

Paris Club Debt Relief, Multilateral Frameworks and Implications for Poor Country debt

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Given that the ultimate goal of debt stock and debt service reduction operations is to completely overcome the debt overhang, and allow debtor countries to proceed on a path that allows them to meet future debt service without compromising on their development agenda, Paris club and multilateral initiatives can be construed to have set the pace for an agenda that requires further development.

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ABSTRACT

This paper examines economic rationale and efficiency effects of proposals directed at alleviating debt problems of poor countries. Key to the investigation is determination of whether proposed mechanisms tackle fundamental causes of the debt crisis.

The paper finds that despite the enthusiasm for debt relief, the major proposals have not tackled issues central to debt problems of poor countries. The Baker plan and Schumer Watkins plan targeted wealthier debtors in Latin America who threatened integrity of the international banking system, while the Bradley Plan failed to identify who was going to bear the cost of the debt write relief.

Proposals of the Brandt report calling for global correction of imbalances in the international economic system [also echoed in Mitterand and Lawson proposals] addressed resource needs of poor countries, but simply failed to get international consensus. Lopsided commercial debt concerns of the Brady Plan have also eluded poor economies the bulk of whose debt is multilateral.

By rescheduling small amounts of debt at market interest rates during 1980's high inflation, Paris Club relief under "Toronto Terms" and "London terms" also failed to ameliorate poor country debt. "Naples Terms" innovatively offered deeper relief, but most poor countries were ineligible as a result of a large part of the debts of being multilateral. By providing funds to buy commercial debt, the *IDA Debt Reduction Facility* of the World Bank similarly eluded poor states.

However, by increasing multilateral financing under SAF, ESAF at a faster pace the IMF has substituted the drop in bilateral assistance, and also facilitated debt stock restructuring. By disbursing IDA credits and resources of the Fifth dimension program the World Bank has also strengthened the move towards greater concessionality.

However, preponderance of exogenous factors that constrained export performance, lack of sustained economic reform, and factors constraining the ability of poor economies to realise their full potential, multilateral debt service demands are rising in relation to exports.

Poor countries always have the 'willingness to pay' but the fact that a large share of new multilateral disbursements is merely being recycled into multilateral debt service while demands of the development program are not met in full is affecting their 'ability to pay'. The challenge facing the bilateral and international financial community is to extricate poor countries from the multilateral debt trap.

INTRODUCTION

As a subject, foreign aid has brought more controversy unrivalled both in theory and practice by any other branch of economics. On one hand, foreign aid is construed in the altruistic context of industrial countries assisting their poorer counterparts to achieve higher rates of economic growth. This is on the premise that high growth in poor countries is key to alleviation of world poverty and, therefore, a source of sustainable growth of the world economy (Bird, 1998).

Thirwal (1987) exemplifies the role of foreign aid in relaxing domestic savings and foreign exchange constraint of poor countries on the premise that most poor countries exhibit chronically inadequate capacities for domestic savings thus undermining the achievement of high investment rates. The significance of investment as a precondition for economic growth is stipulated in the Harrod-Domar Model (Todaro and Smith, 1980; Thirwal, 1987)

A very popular caveat among aid researchers is the view that since technological innovations needed for development of secondary industry are likely to be imported, inadequate capacities for foreign exchange generation justify the role of foreign aid (Todaro and Smith, 1980). The rationale is that since most poor countries do not earn adequate endowments of foreign exchange to finance imported investment, weak export capacities are identified as a secondary constraint (Thirwal, 1987).

Apart from supplementing savings and foreign exchange inadequacies, aid is also assigned the propulsive role of regenerating domestic capacities for savings and also for exports with a view to eventual narrowing of the gaps. Aid is therefore presented in the finite context, allowing systematic reduction of dependence on external financial flows overtime.

In fact, a stylised long run pattern for aid and development anticipates that net recipients of external assistance will meet domestic and foreign investment resource demands in full, and also generate surplus resources to meet future obligations for debt servicing.

However, external debt stock escalated to unsustainable levels without corresponding advances in economic development. The oil crisis that started in 1973/74 [and resulted in quadrupling of prices by 1980] had triggered such worldwide inflation that savings in poor countries deteriorated, thus widening the domestic savings-investment (S-I) gap.

The resultant deterioration in the balance of payments also widened the external import-export (foreign exchange) gaps.

The fact that developing countries resorted to rolling over their debts; contracting new loans to liquidate maturing loans, and in some cases, contracting entirely new loans to service interest only exemplifies the worsening external debt scenario in poor countries. In contrast to the stylized reduction in external resource dependence, western bankers ignored signals of an imminent debt default and remained more than willing to refinance maturing loans with shorter maturities (IMF, 1984).²

Mexico's unilaterally announcement of an immediate moratorium on foreign currency debt in August 1982 exemplifies total collapse of the aid-development paradigm. Four more countries had to postpone amortization payments while servicing interest only between 1975 and 1980.³ By 1983 the number of countries defaulting on their repayments reached twenty-one.

In this analysis of debt relief for poor countries, attention focuses on rationale for formulation of measures to ensure that debts were repaid to safeguard the integrity of the international financial system, but without compromising the financing of development in poor countries. Formulation of debt relief has been largely inspired by various analyses of the primary causes of the debt crisis itself that is a subject of controversy.

This paper examines various hypotheses on evolution of the debt problem and also evaluates theoretical propositions that influence proposals for debt relief. The paper also examines economic and political interventions presented in the context of debt relief, chief among them the Baker, Bradley, Baker, Lawson and Mitterand proposals and evolution of the Paris Club, traditional debt relief and the birth of HIPC. The main thrust of the research is to evaluate the economic efficiencies of proposed mechanisms for debt relief.

² Meanwhile, third world debt snowballed from \$130 billion in 1973 to some \$612 billion in 1982

³ Mexico made the announcement after it had failed to raise a large enough loan to repay external debts that were falling due

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Chapter 1:

ANATOMY OF THE DEBT CRISIS

Theoretically, formulation of debt relief has been largely inspired by various hypotheses on primary causes of the debt crisis itself. Despite the lack of consensus over the main causes of the debt problem, a consensus exists, at least, to the extent that optimal debt relief should include 'stock and flow' operations ensuring that developing countries meet debt service obligations without unduly compromising economic growth. A second condition of the international consensus is that borrowers must contribute to security of the international financial system to safeguard new inflows required to sustain the development process in future.

