THE NEW INSTITUTIONAL ECONOMICS AND THIRD WORLD DEVELOPMENT

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THE WORLD BANK AND THE ANALYSIS OF THE INTERNATIONAL DEBT CRISIS

Beatriz Armendariz de Aghion and Francisco Ferreira

INTRODUCTION

Many Less Developed Countries (LDCs) were devastated by the debt crisis of the early 1980s. Economic growth rates declined sharply and the living standards of the poor in some countries did not improve for at least a decade. Developed countries were also affected, as the stability of the international financial system itself was under threat in the early years of the crisis. Now that the crisis is nearly over — especially from the standpoint of most Latin American countries, where economic recovery has started — it seems appropriate to take stock of the experience, and learn its lessons for the future.

This chapter focuses on the role played by the World Bank in generating, absorbing, disseminating and applying ideas on two main areas: the macroeconomic management of developing countries in the run up to the crisis in the 1970s (‘the origins’), and the proposals of mechanisms to address the problem of chronic indebtedness in the 1980s (‘the solutions’). It is about the internal intellectual dynamics of an important international institution, as it struggled to respond to a serious crisis. Other chapters in this volume have stressed that the new institutional economics sees non-market institutions and organisations arising where they can efficiently correct market failures or, as Bates (Ch. 3, this volume) puts it, ‘transcend social dilemmas’.

But institutions may also adapt sluggishly, and we illustrate the importance of changing ideas, views and perceptions of a problem within a large organisation — the World Bank — in shaping its overall policy response to that problem — in this case the international debt crisis of the 1980s. In assessing the intellectual contribution of the Bank and comparing the evolution of its views with those of outside analysts — mostly academics — we demonstrate, in a case study, that ‘ideas and ideologies play a major role in choices’, as North suggests (Ch. 2, this volume).

It is worth emphasising that, in focusing on the Bank’s intellectual contributions, we deliberately leave outside our scope most of the more applied aspects of operational work with specific countries. Those are perhaps the Bank’s principal concern, and our comments should therefore not be taken as
an overall assessment of the Bank's performance vis-à-vis the debt crisis, but as remarks specific to its intellectual and research activities. A further cautionary note regards the complementarity between the Bank and the IMF. It has generally been the case that, whereas the Bank specialises in internal—often project or sectoral—micro-economic work, the Fund concentrates on balance of payments difficulties and, by implication, on issues of macro-economic management. In the 1980s, therefore, division of labour between the two institutions might entail the Bank dedicating itself to internal problems of structural adjustment, while the Fund focused more firmly on the international aspects of managing the debt problem.

Nevertheless, as has been argued elsewhere (see Ferreira 1992; Stern and Ferreira forthcoming), structural adjustment and stabilisation are so closely related to the debt crisis, that an international institution of the size and importance of the World Bank can not afford to rely entirely on others to respond to events and ideas, or indeed to generate those ideas, on debt. There are two major tasks one might reasonably have expected the World Bank to fulfil in its role as the leading international development agency with respect to the LDC debt crisis. First, during the run up to the crisis in the 1970s, one would have expected the Bank to have monitored the LDCs' debt build-up and macro-economic policy as part of its role in country policy assessment. We will argue that more cautious advice on the magnitude of borrowing in the late 1970s and up to 1982 might have helped avoid—or at least alleviate the severity of—the belated adjustment process that followed in most LDCs.

The second task relates to the period since 1982, when the search for mechanisms to resolve the crisis became crucial to determine how and when growth, poverty alleviation and development in general might resume in a large number of LDCs. The evidence we will discuss suggests that the Bank was over-optimistic before 1982, sometimes disseminating assessments and advice which it would directly contradict later, with the benefit of hindsight. And it also seems that during the crisis, it was a slow follower in the debate on possible remedies.

The remainder of the chapter is divided into sections: the first discusses the origins of the crisis and the second looks at proposed solutions. In both these sections an attempt is made to compare and contrast the views expressed by academics with those of the Bank. In the final section, some conclusions are drawn.

**ORIGINS**

Historically we have come to mark the onset of the debt crisis in August 1982, when Mexico declared a moratorium on the servicing of its external obligations. This announcement was only the beginning of a decade of crisis, the causes of which are now well understood. These fall into three categories: the oil shocks of the 1970s, the sudden changes in the world macro-economy in
the early 1980s and inappropriate policies in borrowing countries, often in the context of an import-substitution development strategy.

