Statement
of
The Roundtable

Money and Finance

FOREWORD

On December 13 and 14, 1985, the North South Roundtable held the fourth session of its Roundtable on Money and Finance in New York. Over 40 leading national and international policymakers, monetary and financial experts, bankers and development economists from industrialized and developing countries met for two days in their personal capacities. The meeting was co chaired by Cesar Virata, the Prime Minister and Finance Minister of the Republic of The Philippines, and Dr. Irving Friedman, President, I.S. Friedman, Inc.

The main objective of the New York meeting was to draw some conclusions from two years' deliberations of the Roundtable on Money and Finance in order to focus attention on the major changes needed in international mechanisms for money and finance in the light of recent developments. Specific items on the agenda were the changing economic environment, special problems of the least-developed countries, especially in sub Saharan Africa, new proposals and priorities for reform.

The first three sessions of the Money and Finance Round. table were held in Istanbul (September 1983), Santiago (February 1984) and Vienna (September 1984). The Istanbul Roundtable addressed the issues of external debt of the developing countries and world recovery. Areas of priority concern were identified, and there was a particular focus on sustained growth of the world economy as vital to all countries for the creation of jobs, for a reduction of debt burdens, for a lessening of protectionist pressures and for new investments to permit smoother adjustment. A decision was made to hold follow-up meetings to examine in depth the areas of priority concern. The next Roundtable in Santiago focused on problems of adjustment. The major conclusion was the need for growth-oriented adjustment and adjustment policies that minimize social costs, rather than the deflationary process generally associated with conventional programs. The Vienna Roundtable focused on the issues of debt renegotiation, linkage of the resolution of debt problems with freer and expanding world trade, the continuing impact of the debt crisis on the human condition, and human resource development in developing countries. Since the underlying fundamentals remained very much the same during this period despite changes in the general economic environment, there were a number of common elements in the proposals emanating from these meetings. Each focused on the need for increased financial flows to developing countries, especially of a medium-term nature, the need for lower interest rates, reduced protectionism, a growth-oriented adjustment process and special low-cost financing for the least-developed countries. There was also a common emphasis on the need for improved coordination among the more developed countries to ensure sustained expansion in the world economy. Each of the meetings emphasized the importance of the human dimensions of economic policy as the major objectives of economic development and the principal criteria for deciding and evaluating policy options.

The New York Roundtable welcomed the new initiative of the U.S. Treasury Secretary, James Baker, as recognition by the U.S. of the need for substantial changes and for positive initiatives by industrial countries. The Roundtable reiterated that the fundamental objective. was to secure a world economic system which will permit countries to combine external balance in the medium term with growth and development. The Roundtable recognized the central and critical role of domestic policies in determining country performance, and the fact that it is unrealistic to expect that international economic measures can make up for inadequacies in domestic economic management. Major changes in the world system of trade and finance were considered absolutely essential to secure an external environment in which countries can combine growth, equity and external balance.

The following statement, which was first prepared by a core group of Roundtable members with Frances Stewart as rappor. teur, was presented, discussed and broadly approved at the Roundtable. However, as with previous statements of the North South Roundtable, it is not to be taken as implying the agreement of every individual member of the Roundtable on each and every point.

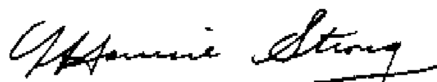
I thank all the participants in the New York Roundtable for the valuable contributions they made towards the successful outcome of the meeting, and in particular, our Co-Chairmen, Prime Minister Virata and Dr. Friedman. Special thanks are due to Frances Stewart for putting this final report together; to the Dean of Pace University for providing the conference facilities; to Susan Kavanagh for superbly organizing this Roundtable; and to our Executive Director, Khadija Haq, for her usual fine job of orchestrating the preparation for the follow-up of the Roundtable, including the preparation of this report.

Maurice F. Strong
Chairman

New York
January 9, 1986

North South.

Roundtable



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THE STATEMENT

Introduction

The Money and Finance Roundtable first met in Istanbul in September 1983, meeting again in Santiago (February 1984) and in Vienna (September 1984). This statement represents our conclusions in the light of our previous discussions and recent developments in the world economic and financial system.

Developments in the World Economy

In 1983, world economic recession posed an overwhelming problem for the world economy. Since 1983, economic growth in the world as a whole has been resumed, but this growth has been weak and precarious, resting in large part on expansion of the U.S. economy. Many developing countries did not participate in economic growth during this time but suffered a further reduction in their per capita incomes. There were, however, a few notable exceptions: the two largest poor countries- India and China - succeeded in sustaining economic growth over this period, and the East Asian countries maintained reasonably good growth performances as well. Today, the prospects for the world economy are very uncertain; most analysts see little likelihood of a sustained acceleration in world growth, and some expect a slowdown.

While a case-by-case approach to the problems of the largest debtors has so far prevented financial collapse, the cost for many developing countries has been very high. In both Africa and Latin America, per capita in come continued to fall over this period. The negative transfer of resources from Latin America, a threat in 1983, became a serious reality in 1984 and 1985. This seems likely to persist for the rest of the decade unless there are substantial changes. A negative transfer of resources out of Africa is likely over the next few years. Although nominal interest rates have dropped, real interest rates remain very high. Private lending to debtor countries has continued to fall, and "voluntary" lending remains almost negligible. Continued capital flight has

compounded foreign exchange difficulties in many debtor countries. The accumulation of total debt owed by major debtors rose further during these years.

Commodity prices did not rise nearly as much with world recovery as in previous cycles and have again fallen; they are now at the lowest real level for over three decades. There seems little likelihood of a recovery in commodity prices in the near future, and some possibility of yet further weakening.

Developing countries generally have made enormous efforts to adjust their payments positions and meet their, debt commitments. In aggregate, developing countries have reduced their outstanding balance of trade deficit by two-thirds. The. main source of this adjustment has been compression of imports and consumption, although in Asia and parts of Latin America, export expansion was also a significant element.

