise in exports and economic creditor confidence is crucial in managing the external debt over the long term. External debt and foreign borrowing cannot be regarded as foes of the development process if foreign resources are considered as important contributions to the growth of developing nations. Instead, mismanagement of external borrowing and debt is the problem, stemming primarily from poor overall management of the economy. The future will likely present a continued shortage of external assistance measured against the investment needs of development. Successful policy making for development will include the effective management of foreign borrowing and external debt. (GEA)

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# Development and External Debt: Friend or Foe?

Nicholas C. Hope



25th Anniversary Seminar Series



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# Development and External Debt: Friends or Foes?

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In many speeches on external debt, I have taken a fairly positive view of developing countries' foreign borrowing, so I chose the topic for today—"Development and External Debt: Friends or Foes?"—to be provocative. I still intend taking a positive view, and will argue that the benefits from borrowing abroad exceed the costs that have been imposed on countries in the past few years through debt-servicing difficulties. But since deciding on this as a topic, I have spent a month in East Asia looking at the debt management problems of countries that are not supposed to have serious debt difficulties. I now might want to hedge my position somewhat; at least I will say something at the end of this speech on the role of effective debt management in securing the benefits from foreign borrowing by developing economies.

## DEBT AS AN ENGINE OF GROWTH

My old boss, Helen Hughes (who has left the World Bank and gone back to Australia to a chair at the Australian National University) insisted quite vehemently in 1979-80 that debt was not a bad thing at all; it was an engine of growth. She meant that countries which had borrowed in the international markets and were now facing the prospects of difficulty in servicing debt would be forced to adopt the internationally oriented policies necessary to restore competitiveness to their economies. She was arguing that, if a country borrows abroad, it has to export in order to service its debt; and if it wants to export in the international market, then it has to be competitive. That means it has to adopt the sorts of exchange rate, monetary and demand management policies that will encourage strong growth of the export sector. I still think of this as a valid view, but in the sort of troubled economic environment we work in, encouraging strong export growth is not nearly so easy as we thought it would be back in 1979 and 1980.

## LOOKING BACK

To set the scene then, in the 1950s and 1960s developing countries occasionally experienced debt-servicing difficulties. This was a period when Latin American countries, in particular, ran into difficulty trying to service suppliers' credits. But there were not many intractable problems until the mid-1970s, when Zaire and some other countries, mainly in Africa, began to make people aware that debt-servicing problems were not something that existed only in the past. From the beginning of 1970 through the end of 1980, 42 of the World Bank's developing members failed to meet their obligations as contractually due. As a result, they were forced, in 144 multilateral debt renegotiations, to reschedule the terms of their debt to official creditors, largely through the mechanism of the Paris Club, and to private creditors (commercial banks) through the mechanism of the London Club.

Both the number of reschedulings and the sums involved have grown remarkably in the 1980s. From 1970 to 1980, a total of less than \$20 billion was restructured—split equally between official creditors and private creditors—and more than half of that amount was dealt with in Turkey's five highly publicized restructurings. In that period, rescheduling was largely for poorer countries, mainly in Africa, and for very small sums. By contrast, our records show that in 1985 developing countries reached formal agreement to reschedule \$93 billion, of which \$6 billion was to official creditors and \$87 billion was to private creditors; both of these figures were record highs. As well, agreement was reached in principle to reschedule a further \$26 billion of debt outstanding to commercial banks, so the total debt being restructured in 1985 was of the order of \$120 billion, making it a phenomenon of a magnitude completely different from that of the debt reorganizations of the 1950s, 1960s, and 1970s. The major difference was the vast restructuring of debt now owed to the commercial banking system.