Sources of the Debt Crisis

Borrowers persistently claim that lenders brought the crisis upon themselves and therefore advocate outright debt stock cancellation. However, lenders insist that borrowers committed themselves to international finance covenants that must be honoured; otherwise there is a moral hazard that new loans will not be repaid in future if current debts are cancelled.

Some researchers attribute the debt crisis to oil price inflation that triggered deflationary policies as a response from the developed world, particularly the rise in interest rates. An extension to this argument is that donors have a duty to get the world environment right so that developing countries can prosper. This is in the context of the argument that international economic relations between industrial economies and the third world are not reciprocal; hence The main thrust of this argument is that; as a result of their robust capital stock industrial economies were able to ride out of the oil crisis while poor countries accumulated debts.

Another set of arguments derives from perception that the debt crisis is another trough in the business cycles that characterize the world economy. For example, in his Financial Instability Hypothesis, Minsky (1992) sustains the view that the commercial nature of debt and inherent instability of world capital markets are such that cycles of boom and bust should be expected to occur.

Da Costa e Silva (2000) and Eichengreen and Wyplosz (1996) echo this view, advocating a need for industrial economies to monitor and regulate the flow of funds to developing

countries to match their requirements for development [as defined in the dual gap model] with developments in their capacity to meet external debt obligations.

While Minsky identifies a need for critical lending, Eichengreen stretches the arguments to emphasize the role of economic reform in spurring growth in poor country economies with a view to enhancing their debt service capacities.

However, Sachs and Radelet (1998) dispute the entire concept of lending-debt crisis paradigm, arguing that the real crisis was precipitated by irrational sensitivity of western financial institutions by virtue of the immediate closure of all financial markets to the economy of Mexico and other defaulting countries. They argue that developing country economies are fatally dysfunctional with long standing ills that are merely concealed by capital inflows, and that the effect of unilateral lender action is to cause financial panic resulting in collective withdrawal of creditors which brings about a capital reversal, as later witnessed in Argentina in 1995 and East Asia in 1997.

This interpretation suggests that it is wrong to ask a debtor to take blame when a debt crisis takes place partly because the failure of a loan usually represents miscalculations on both sides of a transaction or other distortions to the lending process itself. This analysis supports the view that an imminent debt problem requires mutual cooperation of the lenders and the borrowers to avert a crisis, otherwise unilateral behaviour of lenders displays elements of a self-fulfilling crisis.

The resultant financial panic in the banking community is not entirely irrational because each lender will be seeking to protect their interests. However, the collective effect of herd behaviour is to prolong the economic contraction. The insights of Sachs and Radelet (1998) introduce another dimension to the definition of an international debt crisis as the outcome of continued demands for repayment of outstanding loans at a time when an economy [that is a traditional recipient of large-scale capital inflows] is not receiving new inflows.

The views outlined above demonstrate concerns of poor nations with external debt as a constraint to development, but the view of creditor banks, multilateral agencies and developed country governments is manifestive in the threat that non-repayment of maturing loans pose to the international financial system (Sachs, 1989). As fears of an international banking crisis mounted, the stance of creditor governments was to downplay debt relief and, instead pressurise debtor countries to remain current on their interest servicing (Sachs, 1986).

Scope for Debt Relief

These events signalled that some mechanism was needed to restore debtor-creditor relations to normality and also give some direction to the future of international development finance. Since the 1980's, a number of over-simplified formulations have been proposed, but the debate is continually revolving as the debtor countries and creditor countries each pursue their individual vested interests. But while the main issue of what constitutes the most appropriate mechanism for debt relief has still not been addressed to a satisfactory conclusion, it is - nonetheless - correct that both sides are keen to neglect the more historical record, and generally accept debt relief as a catalytic concept shifting debt management policy from the historical experience of default to a new framework of a mutually negotiated resolution of the debt crisis.

The nature of relations between debtors and creditors in an environment of debt servicing difficulty has naturally been underlined by implicit or explicit unilateral threat of default by the debtor while the creditor obtains comfort from the contractual obligation of the borrower to repay. While it is difficult to disentangle whether it is the threat of outright repudiation by debtors or the unwillingness of creditors to grant realistic debt relief that generated a whole range of "re" words such as refinancing, rescheduling, restructuring, renegotiations, the consensus is that intervention has facilitated a new area in which the instabilities of the 1930's can be avoided.

Chapter 2:

THEORETICAL AND EMPIRICAL PERSPECTIVES

Liquidity or Solvency?

Policy discussions on debt relief have been centred on whether the debt crisis is a problem of liquidity or solvency. Contrary to the belief that the debt crisis underlines widespread insolvency in developing countries, Kletzer (1998) argues that developing countries are clearly solvent (able to pay) but merely unwilling to pay. The test of solvency is established by the fact that the present value of their prospective resources (discounted value of real output) was many times greater than debt obligations.

Thus if EDT represents debt stock and PV is discounted future payments, then solvency represented by $S > 0$ because $PV - EDT > 0$.

$PV = \sum GNP_t / (1+r)^t$ (from $t=1 \dots n$) where n is the maximum amortisation period for debt, and r is the applicable average rate of interest on the entire debt stock

Kletzer attributes the failure of countries to pay to the fact that sovereign immunity places debtor countries beyond the reach of legal sanctions normally affected to compel payment from domestic debtors. In this case, debtor countries find it in their interest not to comply with payment obligations. Kletzer's view, which has gained widespread influence on debt literature, is that the real problem regards 'willingness to pay' and not 'ability to pay'.