There have been heavy social costs associated with recession and adjustment. Falling per capita incomes and cuts in social expenditures and food subsidies have led to rising malnutrition and deteriorating health status in many areas. The problem has been especially acute in Africa, where there is evidence of rising rates of infant mortality and malnutrition in many countries following the austerity budgets, falling per capita incomes and drought.

Many countries which have followed tough adjustment programs have not attained a sustainable position, in part because of continued falls in commodity prices. The international monetary system has not found new major sources of finance to assist these countries; under present policies, repayments to the IMF are shortly going to demand a net transfer out of Africa, long before the crisis situation has passed.

The protectionist threat has not eased; indeed, protectionist pressures seem to be growing in the industrialized countries. However, agreement has been reached on a new round of multilateral trade negotiations under GATT. There is also greater awareness of the links between trade and monetary matters.

The belief that economic recovery alone would take care of outstanding problems has been discredited by the experience of the past two years. So has the exclusive focus on a case-by-case
approach to the debt problem, and the view that the market would operate so as to make new interventions unnecessary. The social, human and economic costs of the adjustment policies followed is now widely acknowledged.

The need for policy change, recognized at earlier meetings of the Roundtable, has become more urgent in the light of developments over the past two years.

The critical nature of the situation is now generally recognized in both North and South. The situation in some major debtor countries was powerfully and movingly summarized in a speech to the United Nations by the Brazilian President: "Brazil will not pay its foreign debt with recession, nor with unemployment, nor with hunger. We believe that in settling this account at such high social and economic costs, we would then have to surrender our freedom, *for a debt paid* with *poverty is an account paid with democracy."* The famine in Africa and the widespread public response to it in the North have drawn attention to the plight of low-income countries and provided a favorable political climate for a more generous response by the developed countries.

New Initiatives

The U.S. government has now recognized the need for action and has begun to assume a much-needed leadership role in some areas.

The U.S. proposals (the Baker plan) are still in the process of formulation and elaboration. Nonetheless, there is a clear recognition that adjustment must be growth-or lented, and that adjustment packages that involve prolonged austerity, offering little hope of rising per capita incomes, will not be sustainable. The special needs of low-income countries, particularly in Sub-Saharan Africa, have been acknowledged. The U.S. Secretary for the Treasury has explicitly recognized that the aim of growth-oriented adjustment carries implications for the design of the adjustment package, for the process by which it is negotiated and for the net flow of finance. These views echo some of the ideas expressed by the North South Roundtable at earlier meetings, in particular, on the need to combine adjustment with growth, to develop new forms of adjustment packages, to raise financial flows and to make special provision for low-income countries.

The U.S. initiative is stronger in its general thrust and objectives than in its detailed proposals. The stated intention is that financial flows from the commercial banks should be increased to a group of 15 indebted countries by roughly 20 billion dollars over the next three years, but no precise proposals have been made as to how this might be achieved. It is

also proposed that lending by the World Bank and the Inter-American Development Bank should be increased by about 50 per cent over the same period, with an implied commitment from the U.S. to support an increase in capital subscriptions that might become necessary. An enhanced role for the World Bank is suggested as a means of improving both the mechanism and the content of adjustment packages. A large new fund of low interest finance for Africa was suggested - to be financed in part by recycling IMF Trust Fund finance, and in part by additional bilateral commitments. However, the prospects for extra bilateral commitments are poor as a result of "timidity on the part of others and bureaucratic opposition" (Baker).

Most estimates of the financial needs of developing countries over the next few years considerably exceed the sums suggested in the U.S. initiative if these countries are to be able to combine growth with adjustment while meeting their debt servicing obligations. Yet it is by no means clear that even the relatively modest sums involved in the initiative will be realized. The U.S. government itself has not yet backed up its conviction that much more finance is needed with any substantial additional commitment. Some large commercial banks seem to be reluctant to play the role assigned to them, while the smaller regional banks are resisting further involvement in developing countries. Moreover, with present procedures, the World Bank will find it difficult to. increase disbursement substantially and speedily. Radical changes in procedures will be needed if the extra lending envisaged is to occur in time, through either the private sector or the multilateral institutions.

The changing conditionality proposed by the U.S. may not improve either the mechanisms or content of the packages. The World Bank has usually required an IMF standby agreement for approval of its Structural Adjustment Loans. There is much concern among developing countries about "cross-conditionality," while the style and negotiating stance of the Bank are not viewed very differently from those of the Fund by many developing countries.

In summary, the new initiative at this stage lacks the substantive content which will be necessary if the intentions suggested are to be realized. But we greatly welcome the major positive aspect of the new U.S. Initiative, which Is the recognition of the need for some substantial changes, for positive initiatives by Industrial countries, and for flexibility In approaching these problems.

Priorities for Change

The fundamental objective is to secure a world economic system which permits countries to combine equilibrium in the external accounts in the medium term with growth and development. In recent years, as shown by the dire predicament of so many countries, this objective has not been achieved. Many countries have had to sacrifice economic growth to secure external balance, and many have been unable to achieve external balance even on these terms.

The Roundtable has repeatedly stressed the central and critical role of domestic policies in determining country performance. Without appropriate domestic policies, including proper attention to human resource development, improvements in the external environment may have little lasting impact, while improvements in domestic resource use can bring about substantial amelioration in a country's situation even within a deteriorating international environment. Consequently, although the focus of this Roundtable is on the international system, this does not imply that domestic policies are not of equal, and often greater, significance, as shown by the experience of those countries that have managed successfully even in the current unfavorable international situation.

We believe, however, that major changes in the world system of trade and finance are necessary to secure an external environment which gives most countries a genuine opportunity of combining growth, equity and external balance. These changes fall broadly into four categories: those concerned with the world trading environment; those concerned with debt servicing obligations; those concerned with adjustment; and those concerned with new financial flows.