Even though the Mexican multiyear rescheduling agreement (MYRA) accounted for $49 billion of the $120 billion rescheduled in 1985, no fewer than 30 countries were involved in the agreements reached in that year. Most of them were negotiating sums that on their terms, and even on market terms, were quite significant. Rescheduling activity remained strong in 1986, which should surprise none of you who have read the *World Debt Tables* where we suggested, "in view of the slackening pace of global economic recovery in 1985-86, debt reschedulings and negotiated packages of financial support will be needed to prop up developing countries' external finances for several years to come." We also concluded that to ensure the continuing success of the "concerted financing" approach to dealing with debt-servicing difficulties, the official sector—by which we meant industrial country governments, their agencies, and the multilateral institutions—would have to do considerably more. That meant they would have to coordinate action both to supplement directly the funds available to developing countries, and to strengthen the resolve of the private lenders so that at least the minimum financing requirements of developing countries would be met.

## TODAY'S PICTURE

Partly as a result of rescheduling, there has been an extraordinary change in the growth of developing countries' indebtedness, which, since the Mexican crisis in 1982, has been rather slow. By our estimates, and allowing for the fact that we have not reached the end of 1986 yet, total debt will have grown only 5.5% a year since 1983. Long-term debt, which we associate with development financing, has grown somewhat faster than the total because in 1983-85 some $40 billion of short-term obligations had to be restructured into longer maturities under rescheduling arrangements. Notwithstanding this slower growth, the outstanding debt of all the developing countries still reached $950 billion at the end of 1985—four times what they owed at the end of 1975; by the end of 1986 the estimated debt of the developing countries will be $1,010 billion.

There is a mind-numbing quality to those sums. The outstanding debt is very large compared with the gross and net flows of lending that accompany it. We do not have comprehensive flow data for all developing countries and all liabilities, but for the 107 countries that report to the World Bank's Debtor Reporting System (DRS) new long-term lending has declined sharply over the past few years in the face of an expanding need of developing countries for external financial assistance. Long-term lending has fallen from its peak of $121 billion in 1981, to $92 billion in 1983, and to only $80 billion in 1985. These disbursements exclude rescheduling flows, which change the maturity of outstanding liabilities without providing new money. If we allow for the repayment of principal, the net lending from new long-term borrowings by developing countries has fallen from a peak of $75 billion in 1981 to $50 billion in 1983, then successively to $40 billion in 1984 and $30 billion in 1985. The IMF estimates in its *World Economic Outlook* that this declining trend of net long-term lending is continuing in 1986. A noteworthy fact, given the debt-servicing problems of developing countries, is that net lending from the private sector (mainly commercial banks) has fallen from something over $50 billion in 1981 to no more than $10-$12 billion in 1985. The outlook is for a similar net flow from private sources in 1986.

## INCREASED DEBT—FEWER LOANS

The build-up in debt and the increasing incidence of reschedulings as a means of financial management have resulted in an inevitable—in many cases, I think, a desirable—reduction of developing countries' dependence on foreign borrowing. The economic adjustment programs required of them were, in many cases, a recognition that these countries were relying too heavily on foreign resources to fill budgetary gaps or to try to meet balance of payments needs. But the fall has been particularly sharp for many of the market borrowers, where the decline of creditor confidence and the reluctance of banks to extend new credit have compelled countries into a prolonged deflationary posture that probably has not been in their own interests nor, ultimately, in the interests of the global economy. To compound the difficulty, the countries that have not been troubled by debt problems, particularly those in East Asia, have become very cautious about new borrowing. Those countries have reined in their investment and borrowing programs so that they too have contributed to a reduction in the overall buoyancy of the international economy.

Growth figures clearly show the impact of those policy changes, largely resulting from the debt situation and the difficulties countries have experienced in obtaining external finance. As a group, developing countries grew 6.6% a year during the boom period from 1965 to 1973, and they maintained their growth at 5.4% a year during the turbulent years from 1973 to 1980. Abundant financing was available in that period, the recycling era, which allowed developing countries to continue to invest heavily, thereby helping them to sustain their growth.