The link between the oil shocks and the debt accumulation of the 1970s has demand and supply side explanations (in the international capital markets). On the supply side, the oil price rises in 1973 and 1979 created large current account surpluses in oil-producing countries (the so-called petrodollars) which were made available for financial intermediation through the industrialised countries’ commercial banks. On the demand side, among others, were the low interest rates, and the consumption-smoothing behaviour by oil importing LDCs which had been adversely affected by the oil shocks.

The sudden changes in the international macro-economy in the early 1980s precipitated the crisis. On the one hand, there was the very rapid increase in the world real interest rates, due to tight monetary policies in the industrialised countries, and on the other was the sharp fall in export revenues by LDCs due to the world recession. These two effects combined had a drastic impact on the cost of servicing LDC debts, and on LDCs’ ability to do so.

Finally, recent studies (see, notably, Berg and Sachs, 1988) have suggested that the crisis had (deeper) structural explanations. In particular, import-substitution development strategies followed by many LDCs considerably lessened their ability to service their (foreign currency denominated) debts, by reducing their flexibility to respond to balance of payments crises through a sufficiently rapid export expansion.

Academics

The large build-up of external debt in the 1970s did not appear to trouble most academic economists at the time. The consensus, according to Cohen (1993), reflected the view that foreign borrowing by LDCs to finance current account deficits was an equilibrium phenomenon, in the sense that such deficits would allow LDCs to augment productive capacity and repay their debts. It was not until the early 1980s that the predominance of this view came to be questioned.

The distinctive feature of international debt contracts is that they cannot be legally enforced, and in 1981 the Review of Economic Studies published a paper by Eaton and Gersovitz which highlights this point and pioneers what later came to be known as the ‘willingness to pay’ approach. They present a theoretical model and an empirical analysis for the case of sovereign debt contracted abroad by poor countries. They argue that since such debt cannot be legally enforced, the default penalty from the country’s standpoint is the impossibility of re-accessing the international capital markets.

For our purposes, this paper provides an example of early academic work that could have encouraged a more cautious attitude towards very high levels of borrowing, in the Bank or elsewhere, prior to the collapse of voluntary lending in 1982. Eaton and Gersovitz (1981: 291) note, in their Theorem 1,
that: 'the probability of default in period $t$ increases monotonically with debt service obligations $d(t)$ in period $t$'. Now, since:

$$d (t + 1) = R b (t)$$

it would follow that very sharp increases in the effective interest rate ($R$), combined with an explosion of new lending ($b(t)$), such as was observed from 1979 to 1981, should cause the default risk to be increasing quite rapidly. In their framework, this increase in risk leads to a tightening of credit constraints. This suggestion is in fact borne out by their empirical analysis, where 65 countries in a sample of 81 appeared to have – already in the mid-1970s – a limited access to the international capital market.

This is not to claim that Eaton and Gersovitz ‘predicted’ the debt crisis, as it came to pass. But we do think that it provides an interesting benchmark for comparison with the general tone and some specific statements emanating from the Bank around the same time – and later. They will be the subject of the next sub-section.

The Bank

Between 1974 and 1982, the Bank’s view of LDC borrowing was influenced by the need of the global economy to respond to the large current account imbalances which originated with the vast terms of trade changes of the oil price rise of 1973/4, and were exacerbated by the second shock, in 1979: ‘the world faces the need to adjust – to payments imbalance and expensive energy – on a scale comparable to 1974–75’ (World Development Report (WDR) 1980: 3, our emphasis).

The scale of the subsequent adjustment was, of course, to be much greater than that of 1974–5, but such optimism was partially based on the perception that the large payments imbalances of the late 1970s were something the world had to respond to globally. This was to take place through recycling funds from current account surplus countries to those in deficit. It would allow adjustment to proceed with relatively little reduction in absorption (as compared to the alternative without borrowing), and thus with a lower cost in terms of ‘human development’. It is thus that the WDR (1981: 54) states that: ‘There is nothing inherently undesirable about external deficits, since deficits implied resource transfer. These effects ... provide a rationale for external borrowing to contribute to structural adjustment.’ The WDRs of the day advocated a ‘high growth’ mode of adjustment; of central importance to this was the availability of external finance to allow a smoothing of import reduction over time and cushion its impact on both consumption and investment.