International Trade

The financial system cannot be considered separately –from the trading environment. Expansion of export earnings is essential to enable debtor countries to meet their servicing obligations without a drastic compression of imports. The Roundtable fully supports measures to prevent further escalation in protectionism, and especially to reduce trade restrictions on agricultural products and textiles. We welcome the agreement to have a new GATT round, where a major focus should be on liberalizing trade in products exported by LDCs, including

agricultural products (notably sugar). These markets are too often cartelized, imposing severe costs both on producers in LDCs and on consumers in developed countries.
For countries whose main exports are primary products, the critical issue is that of commodity prices. Difficulties for primary producers arise from the large fluctuations in primary product prices, as well as from the declining trend in real prices.
We propose that the financial mechanisms for providing compensation for fluctuating earnings should be strengthened: the IMF Compensatory Financing Facility should be substantially enlarged, with restoration of the low conditionality previously associated with the Facility. Repayment terms should be altered so that repayment becomes due only as commodity prices are restored to their reference levels. The Facility should also be extended to compensate for interest rate fluctuations. If these changes do not prove feasible, other ways of achieving the objectives should be explored, involving the multilateral banks. The Roundtable would also welcome a resumption of efforts to secure measures to help reduce commodity price fluctuations - such as commodity agreements.
These measures are appropriate for dealing with the problem of fluctuations, not with an adverse trend in prices. Some of the problems encountered by such mechanisms in the recent past are due to the fact that while designed to deal with fluctuations, they have faced a declining price trend. The adverse trend may have become worse as a result of countries' increasing the production of commodities to improve their payments position. This consideration should be incorporated into policy advice given to primary producers; there should be greater emphasis on diversification out of primary products.
The issue of commodity prices was not a central part of the deliberations of the Roundtable. But we found that the adverse trend is becoming overwhelmingly important to the financial and development prospects of many primary producers. We 'recommend priority attention should be given to the question.
In the present restricted trade environment, South-South trade offers considerable potential for countries whose trade is restricted by lack of markets and lack of foreign exchange. Many countries are initiating counter trade deals, often on a bilateral basis. Financial mechanisms-such as payments unions and regional banks-which help secure regional and multilateral expansion of South-South trade should be supported.

Debt

High interest rates and a rising accumulation of debt has led to a situation in which a large proportion of any expansion in export earnings is immediately preempted by debt servicing. This means that countries' import capacity has to be severely limited, with adverse effects on their growth potential.
The Roundtable considers It Is of the greatest Importance to keep debt service payments within reasonable limits. If this is not achieved, not only will countries' growth potential be undermined; their capacity and willingness to meet their obligations in the longer term will also be weakened.
The Roundtable recommends a reduction in real interest rotes as a major priority. This requires a change in the mix of fiscal and monetary policies of the U.S. The Roundtable welcomes the recent signs of determination to cut the U.S. fiscal
deficit but notes that hard decisions remain to be taken. It is important that any fiscal contraction that is achieved be offset, in terms of its impact on output, by monetary relaxation.
If a significant reduction in interest rates is not achieved in the near future, other measures will become necessary to bring the debt servicing obligations down to acceptable levels. If the current level of real interest rates persists, the Roundtable recommends that the immediate burden of debt servicing should be reduced too reasonable proportion of export earnings. This could be achieved by the introduction of a mechanism for systematic "interest-capping," so that all countries could stretch out their payments of interest and amortization in such a way that the total burden of servicing debt obligations does not exceed an accepted proportion of export earnings.
The Roundtable would strongly recommend some reduction in the debt burden. It is agreed that the responsibility for the developments which led to the crisis were shared among borrowers and lenders, LDCs and industrialized countries. There should be a similar sharing of the burden of correcting the situation and restoring normal conditions.
Emergency measures *should* be Introduced to *deal with the debt* of the poorest countries., This should include cancellation of a// bilateral official *debts,* as agreed in an UNCTAD resolution in 1978.

Relief should also be given for the commercial *debt* of those of the poorest countries which are unlikely to be able to service their debts fully in the future, while the attempt to do so may jeopardize their prospects of recovery. It is in the interests of both the banks and the debtor countries that a mechanism be established whereby countries in this situation are awarded a measure of debt relief. A range of criteria should be taken into account in determining the appropriate relief: these might include the presence of exogenous shocks that eroded debt
servicing capacity, low per capita income, the implications for international financial stability, the prospect of a recovery in debt servicing capacity, and evidence of irresponsible lending.

Country Adjustment and Conditionality

Policy Conditionality for program lending is normally necessary and desirable from the point of view of the borrower as well as the lender. A continued flow of finance can only be expected if lenders have confidence in countries' policies, while appropriate policy changes are often essential if countries are to make good use of the finance. The need for symmetry in adjustment must be accepted, with responsibility for adjustment shared by the industrialized countries as well as developing countries.

The present system of arriving at adjustment packages has major defects. Serious negotiating strains have developed in relations with the IMF and the World Bank in the course of implementing adjustment policies in a number of developing countries. There is also a sequencing problem, with countries often subject to a succession of negotiations with different institutions, with resulting delays in both policy change and financial flows. Adjustment and finance need to be planned and coordinated. Countries often feel themselves to be at the receiving end of a succession of policy requirements from different institutions, with little identification with the resulting policy package. To be successful, the country itself must participate fully and agree with the adjustment package.

We therefore believe there is a need for new processes. We propose the development of medium-term country assessment and resource teams to develop and coordinate structural adjustment policies and financial flows at the request of recipient countries. These teams should be independent of the major financing institutions, but the process must be preendorsed by these institutions and should draw on their human resources.