At the same time, recycling created the primary impulse for accumulating substantial external indebtedness. Most countries did not go out and borrow heavily in the national equivalent of adolescent fervor; for most, what now appears as irresponsibility was really a failure on the part of all of us to predict the second oil shock of 1979-80, and the subsequent three-year recession (the worst economic recession that we have experienced since the great recession of the 1930s) and its negative effects on developing economies. Those effects included high real interest rates, poor growth of export markets, weak commodity prices, and constrained official support, at a time when developing countries needed more financing from official sources. The combination of all these factors contributed to reducing the growth of developing countries to 2.5% a year from 1980-83—slower than their population growth.

## RECENT GROWTH TRENDS

There was a strong recovery of growth in developing countries (over 5.2%) in 1984, which coincided with the upsurge of the U.S. economy. The enormous expansion in U.S. imports allowed very strong export growth from developing economies, but, disappointingly, their growth fell with the deterioration in global economic performance in 1985 to only 4.3%. We could still be quite buoyed by this outcome, were it not for the fact that the principal reason for it was the extraordinary growth of the two major Asian economies, India and China, which have had no debt-servicing problems in the past 15 years. Excluding them, the remaining developing countries grew only 3.0% in 1985, down from only a marginally better 3.7% at the peak of the recovery in 1984. Those rates are far below what is needed to restore economic health to their economies and to reestablish their creditors' confidence in their economic management.

Hence, even though the growth of debt slowed, the developing countries' debt still averaged a third of their GNP in 1984-85—up from less than a quarter in 1981-82—and slow export growth in 1985, combined with depressed commodity prices, contributed to a rise in the debt-service ratio for all developing countries to 22%. The previous peak had been 21% during the crisis year of 1982.

The prospects in 1985 for restoring creditworthiness to developing countries were really rather bleak. The prolonged severity of financial problems has caused some observers to ask some fairly searching questions about the value of foreign borrowing and its contribution to economic development. There has been some loss of faith in the presumption that foreign borrowing necessarily promotes growth and development. At the very least, there has been a clear departure from the naive view that if some foreign capital is a good thing, then more foreign capital must be better. Analysts now are taking more measured steps to examine the terms—the interest rates, maturity structures, etc.—on which foreign resources are provided.

A critical reappraisal of the role of external capital in development seems a very worthwhile thing. But the fact remains that in capital-scarce economies—and developing countries are demonstrably short of capital—capital used wisely must have high rates of return. That has been the central tenet of the whole development effort since the Second World War. That does not mean, of course, that all inflows of goods and services supported by foreign borrowing are going to be invested wisely. Even when they are, they will not necessarily yield high enough returns to justify the terms on which the resources are borrowed. For example, a 20-year education program probably should not be financed by six-month commercial bank money. We know that the rates of return to education are high, but to service obligations in the short term, the terms of project funding must match the gestation period of the project benefit.

## GAINING ACCESS TO FOREIGN RESOURCES

There are three ways in which a country gains access to foreign resources. One is through grants—arguably the best way—and large amounts of development assistance have been in that form. More of it should be, particularly for the poorer countries of Africa. But countries can rely too much on grants by trying to invest more than their economies are capable of absorbing productively. A second way is through direct investment, mainly equity, although often some debt is involved in direct investment flows. In countries that welcome it, direct investment has always been regarded favorably because it is motivated by economic incentives, and there is a general presumption that if equity fails to generate high returns there is no drain on the economy. A third way to obtain resources is through long-term borrowing, either concessional (ODA) borrowing, both from bilateral and multilateral sources—or borrowing from non-concessional sources. In 1975, more than a third of total debt was on concessional terms; by 1985, less than a fifth of outstanding debt was on concessional terms. That change is partly a result of the upsurge in developing countries' access to private sources of funding. An alternative view is that it indicates the extent to which support from the official sector has lagged behind developing countries' financing needs.