However, Schmidt (1965) holds the opposite to the views of Kletzer. He argues that countries always have the 'willingness to pay' and that by agreeing to reschedule, debtor countries concede that they have a liquidity problem that affects their 'ability to pay'. The view is Schmidt is that countries require continued assistance so they can rebuild the foreign exchange generation capacity and pay at a later date. However, interpreted differently, the policy of offering new money whenever a debtor threatens to default is itself an incentive for debtors to increase threats in order to gain increased financial assistance.

However, Kletzer has the support of Aliber (1980) who finds - in his analysis of external debt of poor countries - that very few of the developing country debt crises have

escalated to a solvency problem. The view of Aliber is that further disbursements are required to overcome the debt crisis.

However, Agenor and Montiel (1996), observe a serious aggregation problem in the studies of Kletzer in which developing country resources were treated as if they were public sector resources. From a disaggregated perspective, Agenor and Montiel argue that while debtor countries may be solvent, debtor governments were not. This is derived from the empirical fact that - at the onset of the debt crisis - 71% of medium and long-term debt of developing countries was either a direct liability of the public sector or had the blessing of a public sector guarantee.⁴

Thus if EDT represents debt stock and PV is discounted future payments, then solvency represented by $S < 0$ because $PV - EDT < 0$.

$PV = \sum PFB_t / (1+r)^t$ (from $t=1 \dots n$) where n is the maximum amortisation period for debt, and r is the applicable average rate of interest on the entire debt stock

The main argument of Agenor and Montiel warrants replacement of GNP with PFB (primary fiscal balance) because a generalised fiscal perspective of the debt problem potentially eclipses the fact that the public sector's claim on national resources is limited to fiscal revenue, as a proportion of national income.

Thus, while not emphasizing that poor countries are insolvent, Agenor and Montiel suggest the problem is one of liquidity. Kletzer case for debt relief is that poor countries require only new inflows to finance repayment, but the view of Agenor and Montiel is that while needing cash to improve their liquidity poor countries need to embark on major reforms that aim to enhance their productive capacities and therefore generate additional fiscal resources.

Timing of Debt Relief

The arguments of Agenor and Montiel introduce another dimension to debt relief, in the context of whether it should precede or be an integral part of structural adjustment, or follow thereafter. There is a rising constituency of support for the argument that debt relief should precede adjustment because improving domestic fiscal austerity merely for the sake of accumulating resources for debt service could potentially inflame political

⁴ See World Debt tables, Highly Indebted Countries: share of Public and Publicly Guaranteed Debt in Total Debt, World Bank 1989

and economic instabilities the consequences of which might worsen the capacity for debt service. This would be self-defeating and detrimental to the interests of creditors.

In fact, Krugman (1986), demonstrates that a heavy debt burden acts as a high marginal tax rate on the benefits of economic adjustment in a sense that the savings of fiscal austerity actually accrue to foreigners (creditors). He presents a case demonstrating that partial debt relief can be Pareto improving (beneficial to creditor and debtor alike) by improving the incentive for the debtor country to undertake needed adjustments to enhance ability to service debt in future. Krugman also presents a paradigm of debt relief as a supportive measure to moderate regimes that are willing to carry out reforms while paying some of the debt.

Some researchers argue that both debt relief and opening up of industrial country markets must precede adjustment. Their argument is that the prospect of increasing exports to generate funds for debt servicing is not compatible with protectionist trade regimes that aim at safeguarding domestic interests among industrial nations. The main argument is that domestic commitment to reform cannot translate into desired results while the fundamental constraints prevail. On the contrary, these countries suffer consequences of undertaking appropriate measures. Devaluation provides a key example of a policy that fails to raise export revenues while escalating costs of production.

Despite the veracity of these arguments, creditors maintain that debt relief is not an absolute guarantee for improved economic performance. They remain sceptical about the value of debt relief despite the belief that an existing debt overhang serves as a disincentive to policy reform as argued by Krugman. Creditors argue that apart from the tenacity of certain powerful regimes, other disincentives have the potential to slow the pace of economic policy reform after debt relief has been granted.

As argued in Woodward (1995) and also Bokkerick (1996), creditors believe that poor countries face other impediments that continue to militate against investment after debt relief has been granted. The interpretation of these arguments is that the natural instinct of creditors is to regard debt relief as throwing away money, or at least making a sacrifice when there is still the prospect of repayment. The compromise to these arguments is to make debt relief conditional upon specific economic reforms on the principle that the failure among poor countries to attain high rates of growth and export expansion is a result of structural rigidities that need to be overcome.

The Creditors' Blame

Debtor countries have attempted to argue that the debt crisis is a shared problem. They attribute astronomical increases in lending to a careless obsession that had become fashionable in the western banking system. These arguments are exemplified by the fact that a successful deal was often followed by a lavish cocktail in the most expensive of Ritz or Claridges, while the newspapers maintained league tables ranking banks in terms of their exposure to the third world countries as a measure of their outward strategy. Small banks often craved for inclusion in syndicated deals contributing smaller proportions seeking that the international glory that went with lending business rubs on them.

The obsession is also exemplified by the fact that, in some western banks, it simply became the practice for banks to accept parts of a syndicated loan over the telex; without the necessity a new credit analysis. Bank applied immense efforts selling loans to the developing world and went to the extremes of borrowing dollars on the international markets if or when their own central banks failed to provide them as lenders of last resort.

BOX ONE: CARELESS LENDING OBSESSION

One outstanding example of what could clearly be perceived as reckless lending was the joint venture involving an American Bank and French Bank that opened representative offices in Gabon in the mid 1970's. At the end of one year the office had advanced \$600 million in officially guaranteed export credits and \$679 million in syndicated loans. The projects undertaken included a highway linking the airport and the Presidential palace, a flurry of hotels with occupancy below a seaside resort in mid-winter, a fleet of commercial jet aircraft, enlarged government buildings and one of the world's least economic railways constructed against the advice of the world bank.

The implied view of the lenders was that sovereign debt was safe irrespective of what the loans were used for. The euphoria in the banking system translated into an 'uncritical herd instinct' with banks feeling a false sense of comfort through syndicated lending as a team and sharing the risks. The fact that banks were always willing to

refinance debt including interest due to a bank that was pulling out, underscores the level of insensitivity compelling banks to hold on to their clientele while rolling over debt as the borrower country wished.