The teams should contain government officials, representatives of the main international institutions and independent experts. They would aim to take a longer-term perspective the questions of adjustment, development and finance. To do so, they could develop a macro-framework for each country to incorporate prospects for the external environment, financial flows, structural change and policy requirements over the medium term (say, three to five years). The country's own active participation would be essential so that the exercise would not be a monolithic ganging-up of outsiders, but a joint exercise to develop new forms of conditionality. Initially, these teams should be introduced on an experimental basis for a few countries which request such assistance.

These teams could facilitate changes in the adjustment packages which the Roundtable believes are essential. The aim of conditionality should be to secure structural adjustment towards a pattern of growth and trade which is sustainable in the medium term, while protecting vulnerable groups. The adjustment must therefore go beyond achieving short-term current account balance.

The Roundtable recommends that alternative conditionality should be sought embodying the following changes:

-An extension of the time horizon for finance, policy change and performance criteria beyond the short period normally associated with Fund conditions. While some policy changes are often necessary in the short term, performance criteria should be geared to the medium term, since many supply-side and growth oriented policies take some time to have full effect.

-Adjustment packages should be specifically structured for each country individually, taking into account its special conditions, constraints, opportunities and objectives. A less ideological, rigid and automatic view of causality, mechanisms and policy instruments would be necessary.

-The new conditionality should consider a much wider range of policy objectives and policy instruments as part of the package. These would vary with the particular country; as well as the conventional policies, objectives, and performance criteria, other elements

which might be covered include social and economic investments, food prices and food supplies, tax and land reforms, family planning policies, the protection of vulnerable groups and ecological issues. A different selection would be appropriate in each case. The aim should be to include variables of major significance for medium-term development while keeping the conditions to a minimum..

The current mechanisms are not adequate for inducing symmetry in adjustment. The IMF should explore more effective mechanisms to secure this objective through improvements in principles and procedures of surveillance. Surveillance of the industrial countries should include their policies towards economic growth, exchange rates and lending to less-developed countries.

Finance

These new forms of adjustment - especially a greater growth orientation, a more medium-term perspective and the protection of vulnerable groups - will require a substantially larger flow of finance. A large additional flow of finance would permit a higher level of output and trade for all countries, industrialized and developing, as well as supporting debt servicing capacity and financial stability. The whole world would therefore benefit.

The Roundtable recommends substantial additional resource Inflows from public and private Institutions. These additional resources will not be forthcoming as a result of oratory alone; there is a need for some substantial changes to secure the extra finance. Additional commitments from major industrialized countries will be necessary.

- The capital of the World Bank and regional banks should be increased. A change in disbursement procedures of the World Bank and regional banks will be necessary to make them an effective mechanism for increasing resource flows. Project finance is not the only kind of finance required. Structural adjustment loans as presently interpreted have proved slow and cumbersome. Consequently, the World Bank will need to change procedures to permit rapid disbursement of program finance.
- A major new issue of SDRs should be instituted immediately,
- Expansion of co-financing or guarantee schemes could increase private flows to middle income countries. Developing countries could improve the atmosphere for risk capital, while developed countries should remove restrictions on the outflow of such capital.
- A substantial increase in ODA is needed to provide low-interest finance for the low-income debtor countries, especially in Africa.

However, the Roundtable would emphasize that extra finance, though essential, must be accompanied by other necessary changes. Unless countries' growth and export prospects improve and their debt servicing obligations are controlled, extra finance will create new burdens rather than alleviating old ones.

The recent U,S. proposals are mainly concerned with finance. Parallel action on trade and debt is essential so that countries may generate and retain sufficient foreign exchange by their own export efforts to finance development without relying excessively on additional outside finance. Unless this occurs, extra finance can only be a short-term palliative which will further raise debt obligations without improving countries' ability to meet them.

In our view, it is essential that action be taken in each of these areas so that countries may follow policies which enable them to raise their capacity to meet their obligations in a! context of economic growth and development.

Longer-Term Reforms

In recent years there have been frequent demands by the North South Roundtable and other groups for a new Bretton Woods - a world monetary conference which would consider fundamental reforms of the international monetary system -to deal with the evident disarray and inequities in the present system.

The North South Roundtable recognizes the need for fundamental changes in the international monetary system. These include the need for systematic management of exchange rates; the need to deal with the issue of asymmetry in adjustment burdens; the need for some systematic countercyclical r mechanism at a world level; a review of the quantity and distribution of world liquidity, the exchange reserve system and the role of the SDR; a system of monitoring and influencing international interest rates; and a review and reform of inter. national institutions. These and other issues should form the basis of a program for a world monetary conference.

We believe that the political conditions for such a conference are becoming more favorable. Research, discussion and negotiation on fundamental reforms should continue to further this process and to provide analytical underpinnings to proposals for reform.

We recommend that the process of discussion and negotiation on fundamental issues of reform between the G70 and the G24, which has already begun, should be accelerated. If these discussions prove fruitful, a world monetary conference should be convened. In the meantime, progress may be made in some areas through regional conferences - for example, in exchange rate reform and other monetary arrangements.

Immediate Action Urgently Needed

In the immediate future, the Roundtable believes priority should be given to the specific changes recommended earlier in this report. These changes are within the realm of political feasibility, if opinion within both North and South can be effectively mobilized on their behalf. There is a strong mutual interest among industrialized as well as developing countries in' securing a growing world economy and a stable financial system. The changes proposed here could make a major contribution to world prosperity and the economic development of poor countries. Without such changes, the chronic crisis may turn to catastrophe. Many of the newly industrializing countries may turn their backs on the financial system, threatening its viability. In the poorest countries, the main burden of the continued crisis is being borne by the babies and children who live, and often die, in abysmal poverty as a consequence of an international financial system and domestic governments that have failed them.