## TRENDS IN LONG-TERM BORROWING

Non-concessional inflows of loan funds have tended to be mainly import-related and project-related. But increasingly over the past few years, program lending—essentially borrowing through syndications or through bond issues—has been employed to support the balance of payments or the central government's budget. Lending instruments generally are more diversified than the other two forms of external finance, and by far the dominant source of financing for resource inflow to developing countries has been net long-term lending. For countries such as Brazil, Mexico, and other major borrowers that have found the financial markets, often 75-80% or more of their annual net financing requirement over the past 15 years has been met by borrowing. Only the poorest countries provide an exception; for them, grants and concessional lending have split more equally in supporting resource inflows.

There has been a fall in the share of loans in the past three years, not because equity and grants have responded to developing countries' needs particularly, but because net long-term lending has declined. The average flow of funds to developing countries from equity and grants in 1980 through

1985 was about $24 billion a year, with a peak of $28 billion in 1981 when things were going well. By contrast, as noted before, net long-term lending provided $75 billion of the resource flow to developing countries in 1981, which was a fairly typical year in terms of the shares of capital from the different sources. So loan finance has been the predominant vehicle for resource transfer to developing countries, and in the foreseeable future there is no alternative to debt-creating flows if developing countries are to maintain their access to external resources. Developing countries do have a clear need to diversify their sources of external financing, which means that even within loan finance they should be looking at ways of borrowing other than going to banks. But with the existing prospects for aid and with the global economy as it is, long-term lending will continue as the primary source of external financing for developing countries for the next several years.

Part of the reason for that conclusion is the power of financial intermediation. The international financial markets are designed to take investible funds from people who save and to lend them to investors. As we saw during the recycling phase of the 1970s with its dramatic growth in offshore banking, the ability of the banking system to perform this function is unequalled. Borrowing from the financial markets is the easiest way for creditworthy developing countries to obtain external finance and, as they recover from debt difficulties, this probably will continue to be the chief way to finance resource inflows.

Perhaps we now think more about the old injunction to be neither a borrower nor a lender, given the problems that being a net debtor can cause; but we should recognize that the process of development and growth, bringing with it a greater degree of integration of developing countries into the global economy, itself would lead to an increase in gross indebtedness. As gross assets can rise along with liabilities, the net debt of the country may not increase, but from the viewpoint of the debt manager, who has to take care of the overall liability position of the country, the management of gross liabilities may be what is most important. As exports and imports grow, so too do the associated lines of credit, letters of credit, and so on that allow this process to progress smoothly. Similarly, as countries' requirements for liquidity, both in the central bank and in the banking system, expand with the volume of transactions they are funding, reserves accumulate and they are often obtained through borrowing.

## NEW MONEY CENTERS

As well—and this might not have been anticipated 15 years ago—a factor that has been extremely important in the growth of gross liabilities is the emergence of the offshore banking sector. Singapore, Hong Kong, and the Bahamas are examples of countries that have become money centers in their own right; but other developing countries also have regulations that encourage deposit-taking and onlending in foreign currencies by their own banks or branches of foreign banks operating from their economies. The level of gross debt and gross borrowing requirements can be very large compared with the associated net flows. To illustrate, the projections mentioned earlier pointed to a $60 billion net increase in developing countries' debt in 1986, which will raise the outstanding stock to around $1,010 billion. A net inflow of about $60 billion therefore requires that debt managers successfully juggle an outstanding stock of $950 billion. If we assume that the long-term component of that $950 billion is fixed, a net inflow of about $60 billion requires a total (gross) borrowing requirement in 1986 of around $260 billion. So if a country is relying largely on loan finance for its external resources, foreign borrowing and the resulting external debt will have to be managed very effectively to avoid the sort of economic dislocation that could erode the benefits from borrowing abroad.

## WHAT LIES AHEAD?

So far, events in the 1980s have two important implications for the future. First, developing countries are likely to continue encountering a shortage of external assistance measured against the investment needs of development; and, second, the effective management of foreign borrowing and external debt will become an even more important component of successful policymaking for development. We have seen the consequences of debt-management failures in the first half of the 1980s. As developing countries continue to borrow and become more integrated into the financial markets, their ability to manage external finance will become an increasingly important part of their overall economic policymaking in the years ahead.