In his 1975 Presidential Address, McNamara regarded the need of middle-income countries for greater access to external capital as the ‘most immediate and pressing problem in the global development scene’ (McNamara 1981: 297). Two years later, he felt ‘even more confident ... than we were a year ago that

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the debt problem is indeed manageable, and need not stand in the way of desirable rates of growth for the developing countries' (McNamara 1981: 456; see also Gazdar 1990).

The main factors conspiring to make many borrowers’ positions unsustainable by 1982 were clearly identified by the WDR of 1981: the tightening of monetary conditions globally in 1979, the contemporaneous fall in the terms of trade for most LDCs, the world recession, the rising proportion of debt owed to commercial lenders, the rising proportion of loans contracted in variable interest rate (VIR) agreements, and the rise in commercial bank exposure to LDCs (measured in terms of outstanding loans to LDC customers as share of total portfolio) from 49.6 per cent in 1975 to 61.5 per cent in 1978. In light of the Bank’s awareness of these phenomena, it is remarkable that they continued to make the optimistic predictions about the availability of voluntary capital flows in the 1980s which can be seen in Table 13.1. We believe that

<table>
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<tr>
<th>Table 13.1</th>
<th>A comparison of World Bank predictionsa and actual data for a number of variables in the 1980s</th>
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<td></td>
<td><strong>Low case</strong></td>
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<td>prediction</td>
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<td><strong>Average annual % growth of GDP per capita, 1980-90 in.</strong></td>
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<td>Industrial countries</td>
<td>2.3</td>
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<td>All developing countries</td>
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<td>Low-income countries</td>
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<td></td>
<td>(1.3)b</td>
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<tr>
<td>Middle-income countries</td>
<td>2.2</td>
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<tr>
<td>Latin America and Caribbean</td>
<td>2.3</td>
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<td>Oil-exporting countries</td>
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<td><strong>Average annual % growth in exports for all LDCs, 1980-90</strong></td>
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<tr>
<td>Official development assistance receipts (all LDCs) 1985d</td>
<td>3.9</td>
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<tr>
<td>Official development assistance receipts (all LDCs) 1990d</td>
<td>35.5</td>
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<tr>
<td>Direct private investment (all LDCs) 1985d</td>
<td>13.6</td>
</tr>
<tr>
<td>Aggregate net transfers (all LDCs) 1985d,e</td>
<td>36.3</td>
</tr>
<tr>
<td>Aggregate net transfers (all LDCs) 1990d,e</td>
<td>56.7</td>
</tr>
</tbody>
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**Notes:**
a Both low case and high case predictions made in the WDR 1981
b figure in brackets excludes China and India
c excludes the former USSR
d in US$ billions at current prices
e defined, as in *World Debt Tables 1989/90*, as the difference between aggregate net flows and interest payments on all debt.
\(p\) actual figure for 1988.

World Debt Tables (World Bank 1990)
the generally over-optimistic nature of their predictions about the performance of LDCs in the 1980s was strongly related to the assumption that voluntary capital flows would be sustained throughout the decade – in other words, to their failure to foresee, to any extent whatsoever, the coming debt crisis.

So, while the WDR of 1981 predicted middle-income oil-importers to grow by 5–6 per cent p.a. in the 1980s, their actual average growth between 1980 and 1989 was 2.9 per cent p.a. (WDR 1991). Latin America, which had been expected to grow from in the region of 2.3 per cent to 3.2 per cent, had by 1990 averaged negative 0.5 per cent p.a. since 1980. This is clearly not unrelated to the fact that whilst they had predicted net capital transfers to developing countries to have reached US$177.9 billion in 1990 (WDR 1980), the World Debt Tables 1989/90 (World Bank 1990) registered a net capital outflow of US$9.8 billion from all developing countries in 1988 (see Table 13.1). Their unwillingness to read the signs that they themselves had just laid out, or at least to publicly acknowledge their implications, is made quite plain in the same WDR (1981: 61): ‘While [the above] trends indicate that the developing countries will face more serious debt-management difficulties in the future, they do not signal a generalised debt problem for the developing countries’ (our emphasis).