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ON THE QUESTION OF DEBT RELIEF

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Debt relief consists of a reduction in the present value of the debt service obligations on outstanding debt that is mutually agreed between creditors and debtors. So far, debt relief has been conspicuous by its absence since the debt crisis erupted in August 1982. Debt has been renegotiated, reconstructed, rolled over and stretched out, but it has not been forgiven, nor have interest rates been reduced by more than modest cuts in spreads.
The discussion of debt relief in Bergsten, Cline and Williamson 1 makes four points:

a) that debt relief may well be to the disadvantage of the debtors themselves, because it would jeopardize their future access to credit;
b) that widespread debt relief granted by the commercial banks would have a devastating impact on their earnings and even their solvency, which could easily rebound to the disadvantage of the debtors as well as the banks;
c) that, because of these two considerations, debt relief should be restricted to cases of "insolvency" and avoided when the problem is merely "illiquidity"; and
d) that a readiness to grant debt relief even in cases of insolvency might have demonstration effects on less marginal debtors that could ultimately threaten the banking system because of Point (b).

What merits further consideration is whether these four points add up to a convincing case for eschewing all thought of debt relief, or whether an attempt should be made to devise criteria and mechanisms that might permit some countries to be granted a measure of relief while avoiding the danger noted in Point (d). My own view is that a policy of categorically denying the possibility of debt relief is inadmissible on humanitarian grounds; unjust, inasmuch as the banks have on occasion contributed to the problem of excessive Indebtedness; and unrealistic, since in extremis countries will be unable to service their debts, however hard they try. In practice, countries that have found themselves in this situation (e.g., in the 1930s) have ultimately negotiated a measure of debt relief with their creditors in return for a resumption of debt service. Moreover, it seems paradoxical in the extreme to deny to sovereign debtors a j possibility that creditors with stronger enforcement mechanisms I often find it in their own interest to extend to corporate debtors.

Naturally, it makes sense to pursue the possibility of providing for debt relief under appropriate circumstances only if such relief is sometimes in the interest of the debtors themselves, taking account of the fact that debt relief is likely to curtail future access to new credit. In order to decide whether relief would be advantageous to the debtor, one has to compare the present value of the relief with the present value of the benefit of the new lending that would be foregone. The maximum benefit that debt relief could bring is the present value of the debt-service obligations on outstanding debt. However, the recent estimates of Eichengreen and Portes' suggest that the benefits obtained by debtors in the last round of debt relief were much smaller than this; realized internal rates of return on defaulted Latin American debt in the 1930s are estimated at 3.25 per cent on dollar issues and 5.41 per cent on sterling issues, against default-free yields of about 6 per cent on both. It is also unclear how extensive or extended the interruptions to new lending would be. Interruptions could be total and lengthy if lenders concluded that new loans were likely to suffer the same fate. But if the mechanism by which relief were granted were such as to convince lenders that this was a one-time occurrence as a result of circumstances that were unlikely to recur, elimination of a debt overhang might even accelerate a return to creditworthiness, and especially of access to trade credit. Of course, the benefit of access to additional credit cannot be measured by the amount of credit received, but by the present value of the difference between the social return earned on the borrowed funds and the cost of servicing them. Finally, the cost of interrupted access to new credit will be nonexistent so long as countries are not receiving new credits anyway. In view of these considerations, it seems likely that many debtor countries would benefit from the availability of debt relief on a significant scale.

Relief could be provided through several types of mechanism. In choosing between these, the dominant concerns should be the minimization of moral hazard and demonstration effects so as to avoid both choking off new capital flows and threatening the solvency of the international banking system.

One mechanism far providing debt relief would be for the banks to turn a blind eye to the indefinite accumulation of arrears. Such an approach would, however, pose acute moral hazard: it is difficult to see why any debtor should take its debt-service obligations seriously once this policy is understood. Moreover, this approach would do nothing to help countries in the most desperate difficulties to reestablish access to trade credit.

An alternative approach would be for the banks to negotiate a measure of ad hoc relief with countries that interrupt the servicing of their debt. This is pretty much what happened in the 1930s (with bondholders' committees playing the role of bank advisory groups). Once again, however, such an approach would seem to create moral hazard. Indeed, in view of this, it is rather remarkable that relief appears to have been distributed relatively rationally in the 1930s3

Yet another alternative would be to try and make operational the distinction between insolvency and illiquidity[°] and to create some quasi-judicial mechanism for awarding debt relief in the former case while denying it in the latter. This represents an improvement over the first two alternatives, in that it introduces into the decision-making process an impartial third party charged with seeking to answer a question that is in principle objective, and that certainly bears on the desirability of providing relief.

The approach nevertheless has two major drawbacks. The first is that the distinction between insolvency and illiquidity, although objective in principle, is both difficult to draw in practice and dependent upon the policies that countries are prepared to adopt, thus raising again the issue of moral hazard. It would be tragic if the pursuit of debt relief led countries to relax in their quest for export-led growth, which is the only hope most of them have for a marked improvement in their position. The second drawback is that, in the case where debt relief is indeed in the national interest of the debtor, there are other factors that should bear on whether relief is provided - such as the degree of responsibility that the lenders exercised when they made the loans. The incentive effects created by this approach would seem appropriate only in cases where countries suffer from debt relief because their loss of access to future credit imposes losses greater than their gain through immediate relief.