Economic Policy Failures

The apparent failure of adjustment policies to lift poor countries out of poverty is also becoming significant as a basis for debt relief claims. Mosley (1996) specifically points at the fact that aid flows have done little to stimulate development in Africa while total debt stock has continued to accumulate. Despite a rise in external flows to GNP ratios from 3.1% during 1969-76 to 11.5% in 1993, growth of per capita incomes continues to decline in Africa (World Bank, 1995; OECD, 1977).

Mosley (1996) finds that even when other determinants of growth are held constant, the partial regression coefficient of aid on growth in Africa remained negative, whereas it is positive in other continents. The fact that since the 1980's lending to Africa has been largely policy based, suggests that lenders have much more to blame for policy failures which stalled economic growth while poor economies continued to accumulate debt.

Easterly (2001) introduces a growth-implosion debt-explosion paradigm based on the principle that worsening indebtedness in poor countries has, in fact, arisen from the fact that between 1971 and 1982, economic growth had stagnated in developing countries. The rise in external debt is, in fact, only 19% per annum in nominal terms, while real growth is only 12%, if the approximate doubling of the price level in the USA is taken into account. Easterly's hypothesis is that external debt accumulation, *per se*, must be exonerated, as its stock was never extraordinarily high. In fact, at the climax of the debt crisis external debt was only 24% of GNP and 111% of exports (Sjaastad, 1983).

Financial Oligarchy and Debt

Some researchers argue that the outstanding stock of debt does not reflect the amounts that were actually lent out to poor countries. The fact that total external debt of developing countries rose by 600% between 1971 and 1982, while debt service rose by 1,100% is used to advance the argument that repayments have exceeded the amounts originally borrowed in the first place.⁵ Using the 1971 ratio of debt service to debt stock, it can be shown that debt service would have been \$63 billion rather than the \$98 billion paid in 1982. The difference of \$35 billion arose largely from rising interest rates attributed to the economic ideology of monetarism.

⁵ Calculated from Table 1 and 2, of 1982 survey : External debt of developing countries, OECD Secretariat, Paris, 1982.

This strand of debt relief is premised upon the fact that high interest rates in the late 1970's and early 1980's resulted from intensification of fiscal deficits in industrial countries. As a result interest rates had escalated to 15-20% by 1980. High interest rates magnified debt service obligations of poor countries and also diminished industrial country demand for their commodity exports resulting in price deflation.

To a significant degree, poor countries paid the price for measures that industrial countries adopted to ameliorate their economic problems. It is logical that debt relief is undertaken as a matter of reciprocation. The industrial countries also have a moral duty to assist their poor counterparts to emerge from debt problems so that the world economy can be regenerated. In the absence of appropriate considerations the economic stress exerted on poor countries by interest rates amounts to an international subsidy.

According to the OECD the ratio of debt service to external debt for all developing countries rose from 12.2% in 1971 to 17.1% in 1978 and 21% in 1982. The share of interest was more or less constant at 30%, and it actually did rise to 45% by 1982. The fact that between 1970 and 1980, nominal debt service rose at the annual rate of 25% (or 17% after adjusting for US\$ inflation) is sufficiently alarming. **The debt crisis therefore seems to have** its roots not in the level of debt, but the enormous cost of servicing it, which is closely attributed to economic conditions in the developed world.

A further argument is that the fact that lenders (especially banks) are still solvent after developing countries have shown a clear inability to pay suggests that creditors had cushioned themselves sufficiently during the rise in monetarism. It will therefore be in the interests of the world economy for creditors to relieve debtors of interest obligations that fell into arrears during the period of distress. External debt is a financial asset whose transaction value is much less than its current face value.

Politics and Debt Relief

Helleiner (1989) simplifies debt relief as a political problem requiring a mere political decision. His argument is that since the debt problems of the lowest-income countries relate primarily to official rather than commercial credit, the provision of debt relief should be under taken at a political level. Helleiner contends that since there are no secondary markets in which official debt can be traded, donor and recipient governments do not have to search for a market-based solution.

Helleiner also argues that since the liquidity effects of grants are not different from debt relief among debtors, and creditors do not have to make disbursements under debt relief, then debt relief should be provided. The French government is cited as one creditor that responded to demands for debt relief by offering grants, while the US government that has been very reluctant to provide debt relief has also resorted to grants. The provision of grants while debt remains unaddressed stores up the debt overhang for the future and may abort sustained recovery at a time when Africa's development prospects could be much brighter.

Helleiner also contends that the quality of new aid may be much lower, with higher accompanying transaction costs, than from mere debt relief which is a book transaction. As a proponent of outright debt relief, Helleiner also contends that a succession of "short leash" debt restructuring exercises consumes inordinate proportions of the time and energy of key African technicians and administrators.

As much as there is consistency in the need for debt relief, the diversity of diagnoses for the debt crisis seem to explain why a range of proposals exist on the subject. Disagreements of the timing of debt relief similarly influence policy issues at the centre of adjustment and the debate on trade concessions. Central to final resolution of the debt crisis are the perceptions between creditors and debtors and their role of cultivating the needed cooperation. The controversy in this context depends on whether creditors accept blame for loose lending and policy failure and whether borrowers also accept blame for excessive borrowing and macroeconomic mismanagement.

Chapter 3:

NON PARIS CLUB DEBT RELIEF

The first attempt at a systematic approach to the debt problem is traced to James Baker, then Secretary to the US Treasury – under Ronald Reagan – at the peak of the Latin American debt crisis in 1985. By this time bank lending to Latin America had fallen to a mere one third of the levels in during 1979-81 period. There was also latent danger that distressed nations would not even be eligible to borrow to service interest on outstanding debt. Declining export revenues underscored the extent of the predicament.

The Baker Plan

The Baker Plan advocated increased bank lending by \$20 billion. The World Bank and other multilateral finance institutions were also to increase their lending by 50% to a target of \$9 billion. Under these proposals, \$2.7 billion of IMF money was to finance new flows to the poorest countries mainly in sub-Saharan Africa.