## CONSTRAINED FINANCING

On the scarcity issue, the budgetary difficulties of industrial countries have added to other factors that were leading to a slowdown in the provision of aid to developing countries, and there are poor prospects for substantially increased levels of aid. (Somewhere down the road there could be more grants extended, associated with writing off some of the outstanding obligations of the very poor countries. In mid-1986, however, that is more wishful thinking than a reading of policy signs from creditor governments.) The slowdown in aid-giving also has had a pronounced effect on official loans. Bilateral programs have been slashed over the past three or four years; they are stagnant and unresponsive to developing countries' needs.

To a very large extent, the ability of the multilateral development banks to respond also depends on what governments are willing to provide through their aid programs. The experience of negotiating capital increases and additional subscription to the soft windows of these organizations has been discouraging. Developing countries cannot anticipate substantial additional help from the official sector beyond what can be provided from existing and known increases to resources.

Beyond the official sector, the key failure in 1985—the repercussions of which are going to be felt for the rest of the decade—was the inability to re-establish normal lending relations between the major borrowing countries and their private creditors during the economic recovery. For a period in 1984, many observers were ready to declare victory on the rescheduling front. The upturn of that year created the opportunity to restore the access of the major debtor countries—Argentina, Brazil, Mexico, Venezuela, the Philippines—to private sources of credit. Success during 1984-85 in orchestrating multiyear restructuring agreements for the major troubled debtors that were flexible enough to meet their demands for new financing and to restore creditor confidence would have made the problems of the "second tier" borrowers, such as Peru, Chile, and the Central American countries, as well as the very poorest countries of Africa, much easier to handle. In that event, the continuing problems of the major debtors hold center stage, with consequently reduced attention to the pressing problems of the smaller borrowers.

## THE "BAKER PLAN"

The result is that rescheduling is going to be part of doing business with the major borrowers for much longer than anyone would have wished. For that reason, the initiatives outlined by U.S. Treasury Secretary [James] Baker in Seoul were welcomed as concrete contributions to that process. Criticisms of those initiatives have been directed mainly at their limited financing provisions, but frankly, the initiatives do not depend only on money. The key consideration is to give confidence to the negotiating parties. Negotiation is essential to managing the debt problems of the major borrowers, and what Mr. Baker has done is to recognize explicitly—and to endorse—the value of the role being played by the steering committees of banks, and by the multilateral development banks. The role combines both lending and advice to countries that are implementing medium-term policy programs for economic adjustment with the promise of economic growth. The Baker Plan was a very welcome development during 1985, not because it offers a prospect of large amounts of additional funding to developing countries, but because it commits official support to a negotiated solution over a long enough period and with sufficient external financing to allow countries to rebuild debt-servicing capacity. Some banks, weary of negotiating, were becoming extremely reluctant to continue participating in a process that is essential to resolving debt problems satisfactorily.

## INVESTMENT PROSPECTS

In contrast to lending, the prospects are reasonably good for an upturn in direct investment, but direct investment realistically can meet only a small part of developing countries' overall financing needs. Also realistically, at a time when developing countries' economies are not performing well and when the global economy is growing slowly, entrepreneurs are not likely to be willing to invest large sums of risk capital. That will only happen when the prospects for profitable investment are good. I expect a fairly strong recovery of direct investment flows in the 1980s (perhaps to levels comparable to the 1960s) if only because real interest rates are not likely to be negative for a long period as we saw during the 1970s. In the 1970s, if you could do it, borrowing from the markets was much cheaper than the return required to attract equity. The prospects for equity investment are therefore rather good in the 1980s, but only as good as the underlying economic environment will permit.