The final approach would seek to meet the objections to the preceding ones by broadening the criteria deemed relevant to the award of relief. The following criteria might be potential candidates:

a) Exogenous shocks that unexpectedly caused an increase in the burden of debt service. Alone, such a criterion would be most unwise, because every banker knows that his clients are going to suffer adverse shocks from time to time, and the criterion would therefore strangle sovereign lending. As one criterion among a number, however, that objection has little force. On other grounds it scores well: it poses no moral hazard, and it is positively associated with the difficulties that countries experience in maintaining debt service. Of course, it would be necessary to specify a threshold for the size of the shocks that would be counted (perhaps in the range of 2 to 4 per cent of GNP).

b) Low per capita income. Use of this criterion on its own would again be unacceptable, for it would preclude any poor country's becoming creditworthy. As one of a number of criteria, however, it would be much more appealing. It would help ensure that any relief that was given went to the poor, thus countering the charge that relief of commercial bank debt would be distributionally perverse, because the poor countries did not have the creditworthiness to borrow. It would help exclude the big debtor countries, where relief would pose a serious threat to the banking system. Even the obstacle this criterion would place in the way of commercial borrowing by low-income countries might be advantageous, since it would undermine the argument that properly behaved countries can always borrow. more on the international capital market, and therefore do not need concessional flows.

c) The lack of a threat to international financial stability. Adoption-of this criterion on its own would be as misguided as adoption of the preceding one, since it would virtually preclude small countries from becoming creditworthy. At the same time, it is clear that it is the large countries whose non fulfillment of debt service would jeopardize the viability of the international banking system. Although it does not accord with natural justice to deny the large countries equal treatment, there may be a case for using this as one criterion among several.

d) Little prospect of being able to service debt without an unacceptable cost to domestic welfare. This is intended to capture the essence of the "insolvency" criterion, while recognizing that the dividing line between insolvency and illiquidity is fuzzy (it is always possible to pay a little more debt service in the short run by cutting back income further), and that the cost to the debtor country should be a matter of international concern. By making this merely one criterion among several, any temptation to relax on adjustment efforts should be much diluted.

e) Poor use made of the proceeds of the loans. Countries which make good use of borrowed funds are in a better position to service their debts than those that waste them on armaments, capital flight or a consumption spree. Adoption of this criterion could be expected to have incentive effects on both borrowers and lenders. Borrowers might be somewhat more relaxed about permitting wasteful use of borrowed funds, whereas lenders would have a strong incentive to make sure that funds are directed to productive investment, or the minimization of a recession following a payments deterioration. The effect on the lenders would surely dominate.

f) Irresponsible lending. More generally, any evidence that the lending banks had not made a proper assessment of the prospects that the borrower would be in a position to service the loan, and especially that they had pressured a country into taking loans it could not afford or did not need, should count toward allowing debt relief. The Incentive effects of such a provision would be unambiguously positive.

g) Doubt full legitimacy of the government that contracted the loan, The Argentine example has again raised the question of the propriety of expecting a successor government to service the debts of an illicit predecessor that used the proceeds of the loan for narrow sectional interests rather than the general interest. To some extent, the concern here might be met by criterion (e), but the question should at least be raised as to whether the legitimacy of the government should not be an independent criterion. One incentive effect would presumably be to discourage authoritarian governments. On the other hand, given that inclusion of this criterion would certainly not free the world of authoritarian governments, one would not wish to see those who suffer such governments receive the double punishment of denial of the economic benefits that access to borrowing permits. This is perhaps the most problematic of the suggested criteria.

The first two criteria would seem particularly strong candidates, and indeed might well be specified as necessary conditions for any thought of awarding relief. The others tend to be more subjective, to raise more difficult political judgments, and)or to involve more dubious incentive effects. Nevertheless, there would seem to be such a significant advantage in operating with a range of criteria rather than with any single criterion as to justify considering including them all.

A requirement that several of the preceding criteria had to be present in order to qualify a country for debt relief should avoid strangling capital flows, minimize moral hazard (including any temptation to relax adjustment efforts) for the debtors and have desirable incentive effects on the lenders. Banks which conducted their affairs with due prudence would have no reason to fear an award of debt relief except where external circumstances proved so adverse that the probability of recovering full debt service due is minimal in any event. Countries which did qualify for debt relief would benefit by the easing in their balance of payments constraint and the increased incentive to seek payments adjustment once the fear that any improvement would all be siphoned off by the banks was removed. Provided the relief was perceived as once-for-all by the banks, it might even restore their access to trade credit.

The organ charged with awarding debt relief might appropriately be expected to determine the value of the relief according to its assessment of the severity of the country's predicament and the other criteria in the list presented above. The form in which it reconstructed a country's debt could advantageously be negotiated with both creditor and debtor, however. Stretch outs which lowered the present value of the debt service due, absolute interest caps, lower interest rates and payments related to export earnings might all find a place at some time or another.

For example, in an extreme case which met most of the criteria, a democratic successor government to an illicit dictatorship might have its entire bank debt converted into long-term bonds with a yield and amortization tied to the country's terms of trade, such that the country would pay nothing while the terms of trade remain as unfavorable as they are at the moment, and a rate of return equal to that prevailing at the time the loans were contracted should the terms of trade and interest rates return to their value at that time. Banks would probably not like holding such bonds, but they could sell them for what the market would bear, which would undoubtedly be much less than the face value of the loans they would replace (though not necessarily less than the written-down value of those loaned on the banks' balance sheets).

If such an organ were to be established, it would be easy to include in future loan contracts a clause binding on both creditors and debtors to abide by its decisions. It is less obvious that the banks could be persuaded to agree to accept the adjudication of such a body on the basis of criteria such as those proposed above on a retrospective basis. Yet, without this, the proposed mechanism would be irrelevant to resolution of the existing and important problem of providing definitive relief to present "basket cases" without either precipitating a round of economic sanctions or initiating a generalized demand for relief. Is it conceivable that enough banks might come to feel an interest in an amicable resolution of this problem to persuade them to support a proposal to create such a body and give it retrospective authority?

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THE DEBT CRISIS AND ECONOMIC INTEGRATION IN LATIN AMERICA

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New Mandate for Integration?