The Baker plan undermined itself as a global remedy because increased lending was to target the fifteen largest debtors, among which application would also be on a case-by-case basis. Most debtor nations were also not prepared to submit to stricter adjustment conditions and the amount of only \$9.3 billion per annum for three years was considered miniscule in relation to debts that encompassed the crisis.

| | NET BANK LENDING | | |
|------|------------------|------|---------|
| 1981 | \$ | 30.5 | Billion |
| 1982 | \$ | 12.1 | Billion |
| 1983 | \$ | 7.8 | Billion |
| 1984 | \$ | 5.7 | Billion |
| 1985 | \$ | 1.3 | Billion |
| 1986 | \$ | -0.5 | Billion |

The impasse brought about by the Baker plan unfortunately sustained the continued strategic withdrawal of banks while reinvesting elsewhere. By the end of 1986 they had only lent 25% of their commitments in 1985 as reflected in Table 3.1.

The main weakness of the Baker Plan seems to have been its failure to concurrently address the problem of reducing existing debt stock. The plan neither provided comfort

to lenders nor did it provide more resources to developing countries. As a result, Banks continued to fear the possibility of collective repudiation.

To some extent the Baker Plan worsened the debt situation as developing countries resorted to borrowing in short term trade credits to finance long-term uses. Short-term credits accelerated to account for 50% of total foreign debt that carried higher rates of interest and shorter repayment periods. However, the Baker Plan set the tone for future debt relief for its implied acknowledgement that the debt problem could not be left to the market alone.

The Bradley Plan:

The Bradley Plan proposed that banks and creditor governments should discount all debts by 3%. The Bradley Plan further proposed that for one year only a concession should be provided through a discount on interest rates by 3%. The Bradley Plan, however, failed to address the question of who was going to bear the cost of the debt write offs. To that extent, the plan is credited for proactively bringing to the fore a potential problem of debt relief that was to haunt the international community into the millennium.

By raising the gross discount on their debt stock to 9%, for countries prepared to follow IMF policies, the proposal seems to have recognised the need to incentivize economic reform although few countries accepted debt relief on such terms.

Schumer Watkins Plan:

More radical suggestions emerged from a joint proposal of Congressman Charles Schumer and economist Alfred Watkins. Their proposal acknowledged that 70% to 80% of the existing debt was simply accrued interest, and not money that had directly been borrowed. The plan therefore proposed that banking law be changed so that interest paid by money that had been borrowed from the same bank should not be classified as part of profit.

The S-W plan recognizes debt accumulation as a consequence of wider recognition of interest as income, thus compelling banks to reclaim all kinds of interest due for purposes of enhancing their corporate standing. The aim was to undermine profitability of the process of refinancing overdue interest and also incentivize banks to reduce levels of interest rates so that debtor countries can pay without taking out new loans.

The Mitterand Plan

The Plan outlined by President Mitterand of France in 1986 adopted perspectives similar to those contained in the Brandt report calling for a powerful global institution to rectify existing imbalances in the international economic system. President Mitterand conceived the notion of a Marshall Plan for the Third World to facilitate capital redistribution on the scale of the world economy.

The plan was based on an increase in aid disbursements from 0.35% of rich country GDP to 0.55%, in the interim period and eventually rising to 1% of GDP. The fact that this was to result in the transfer of between \$35 billion and \$70 billion to the developing world underlines its own failure for placing high demands on the rich countries.

Lawson Proposals

In 1987 the British Chancellor of the Exchequer Nigel Lawson, promulgated the very first plan that focussed on Africa's least developed countries. He proposed the conversion of all bilateral loans to grants, retroactively, and that much longer periods should be allowed on all other official debts e.g., exports credits. Nigel Lawson also suggested discounted interest rates by 3% below the market rate.

The Lawson proposals recognize that since there was no realistic prospect of repayment if interest rates remained unchanged, the accumulated arrears of interest rates was already a foregone cost. However, to ensure that lenders did not think of the write off as throwing money away eligibility to Lawson concessions was conditional upon acceptance of IMF macro economic management guidelines and programmes.

The significance of Lawson concessions was its coincidence with the Sahelian famine that had been more visible than the problem of Latin America. Despite 18-month of lobbying for support especially - for the poor nations of sub-Saharan Africa - Germany flatly refused to support the proposals while the United States was more interested in resolving the Latin American debt crisis on the basis of the Baker Plan.

The Lawson concession was largely smothered by popularity of debt-equity swaps in the United States since government had to resort to this aspect of the Baker menu of options after banks had appeared very reluctant to co-operate with large amounts of

proposed lending. In fact, the popularity of debt equity swaps provided the impetus for further innovations into exit bonds, buy backs and the novelty of debt for debt swaps.⁶

Banks and investors generally acceded to debt swaps, but since poor countries faced the difficulty of raising the local currency macro management weakened. In Brazil debt equity swaps were instrumental in cranking the economy towards hyperinflation as a result of printing money. In retrospect, the \$10 billion concluded in debt swaps was so insignificant it only amounted to debt stock reduction by 1%. This was largely occasioned by the fact that the number of private sector companies and levels of intended investment did not match the level of bank debts.

Variations of debt swaps also extended to 'debt for nature' largely advocated by the US pressure group Conservation International. A total of \$650,000 worth of Bolivian debt was sold for \$100,000 in exchange for creation of a 1.6 million ha conservation zone. In the Beni Forest, Peru also formulated the concept of debt for drugs for consideration by the American government.

A very important innovation of the Baker Plan was 'Exit bonds' that became popular as an instrument for enabling banks to quit the process, by cashing in their debt for bonds, which paid less than the former debt. The consolation was that payment was made at once. The debt buy back system was later adopted by nations that bought their own debt at a discount on the secondary market while the debt for debt swap served as a way of switching debt into long term bonds held by the creditor bank.