The importance of external finance to enable most of these countries to manage the high-growth mode of adjustment advocated in this WDR – and generally by the Bank at this stage – was obvious, so any vestige of doubt as regards its availability was quite uncomfortable:

However, given the profitability of lending to developing countries, their exemplary records (with few exceptions) in meeting their obligations and their continuing need for foreign finance, it seems unlikely that financial intermediaries will discriminate against developing countries as a group.

Hence:

Summing up these various influences on commercial banks, it seems highly probable that both borrowers and lenders will adapt to changing conditions without precipitating any general crisis of confidence.

(WDR 1981: 61)

These quotes and predictions reveal an institution publicly unable or unwilling to foresee the impending collapse of voluntary lending, or any of its severe consequences to developing countries. In this chapter, we have not claimed that there was, anywhere outside the Bank, a crystal ball predicting the debt crisis either. We have presented some evidence, however, of academic work which should have been taken more seriously by the Bank.
THE WORLD BANK AND THE DEBT CRISIS

SOLUTIONS

Academics

The debate among academics after 1982 turned to the best ways to remedy the crisis in the LDCs and to prevent the world financial system from collapsing. In the first three years (1982–5), the debate centred on whether LDCs were experiencing a liquidity or a solvency problem. A debtor country was defined as illiquid if the expected present discounted value of its trade surpluses in the short run was not high enough to service its external debt, but when such surpluses in the longer run were.

Advocates of the liquidity view argued that the crisis was a short-run phenomenon. In particular, Sachs (1984) suggested that the amount of money borrowed was decided by an LDC government so as to maximise the growth rate, with investment as the control variable. He admitted the possibility that some of the external borrowing did not materialise in higher capital accumulation, particularly because of political reasons, but he did not perceive that as a danger to the ability of LDCs to repay, albeit after some 'adjustment period'. The policy implications of this view were clear: countries should be granted greater access to external financing until they adjusted to the sudden changes in the international macro-economy.

Advocates of the solvency view, on the other hand, emphasised that, first, the debt accumulation of the 1970s came about as a result of LDCs wanting to maintain consumption levels, at the expense of investment, after a negative terms of trade shock and, second, the way consumption was being maintained in the short run was through an overvaluation of the real exchange rate (see, in particular, Dornbusch, 1985). Both the framework and the empirical evidence Dornbusch presented suggest the possibility that highly indebted countries were not going to repay their debts, at least not out of the returns on investment, because a large portion of the money borrowed had not been invested but consumed. Moreover, a large volume of such debt had taken the form of capital flight, as in Argentina and Venezuela. Dornbusch's paper suggested that the whole financial strategy of the 1970s had been a failure and that ways should be found to share the costs, as had been the case in the aftermath of the defaults of the 1930s.

This view seems to have been shared by Peter Kenen who, as early as 1983, suggested the creation of an 'International Debt Discount Corporation' which would buy the debt from the commercial banks at a 10 per cent discount. It would then be able, because of the discount from which it benefited on purchase, to lower the interest rate charged to debtors. He further envisaged it to extend loan maturities, in another concessional element.

But those early proposals containing a debt-relief element, although important from a historical viewpoint, were not very influential at the time. The predominant view among academics in the first half of the 1980s appears to
have had two distinctive features: first, countries are illiquid and, second, countries may be unwilling to repay if they are not given the ‘right incentives’; i.e. if creditors fail to implement an appropriate carrot-stick mix. Accordingly, the provision of increased access for LDCs to lending (or debt rescheduling) was perceived as the key to solving the crisis.

Sachs (1984) sees the relationship between a debtor country and its foreign creditors as a Repeated Prisoners’ Dilemma. In particular, he argues that, as long as both parties value positively their future relationship, it is in their own interest to play cooperatively. Accordingly, we should expect creditors to be willing to extend new lending to a debtor experiencing financial distress. New lending, or more specifically, the re-lending of the due interest, principal, or both, was seen as the strategy that would prevent widespread defaults and keep the international financial system alive. The problem with such a strategy, however, is that there was a multiplicity of creditors involved, leading to a free-rider—or ‘moral hazard in team’—problem. This could threaten the whole approach by severely reducing voluntary lending levels, as anticipated by Cline (1983), Sachs (1984) and Krugman (1985, 1988).