One of the consequences of the Latin American debt crisis of the last few years has been a renewal of political and diplomatic interest in regional integration.' To illustrate:

- In 1982, the Heads of State of the countries of the Caribbean Community (CARICOM) met for the first time in five years.
- In July 1983, for the first time in the history of the Cartagena Agreement, the meeting of the Commission of the Andean Group was attended by the Presidents of the five member countries.
- In September 1983, at the Special Meeting for the Economic Development of Central America held in Brussels, representatives of the Central American countries emphasized their desire to solve their problems jointly, within the integration framework,
- In January 1984, the Latin American Economic Conference, convened by the President of Ecuador, issued the Declaration of Quito, which reaffirmed that "the present crisis calls for urgent solutions through joint actions rooted in regional cooperation."

There are sound economic arguments underpinning this resurgence of political commitment to integration. One strategic consideration is that addressed by W. Arthur Lewis in his Nobel Prize lecture of December 1979.' Lewis was concerned with what might happen if growth in trade of the less-developed countries (LDCs) with the more-developed countries (MDCs) were to slow down from the extraordinarily high rates experienced after World War II. In such circumstances, Lewis argued, the LDCs could maintain high rates of economic growth "by accelerating their trade with each other."

Also important Is the point made by Professor Albert Fish low that in a situation of foreign exchange shortage, "trade diversion, by substituting for imports originating outside the region, and reciprocity, by matching new markets to new purchases, permit all the parties to a preferential trading arrangement to increase their disposable foreign exchange."'

The Lewis and Fish low arguments are not mere academic curiosities; they have direct relevance to the present situation in Latin America, which is characterized by stagnant exports and an extreme shortage of foreign exchange. A few statistics will help to underline this point:

- Between 1980 and 1984, Latin America's exports increased a mere 8.6 per cent, about 2 per cent per year.
- During the same period, net external financing to the region declined from a positive inflow of US$12 billion in 1980 to a negative outflow of US$27 billion in 1984.[4]

But the surprising fact is that intraregional trade between Latin American countries has not responded in the way indicated by economic theory and mandated by the region's political leaders. Instead of regional trade expanding to pick up the slack caused by stagnation in exports to the MDCs, it has collapsed. For example, trade among the members of the Latin American Integration Association (LAIA) fell from US$11 billion in 1980 to US$7 billion in 1983; trade in the Central American Common Market (CACM) fell from US$1.1 billion to US$750 million in the same period; and, most striking of all, non-fuel trade among the Andean Group countries declined by 50 per cents

This paradoxical response to the debt crisis is frustrating to integration its, leading some to lament that "the regional movement is in deep trouble."' Others conclude that regional integration can play only "a supplementary role" in Latin America's future development.?

These opinions are unduly pessimistic. In my view, the history of Latin American integration shows a healthy long term dynamism, and the recent collapse is the result of unusual short-term conditions for which there was inadequate institutional preparation. Provided that the necessary institutional steps are taken, integration can rapidly resume its dynamic role in the region's development. Before elaborating on these steps, however, I would like to present a brief review of Latin American integration in the last 30 years.

A Review of Latin American Integration

The formal commencement of Latin American economic integration took place in June 1951, when the Central American Economic Committee was formed with the support of the Economic Commission for Latin America (ECLA). In 1960, the Central American Common Market and the Latin American Free Trade Association were formed, followed in 1965 by the Caribbean Free Trade Area and in 1969 by the Andean Common Market. Thus, by 1970, almost all Latin American nations were members of one or another preferential trading arrangement.

The integration movement in Latin America derived its philosophical impetus from "Bolivarian sentiments on the one hand and on the other, the influential economic doctrines of Raul Prebisch and ECLA, who saw regional import substitution as the only realistic strategy of industrialization in a world trading environment characterized by declining terms of trade for primary products.

But there was another reason why the integration process really got going in the early 1960s. As Sidney Dell records,° between 1955 and 1961, trade between the countries that later formed LAFTA fell by some 41 per cent. Thus, the formation of Latin American trading arrangements in the early 1960s was as much a practical response to a crisis of disintegration as it was an act of faith -a situation which is not dissimilar to today's reality.

The historical record of Latin American integration is quite impressive. First of all, in institutional terms, it has been a clear success, as indicated by the remarkable proliferation of mechanisms which have been created.[1]0 To illustrate: two free trade areas; four common markets; four multinational development banks; more than a dozen multinational public enterprises; and hundreds of private multinational joint ventures and subsidiaries.

Second, at the political level, it is undisputed that the integration arrangements have contributed to an atmosphere of peace within the region. This is most clearly seen in the Central American area, where the institutions of regional cooperation continue to exist and provide a counterpoise to the very dangerous tensions which exist, in military terms, between some states.

Third, the growth of intraregional trade, which is the measure used most often to record progress in integration, although not spectacular, is substantial. To begin with, the formation of LAFTA in 1960 was instrumental in reversing the disintegration in intraregional trade referred to earlier. Between 1960 and 1965, in fact, LAFTA trade grew by more than 60 per cent, and the share of regional exports in total exports almost doubled, from 6.8 percent in 1961 to 12.6 percent in 1965."

The period after 1965 is often regarded as one in which intraregional trade was disappointing. Fish low, for example, states, "The new reality of more buoyant external markets began to render regional import substitution obsolete."" But the data tell a different story. After 1965, intraregional trade expanded faster than trade with the rest of the world for nearly every Latin American country, so that regional trade continued to increase as a percentage of total trade, reaching 17 per cent in 1975 and staying at that level until the collapse in the 1980s.'[3]

It is also important to note that intraregional trade is structurally different from trade with the MDCs. In all Latin American countries, the share of manufactured products in regional trade is higher than in exports to the MDCs. For the Central American countries, for example, nearly 90 percent of exports of manufactures are to regional markets. Moreover, there is evidence that for countries like Brazil, regional trade in manufactures has been used as a training ground for eventual exports to the rest of the world. In other words, in addition to its quantitative importance, intraregional trade has been qualitatively significant in furthering the industrialization process.' °

Obstacles to Integration

This review of the integration process in Latin America demonstrates that (i) institutional development is very advanced, (ii) intraregional trade grew faster than trade as a whole, even during 1970s, when trade with the MDCs grew very fast and foreign exchange was abundant; and (iii) intraregional trade has been important structurally in providing a platform for the development of manufacturing export capability.