The Brady Plan:

Against a background of piecemeal debt swaps, the new US Treasury Secretary, Nicholas Brady outlined plans for a framework that introduced the concept of 'debt forgiveness' for the first time. The plan proposed reductions of debt stock, using public money (disbursed through the channels of the World Bank and IMF) to encourage banks to accept the face value of their debts.

The Brady Plan recognised that existing debt could not be serviced on its original terms with claims in excess of the present value of expected future debt service payments. The Brady Plan proposed changes to US banking law to remove disincentives for debt

⁶ In the debt equity swaps commercial creditors would sell their debt denominated in US dollar to buyers on the secondary debt market at a discount. Most often the buyers were investors in developing countries who would sell the debt to the domestic government in local currency to finance his purchase of shares. Debt equity swaps were a principal device in facilitating debt reduction and 1988 had swapped some \$10 billion

reduction. The Plan also proposed the scaling down of claims by writing down debts to more realistic values, using market determination.

For the first time, Brady proposals sought Japanese involvement to enhance participation in the proposals. This was in view of the significant role of their Banks in international lending operations. The plan also replicated the case-by-case approach and adherence to IMF policies.

The rationale of the plan was to require debtor countries to negotiate with their creditors offering a menu of other financial assets to replace existing liabilities on clearly laid down terms. The menu included fixed rate bonds, variable rate bonds, new money, etc. Brady bonds was the term used to describe the new menu of assets offered to creditor banks, in some cases requiring debtor countries to purchase zero-coupon US Treasury bonds as security for repayment of principal. Blocked deposits were also maintained at the New York Federal Reserve Bank to secure payments of interest. The funds for these new claims were obtained from debtor countries' own reserves or through loans from international organisations or bilateral donors.

During the consolidation period of the Brady Plan (March 1989 - May 1993) 12 developing countries restructuring debt to commercial banks under a framework laid down by the plan. Debt reduction was achieved through repurchase of debt at less than face value (debt buybacks), exchange of loans with bonds at discounted face value but serviced on market terms and exchanges of loans for bonds at par but serviced at below rates ruling on the market. Restructuring proposals also included placement of collateral as up-front payment of debt.

For smaller countries like Guyana, Mozambique, Niger and Uganda, the Brady Plan literally wiped out all commercial bank debt through buy backs alone. The impact of the Brady Plan was, however, limited for the larger and more heavily indebted countries like Argentina and Mexico.

The limited usefulness of the Brady Plan arises from the fact that most African countries have very limited amounts of commercial debt. Secondly, official debt, which forms the bulk of Africa's debt, is simply not tradable in secondary markets. Thirdly, determination of market value for bank debt is still subject to ambiguity. Perhaps the most important aspect of the Brady plan is its ability to avert the free rider problem.

Chapter Four:

PARIS CLUB AND MULTILATERAL DEBT RELIEF

Preamble

Traditional debt relief measures encompass mechanisms that include provision of external finances and application of sound economic policies. The principle objective is to overcome debt as an impediment to economic growth while regenerating the structural capability of Severely Indebted Low Income Countries (SILIC's). Both Paris club and multilateral debt relief aim to exonerate governments from 'fire fighting' so they can focus on long-term policies and programs towards achievement of sustainable development.

The bilateral donor community provides traditional debt relief in the form of Paris Club flow rescheduling and Brady stock of debt deals, but in conjunction with structural adjustment programmes supported by the multilateral financial institutions. These instruments have been applied since the debt crisis emerged in the 1980's and they take two forms.

The first part encompasses rescheduling of arrears or *debt service* payments due to Paris Club creditors. Rescheduling is undertaken on concessional terms, but only as a means of supporting a country's adjustment programme.

The second part is supplementary, providing outright debt stock reduction, but on condition that a debtor country will have adhered to a policy framework agreed with the IMF and World Bank for three years.

The third element includes the adoption of stabilisation and economic reform programmes supported by further concessional loans from the IMF and World Bank. These modalities aimed to restructure debt stock towards greater concessionality, by synchronizing maturities on bilateral debt with new inflows of concessional multilateral debt.

Given these modalities a large majority of middle-income countries gradually salvaged themselves out of the debt crisis. However, despite that in the early 1980's, Paris Club creditors had provided similar rescheduling for low-income countries on non-concessional terms, low-income countries sank deeper and deeper into the abyss of debt.

The failure of low income countries seem to arise from the fact that conditions for rescheduling limited the grace period to only five years, while maturity was extended to ten years. The main difficulty seems to arise from the fact that these measures were subject to application of market related interest rates at a time when world interest rates were escalating. Inevitably, this resulted into rapid accumulation of debt making it very difficult for countries to adhere to their repayment schedules.

A more appropriate understanding of debt relief operations can be derived from further analysis of agreements produced at relevant G7 summits and how they impacted on external debt of poor countries. Most notable is that concessional rescheduling was first introduced in 1988 under "Toronto Terms". Subsequent "Houston Terms" (September 1990) were applicable only to lower middle income countries, and it was only in December 1991 that Paris Club "London Terms" [also known as "Enhanced Toronto Terms"] re-focussed attention to poor countries, followed by "Naples Terms" introduced in December 1994.

"Toronto Terms" (October 1988-June 1991)

"Toronto Terms" included a range of options aimed at reducing debt stock and annual debt service obligation with a view to reducing the Net Present Value of rescheduled amounts by one third. Under Toronto Terms, a grace period of eight years, facilitated debt service reduction. For longer maturities, a grace period of 14 years applied.

The period of amortisation was extended to 14 years (post grace period) while longer maturities attracted 25 years. As a principle, eligibility was limited to debt service falling inside the period from October 1988 to June 1991.

However, interest rates for both debt service and debt service reduction was based on prevailing market rates and the repayment schedule remained flat. These measures undermined attempts to increase concessionality of debt stock by applying a reduced rate to all long maturities while allowing new ODA credits to carry a grace period of 14 years and amortisation period of 25 years.

The 'Toronto terms' made very limited impact after four years of combined attempts at debt stock and debt service reduction. The main weaknesses arise from the fact that debt stock reduction available under "Toronto Terms" was limited to 33% and calculated in Net Present Value terms (as opposed to nominal stock) while debt service reduction qualified for between 20% and 30%. 'Toronto terms' also excluded long maturities from debt reduction.