## RESTORING GROWTH AND CREDITOR CONFIDENCE

In the short-term, the clear priority for developing countries is to reduce the growth of debt relative to the growth of exports and their economies. This will allow their debt-servicing capacity to expand. Rapid export growth is also the principal ingredient in restoring the confidence of private creditors; unless they see developing countries' exports growing rapidly and the debt-servicing situation easing, banks are unlikely to want to lend to developing countries.

Creditor confidence is of the utmost concern in managing external debt beyond the short-term aims of the 1980s. A country that relies on foreign resources is going to be a borrowing country, and a borrowing country will have to manage its debt effectively to avoid the costly economic dislocations endemic in the late 1970s and early 1980s. That can happen only if creditors have confidence in the borrower's economic performance. When countries are forced into continuing debt renegotiations, debt probably does become a foe of development; the demands of external payments become the focus of all economic policymaking. This was apparent in Latin America over the past few years.

A further lesson is that private market funding is no substitute for aid. Commercial banks are not development agencies; treating them as if they are will be very costly if it causes debt-servicing problems that disrupt access to finance. When this happens, not only does the inflow of resources stop, normal commercial financing relationships necessary for trade also are interrupted.

## THE NEED TO MANAGE FOREIGN DEBT EFFECTIVELY

All of this brings me to my promised final point: the need to manage foreign debt effectively. The real enemy of development is not foreign borrowing; it is mismanaging the debt. Managing debt effectively means that the economy can use external resources to sustain economic growth and can service its debt without disruption. To allow this, the debt stock must have certain characteristics—of maturity structure, of interest rate level and type, of currency composition, and so on. If a large share of the debt is maturing in the near term, or if a very high proportion carries variable interest rates at a time when interest rates increase sharply, or if a large share is denominated in yen just when the yen is about to appreciate by some 60%, the potential for debt-servicing problems increases. The level of borrowed resources may be appropriate in a policy sense, but the form of the borrowing may create problems because its characteristics make it unmanageable.

Debt management involves three interdependent and interrelated functions. The first is to determine how much a country can and should borrow. That is the essential policy decision; it can be made at the level of how much the government should borrow, but I think of it more broadly as how much the economy should borrow. Allowance must be made for what private borrowers will do. The second function of debt management is to determine how the country will borrow. By that I mean the identification of sources from which a country can obtain finance, and then the techniques through which it approaches those sources. Finally, a country must have the capability to keep track of what it borrows. A country has to be able to monitor its debt if it is going to make sensible borrowing and debt-management decisions. Policymakers and financial market managers require adequate knowledge of the country's overall external financial situation. Billions have been borrowed by some countries, without their major economic managers' being aware of what was happening. One of the World Bank's hardest tasks is to convince governments that they cannot make sensible borrowing decisions if they do not know the status of their external debt.

How much a country should borrow depends, of course, on the terms on which it can borrow. If a country can borrow only on market terms, it probably should not borrow as much as if it can obtain bilateral credits on concessional terms. Good information about the availability of finance from different sources helps a debt manager to plan an effective strategy. Good information does not guarantee good debt management, but bad information virtually ensures that debt will be managed badly.

## IN CONCLUSION

External debt and foreign borrowing cannot be regarded as foes of the development process if foreign resources are regarded as contributing importantly to developing countries' growth. I for one am convinced that this is the case; there is no substitute for long-term borrowing to supply the external resources required to promote developing countries' growth and development. The enemy is mismanagement of external borrowing and debt, stemming principally from poor overall management of the economy. The extent to which external borrowing is a friend of development must be hedged, however, because of the complexity of the task that debt managers face. Let me conclude, therefore, by saying that perhaps we should regard external debt and development as sparring partners rather than foes. Treated respectfully, external borrowing contributes much to resolving the problems of development and to enabling an economy to achieve its full potential, just as working with a sparring partner can sharpen the performance of a boxer. Casual treatment, however, creates the risk that the sparring partner—as happened in the economic context in the 1980s—will land an unexpectedly devastating punch.

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