Given this quite substantial record of achievement, I return to the paradox raised earlier in this paper - why did intraregional trade collapse in the early 1980s?

First of all, it is necessary to note that the debt crisis resulted in a severe decline of all imports to Latin America, and not merely of those imports originating in the region. In fact, total imports fell from US$89 billion in 1980 to US$54 billion in 1983, a steeper decline, in percentage terms, than that suffered by intraregional trade. Thus, in relative terms, regional trade did not worsen.

This fact, however, does not explain why intraregional trade was not used to pick up the slack caused by stagnant exports to the MDCs - why, in other words, was intraregional trade not used as a solution to the foreign exchange scarcity caused by the debt crisis, rather than being merely part of the wider problem?

There are two answers to this question. The first relates to the relative cost of intraregional imports, the second to the financing of intraregional trade.

First, in many cases, regional imports cost more than the corresponding imports from MDCs. From the point of view of the importing country, the extra cost may be unimportant if these imports can be paid for with domestic goods produced with idle resources, since there will be a net savings in foreign exchange. However, this saving is not relevant to the importer, who has to pay the extra cost of particular imports since in most cases, he is not the beneficiary of the earnings from additional imports. Similarly, domestic producers who suffer competition from intraregional imports are not likely to be enthusiastic about opening up opportunities for domestic exporters, who are different individuals.

If intraregional trade is to regain its dynamism, mechanisms have to be developed by which individual calculations of benefits and cost scan incorporate the macroeconomic savings.' s One way of doing this would be to create a regional margin of preference for regional imports.'° Unfortunately, negotiations for such a measure would be very difficult to achieve. Moreover, it has been the practice of most regional governments to grant state enterprises exemptions from import duties, a practice which renders regional tariff preferences useless.

The *second* factor hampering intraregional trade has been the problem of finance. In theory, it should be easy to finance intraregional trade since, if trade is reciprocal, imports would be paid for by exports. Thus finance would be needed only to provide liquidity for temporary deficits. This was the basis on which "clearinghouse" arrangements were established in the various regional schemes in Latin America.

During the I960s and 1970s, however, a structural imbalance of intraregional trade emerged . 17 Prior to 1980, these structural imbalances could be covered, because the deficit countries were able to obtain adequate foreign exchange from commercial sources. With the onset of the debt crisis, however, deficit countries could neither get cash to clear their deficits, nor could they rapidly expand their exports to intraregional markets. The inevitable consequence was that all of the regional clearing arrangements were depleted of liquidity and ceased to provide finance for regional trade.

The lesson of the above is quite clear: recovery of intraregional trade requires first, that measures be found which allow individual importers to internalize the macroeconomic savings of intraregional trade, and *second,* that intraregional trade should be reciprocal. In other words, countries should pay for their imports with their own exports, and not with scarce foreign exchange.

These are simple requirements to formulate in theory, but in practice, their achievement will require new institutional mechanisms.

New Mechanisms of Integration

The institutional development of Latin American regional integration has been very rich. However, the formal arrangements of treaties, accords, regional secretariats; etc. have been excessively rigid and have not provided sufficient flexibility for pragmatic reaction to changing circumstances,

In this respect, the Treaty of Montevideo, which replaced LAFTA with LAIA, was a breakthrough, since it permits countries to negotiate separate bilateral or multilateral agreements without having to seek a consensus of all LAIA members. Thus under the LAIA arrangements, it would be possible for countries such as Brazil and Argentina, for example, to enter Into a long-term arrangement for balanced reciprocal trade ("counter trade," as it is often called).

The establishment of agreements for reciprocal trade will create the framework for dynamic, balanced trade. But to inject life into these agreements, we will need something

else, namely, economic agents who are committed to regional trade rather than to protected markets. In recent years, we have seen the development of such agents in the form of national and multinational trading companies. Provided that these companies are adequately capitalized and staffed, they will have the flexibility and agility to ensure that the social benefits of regional trade can be made available to individual importers, and thereby that the private sector in the region can be increasingly incorporated into the process.

In the case of those Latin American countries which are already fairly advanced in their industrialization (for example, Argentina, Brazil, Colombia and Mexico), the existence of long-term trading agreements and the action of trading companies should be sufficient to allow the exploitation of actual and potential complementarities in production. In the case of the less-developed countries, however, this will not be enough, as these countries simply do not have, and will not achieve, a diversified export capability in the near future. For such countries it will be necessary to use long-term development capital to finance their trade deficits, as well as to provide investments in new productive capacity. As an alternative, such countries could be permitted to cancel their intraregional trade deficits in their own currencies (with indexation, to maintain the real value).

Conclusions

The logic of economic forces, as well as the political mandate of the highest authorities in Latin America, indicate that there should be a new life for Latin American economic integration. The recent collapse in regional trade shows that such resurgence is not automatic, but will require new mechanisms and institutional arrangements. Fortunately, these new mechanisms can be put into place without new treaties. All that is required is a commitment to reciprocity on a bilateral or multilateral basis, as well as pricing mechanisms which allow importers to gain from regional trade.

A final thought is that such arrangements need not be restricted to regional schemes. In fact, there probably exist as many opportunities for reciprocal trade between Latin America and countries in Asia and Africa as within the Latin American region itself. This, of course, is the rationale of UNCTAD's program for economic cooperation between developing countries.' ° Here again, what is needed is not elaborate, formalistic alliances, but a pragmatic commitment to South-South cooperation, as well as dedication of a comparable effort to that which is spent, with such limited results, in pursuing more equitable North-South relationships.

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