"London Terms" (December 1991-December 1994)

The "London Terms" attempted to radicalise the approach to debt relief. Although working in Net Present Value terms, the reduction level in both debt stock and annual debt service was increased to 50%. The period of amortisation for existing stock was increased to 23 years while new ODA credits attracted 30 years amortisation. The most radical change arose from the graduated repayment schedule, which replaced the flat repayment schedule.

The "London Terms" also introduced capitalisation of interest accruing during the moratorium period that had been paid out under previous mechanisms. The full impact was, however, offset by the fact that interest rates applicable to longer maturities were hiked to the level of market rates, and reduced interest rates only applied to rescheduled debt service. The grace period on new credits was also lowered to 12 years, while the grace period on new longer maturities were extended to 16 years.

"Naples Terms" January 1995 -

"Naples Terms" enhanced the level of debt relief, raising the reduction in Net Present Value of debt service payable during the consolidation period to 67% while grace period for capitalising moratorium interest was extended to 8 years. The grace period for longer maturities was extended to 20 years with accompanying capitalisation.

The maturity period was also extended to 33 years; extended to 40 years for longer maturities. To enhance the concessionality of debt stock, new ODA credits also carried a grace period of 16 years while repayment period was extended to 40 years.

The 'London Terms' and the 'Naples Terms' are applauded for including a "goodwill clause" under which participating creditor countries agreed to undertake debt stock forgiveness. The general principle was that exercise of such goodwill would be based on an established record of sound economic management under an IMF supervised program, as well as a good record on debt servicing, in each case for three years.

The aim of such a provision was to cultivate an avenue for "exit" rescheduling and the building of confidence among creditors that a debtor country would be able to meet future debt service obligations without recourse to further or additional debt relief. However, the restrictive condition that recipient countries will not return to the Paris Club for further debt restructuring after receiving "Naples Terms" debt relief has been a major source of criticism.

“Naples Terms” have also had little significance for Africa, despite the attractiveness of high rates of debt relief. This is on account of ineligibility of a large part of the debts of sub-Saharan Africa that is multilateral; and the application of rules pertaining to cut off date debt. Since 1995, only Benin, Bolivia, Burkina Faso, Guyana, Mali and Uganda have agreed to comprehensive stock of debt operations with Paris Club creditors under Naples Terms.

“Naples Terms” are commendable for incorporating elements that explain the successes achieved in stabilising the growth of debt stock, but failure to achieve absolute reduction, not even in present value terms. The fact that “Naples Terms” is available to developing countries with per capita income of below \$500 and present value of debt to export ratio of 350%, is also too restrictive. Qualifying LDC will also have complied with previous Paris Club agreements and IMF programmes for three years. Although, the level of relief available is a 67% reduction on debt stock at their pre cut off date debt or debt service, several poorer countries have been granted only 50% debt reduction.

Commercial Debt

Paris club initiatives also recognized that debt alleviation might be constrained by existence of commercial debt or non-Paris Club debt not ordinarily eligible under its terms. As such, rescheduling agreements included a “comparability clause” requiring a debtor country to seek at least comparable terms on debt owed to non-Paris club bilateral and commercial creditors. The “comparability clause” also requires bilateral forgiveness of ODA debt by many creditors and that new financing be provided on concessional terms.

Despite its ambiguous appearance, the clause focussed beyond the primary concern of intensely addressing the question of debt relief for poor countries and identified a need for mechanisms for the secondary concern of burden sharing. Among the measures that materialised was the *IDA Debt Reduction Facility* that provided funds for buying back most of the commercial debt that was being traded in the secondary market at a large discount from the face value. Some bilateral donors provided new resources that were used to redeem existing loans from private commercial sources.

Traditional debt relief exhibits a clear failure to provide adequate treatment to debt from non-Paris club sources, largely because of its evolution from the precincts of the Paris Club itself. The process of rationalising relations between debtors and creditors has therefore been lopsided and creditors like China, Kuwait, Libya, Russia and Saudi Arabia

have not been able to find exit strategies to contribute to worldwide improvement in the external debt situation. While Kuwait sometimes participates in Paris Club rescheduling, discussions with Russia have remained protracted, except for the rescheduling terms agreed in favour of Nicaragua.

Multilateral Debt Relief

In the context of the Paris Club initiatives, the role of multilateral financial agencies has been to assist indebted countries to design and implement stabilisation and economic policy and structural reform programmes supported by concessional lending from the IMF and World Bank. The IMF has made loans with a strong concessional element under the Structural Adjustment Facility (SAF) and "Enhanced" Structural Adjustment Facility (ESAF). The World Bank has also undertaken similar tasks through IDA credits and other supplementary credits under the Fifth Dimension Program that assists IDA only countries to cover part of their interest on outstanding IBRD loans.

The established record is that multilateral financing has increased at a faster pace and, apart from substituting the drop in bilateral assistance, and facilitating debt stock restructuring, it has accomplished some degree of debt relief because of its concessional nature. However, as a result of the increase in multilateral debt stock to poor countries debt service on multilateral debt has remained stable at around 8.5% of exports per annum during 1985-95. The exceptional rise in the ratio of debt service to 11.5% reflects the clearance of Zambia's arrears to the IMF in 1995.

The net aggregate resource position of all low-income countries also reflects not only on the advantage of concessionality but availability of new resources for development. For example, during 1990-95, multilateral institutions as a group provided net positive resources amounting to US\$ 3 billion a year, up from the average of US\$ 1.5 billion a year during 1985-94. In addition to bilateral arrangements, these flows have been provided through the Special Programme of Assistance and the Consultative Group fora's have been aimed at meeting financing requirements identified under adjustment programmes.

OBSERVATIONS AND CONCLUSIONS

In general, the main trend in the composition of external assistance has been a move towards increasing the concessionality of developing country debt. While restructuring debt stock (in terms of maturity, grace period, etc.) under direct flow rescheduling, countries also enjoy debt stock reductions under the required track record. These concessions also provided support to adjustment operations being undertaken with the aim of re-orienting economies of poor countries to unleash their full potential.