Sachs (1986) and Krugman (1988), on the other hand, were first to suggest that some LDCs had accumulated so much debt that creditors no longer expected it to be repaid in full. Hence the high discounts in the secondary market. At such high levels of debt, it was no longer possible for indebted LDCs to obtain voluntary lending. Therefore, existing creditors faced the following trade-off (see Krugman 1988): new lending (or rescheduling) could avert defaults, but would at the same time trigger disincentives to invest in adjustment, as LDCs at such high levels of indebtedness would be discouraged by the awareness that future benefits from investment (or economic adjustment) would accrue largely to their creditors. One way out of this dilemma, Krugman argued, was by forgiving portions of the debt instead. This trade-off is didactically captured in Figure 13.1 (see Krugman 1989).

![Figure 13.1 The debt relief Laffer curve](image-url)
As we move from left to right on the Laffer curve in the above figure, we are first on the 45° line. The market value of the debt is then identical to its face value. As the face value of the debt continues growing, say, through rescheduling repayments, the disincentives to invest (or to undertake adjustment policies) come into play. Such disincentive effects will be reflected in the market value of the debt, which will rise less than proportionally as the face value increases. After a point (to the right of A) the market value of the debt will actually start declining. Creditors may then find it in their interest to forgive portions of their claims.

The above incentive argument, known as the debt overhang hypothesis, stands as the most widely accepted rationale for forgiveness. It gained official support from the US Treasury in March 1989, with the so-called Brady Plan, which called for debt write-downs in the case of heavily indebted middle-income countries. Its counterpart for low-income countries is the Toronto Agreement.11

In practice, the adoption of the Brady Plan by the US, and its subsequent acceptance by most other creditor governments, meant that debt reduction became a feasible option, albeit generally in fairly restricted conditions. Due to the large discounts in the secondary market, some LDCs began to engage in a number of transactions involving debt retirement. The simplest of all was straightforward buy-backs. However, because debtors were generally officially banned from undertaking buy-backs,12 more sophisticated ways of taking advantage of low market prices for debt were found. Among the most common types of market transactions were the debt for equity swaps, debt securitisation, and debt for nature swaps. Because debt retirement triggers positive incentive effects, these market transactions are generally viewed as a mutually beneficial way out of the crisis. In reality, such transactions have not been substantial.13

The Bank’s approaches to solving the crisis

Having traced the principal ideas in the debate on solutions to the debt crisis since 1982, we now attempt to place the Bank’s views and contributions into that context. At the onset of the crisis, the Bank, now under Clausen and Krueger,14 took a very cautious line, changing the focus from macro-economic concerns with the availability of foreign finance, so prominent under McNamara and Chenery, to micro-economic advice on ‘getting prices right’. External causes were de-emphasised, and blame for the crisis was laid predominantly on domestic policy errors, notably the use of borrowed funds for consumption or inadequate investment purposes, due to distorted prices. In 1986, an Operations Evaluation Department report stated that: ‘The flexibility provided by access to foreign borrowing will have been lost because of past policy errors’ (World Bank 1986).

The Bank adhered closely to the view, espoused publicly by the
governments of its major shareholders, that a ‘solution’ to the crisis must be based on a ‘restoration of creditworthiness’, and that the way for countries to achieve this was to maintain debt service up to date and avoid the need for rescheduling loans as long as possible. These objectives could best be secured through prompt efforts at internal adjustment aimed at switching production toward tradables, through the familiar combination of expenditure-reduction and expenditure-switching policies:

Despite the many problems they have had recently, developing countries need a continuing flow of bank lending to regain their growth momentum. For this to happen, however, developing countries must restore their creditworthiness – and that depends on their own policies and on the strength and stability of world economic growth.

(WDR 1985: 124)

The role envisaged for the international financial system was merely to provide some rescheduling when there were no other alternatives. In other words, the Bank adhered firmly to the liquidity view of the debt problem, and gave little serious consideration to the more radical early proposals mentioned above, such as that by Kenen.

The liquidity view was the prevalent one at the ‘International Debt and the Developing Countries’ conference, held by the Economics Research Staff of the Bank in April 1984. The papers presented there were compiled in a volume edited by Cuddington and Smith (1985), and included contributions by Cooper and Sachs, Gersovitz, Krugman, Simonsen, Dornbusch and Harberger.