A clear advantage of the traditional debt relief measures has been the inherent degree of flexibility in applying the case-by-case rule that availed debtors a chance to have their specific circumstances examined outside the standard criteria. The consultative group process also provided another over-arching dimension allowing donors to consider each country separately from the overall Paris Club meetings.

However, the results of traditional debt relief are more visible among the middle-income countries, than the low-income countries. Out of thirty middle-income countries that needed debt relief, as many as 23 had graduated by 1996. All 23 middle-income countries had graduated after a single dose of the "Houston Terms" which were far less generous than the "Toronto Terms" enjoyed by low-income countries since 1988.

Some countries, such as Costa Rica, had graduated after rescheduling arrears only, while Ghana, Kenya and Lao PDR have never received concessional rescheduling at all, but had managed to improve their debt situation purely on the strength of the traditional debt relief measures. Other countries, like Equatorial Guinea, and Vietnam did not require the entire menu available under traditional debt relief measures in order to reach debt levels that became sustainable.

While countries like Turkey and Romania had undertaken their consolidations as early as 1983 countries like Bulgaria, Croatia, Jamaica, in the same group had rescheduling agreed as late as 1995 while Ghana rescheduled in 1996. It might therefore be argued that a large part of the graduation from unsustainable debt situation arose from successes achieved in the field of economic reform. For countries like Egypt, for example, the economic resurgence was so strong that the country graduated without implementing the last of the three stages of debt reduction agreed under the 1991 agreement.

Most notable was the graduation of Kenya after rescheduling on non-concessional terms, and Ghana that was only allowed limited deferral of long standing arrears (only) to three creditors, and on non-concessional terms. The Philippines is also noted for having graduated and later volunteered to cancel their 1994 rescheduling agreement.

As a result of these measures, the developing world has witnessed the re-entry of many middle-income countries, especially those in Latin America, into the international capital markets. As at 1996 only the Russian Federation, Algeria, Gabon, Jordan and Peru were the five middle-income countries (out of the thirty) still struggling with rescheduling while their debt remained unsustainable. At the extreme end were Nigeria and Yugoslavia that had exhausted previous rescheduling arrangements and were desperately seeking more rescheduling to alleviate their debt situation.

For African countries, the Toronto, London and Naples agreement were merely tangent to the ultimate settlement of their debt problem. These agreements count for merely shifting the paradigm for international action without dealing with fundamentals of the debt problem. It is to be acknowledged, though, that the Toronto agreement set a precedent, not for the amount of debt relief offered, but the fact that an institutional approach was needed to deal with the external debt crisis. London and Naples Terms also brought innovations of the concepts of debt write down an obvious enhancement of the Toronto terms that has evolved into the HIPC initiative.

The limited gains made by debt-distressed African governments can be explained partly by the findings of the Wass report (1988) which found that African countries needed deeper debt write downs and interest rate reductions. The report had found that even at rates applied by the IDA and the IMF, debt stock would still double every eleven years. Given that market rates rose by 3.5% after conclusion of the Toronto agreement there was not much left out of the Toronto terms for debt relief.

Failure of Toronto terms is also attributed to the fact that no relief was offered for the heavy transaction costs imposed by short leash approaches to debt relief for hard-pressed governments that had been stretched beyond their capacity. The Wass committee had in fact deplored the 12-18 months consolidation period and recommended a three-year period and the possibility of Multi-Year Rescheduling Agreements (MYRA). The OAU has also called for a ten-year moratorium. The short consolidation periods significantly reduced the proportions of debt that was to be considered in the first place.

Furthermore, the requirement for adhering to IMF conditions literally excluded many countries from qualifying for debt relief. This was either because the countries had arrears with the IMF, or

had failed to adhere to an agreed programme or their balance of payments problem had not been so dire as to send them to the IMF. But for the countries whose debt service payments had been curtailed or eliminated, the effect of debt relief was to reduce obligations arising in future without addressing the current need for new capital flows on which recovery prospects depend.

Since the onset of the debt crisis of the 1980's, most debt-ridden countries have experienced enormous difficulties in meeting their external debt service obligations. In Africa the debt service problem has been manifested through outright failure of a majority of the countries to meet their contractual obligations in full. As a result actual debt service has dropped continually in relation to contractual obligation, while the widened gap resulted in accumulation of arrears which now account for nearly 27% of total debt stock.

The fact that new debt flows to the region have been declining since the beginning of the 1990's also suggests that external debt accumulation in Africa is largely associated with arrears than excessive new borrowing. The fact that arrears continue to accumulate despite repeated debt rescheduling - which accumulated to account for 17% of debt stock - also exemplifies inadequacies of the existing debt relief mechanisms.

Hence, the fact that this bleak scenario persists despite many years of concerted attempts by the international community to implement debt relief initiatives could only lead to two possibilities. The first possibility is that the preponderance of exogenous factors that constrained export performance, combined with lack of sustained economic reform, to extricate Africa from the low-level equilibrium trap that constrains the ability of her economies to realise their full potential.

This is partly evidenced by the fact that despite the slowdown in actual debt service paid out, the debt service to export ratio has only improved marginally from 18% to 15%. This suggests that, rather than being a problem of debt stock or the consequent debt service pressures, Africa's debt problem is fundamental to the wide-ranging structural bottlenecks affecting the region, calling for a wider focus in policy reform and economic engineering than the limited attention being given to the arithmetic of debt.

The second possibility - which is the centrepiece of this analysis - is that contrary to announced intentions; debt relief initiatives have failed to provide needed external finances and alleviate existing burden of African countries. In this context, the successive modifications to traditional debt relief initiatives merely feign concern, but without the conviction to eliminate debt as an impediment to economic development.

Given that the ultimate goal of debt/debt service reduction operations is to completely overcome the debt overhang, and allow debtor countries to proceed on a path which allows them to meet

future debt service without compromising on their development agenda, Paris Club initiatives can be construed to have set the pace for an agenda that requires further development.

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