Generally, they emphasised two shortcomings of the current strategy. It was felt that the ‘public good’ nature of involuntary sovereign lending by a private bank and the ensuing free-rider problem provided scope for greater coordination of the process by the IMF, the Bank and even creditor governments. As already suggested, the lead here had clearly been taken by the academics, as in Cline (1983) and Sachs (1984). Second, short-term rescheduling (generally of one year) which were then the rule, were seen as collectively inefficient, even if a single lender had an incentive to keep a problem debtor on a ‘short leash’.

Thus, whilst there were indeed suggestions that some due interest should be capitalised, and the loan maturities extended (Simonsen), as well as that banks ought perhaps to charge interest rates below market rates on some of their loans (Krugman) – justifying the organisers’ claim that debt relief was suggested – this was on a very modest scale. This was in contrast to the more radical proposals mentioned earlier, as well as to the tone of the academic debate a few years down the road, and to the views expressed in the Bank’s own subsequent conference in 1989. In short, the 1984 Conference brought the current state of the academic debate to the Bank. Most of the participants were key academics, and their conclusions were broadly in line with the
predominance of the liquidity view in the debate which had been taking place outside the Bank for at least two years.

In terms of policy implementation, there was some response to the concerns expressed most vocally at the 1984 conference, notably with the short-term nature of rescheduling and the need for greater coordination of involuntary lending, to combat the free-rider problem. The Baker Strategy, proposed by the then US Treasury Secretary in March 1985, was intended to address exactly these issues. Longer periods for rescheduling became more common, starting with a $49 billion multi-year package for Mexico. In light of the prominence of these ideas in the public debate for some time, however, it would clearly be incautious to claim that the driving force behind the Baker Strategy was the aforementioned conference.

But if the Bank's official positions were not radical or innovative in the 1982–5 period, from 1986 to 1988 they appeared to lag further behind the rapidly evolving debate. In a paper written before joining the Bank, Fischer (1989) emphasises the severe decline in income per capita in the Baker fifteen heavily indebted countries, the massive resource transfers from these countries and the resulting collapse in their domestic investment rates. The focus had changed substantially from the liquidity view, towards a concern with the seriousness of the effects of the crisis on the debtor countries, and the proposed solutions reflect that change. In this, as well as in most other papers devoted to possible solutions to the crisis in Sachs (1989), the possible desirability of debt relief and a variety of mechanisms through which to achieve it efficiently are discussed. There is no contention over Sachs's claim that 'partial debt relief can therefore be Pareto improving (i.e. to the benefit of both creditors and debtors)' (1989: 28). Yet, years after the debt overhang hypothesis had been proposed, the role of the Bank continued to be that of a supporter of the Baker Strategy, with its response to the concerns so widely voiced in 1984/5 still based on concerted lending and loan rescheduling.

An indictment of this role appears in the paper by Diwan and Husain (1989) which introduces their volume on Dealing with the Debt Crisis, a report on the Bank's 1989 Conference on Debt. There they acknowledge, in so many words, that the strategy was unsuccessful, that it had modest targets for new money ($13 billion annually), that even those targets were never achieved (net annual flow was only about $4 billion), that 'the official sector had only moral suasion to ensure that the private sector met the plan's targets' and, fundamentally, that: 'controversies, even of a few billion dollars, miss the point: the transfer of resources from the highly indebted countries to the industrial countries for external debt was more than $100 billion during 1986–88' (1989: 4).

An admission of the reasons behind the Bank's behaviour was given by the Chief Economist in 1989:

the record shows that frank and open debate does not take place in official
and banking circles. It was clear to the participants in this conference at the beginning of 1989, as it had been clear to many much earlier, that growth in the debtor countries would not return without debt relief. But the official agencies operate on the basis of an agreed upon strategy, and none of them could openly confront the existing strategy without having an alternative to put in place. And to propose such an alternative would have required agreement among the major shareholders of these institutions. So long as the United States was not willing to move, the IFIs were not free to speak...

(Fischer, in Diwan and Husain 1989: v)\[17\]

In 1988, a willingness to contemplate some debt reduction began to manifest itself among those ‘major shareholders’. K. Miyazawa, then Japan’s finance minister, used the IMF–World Bank meetings in Berlin that year to propose officially sponsored debt reduction schemes. Mitterrand of France followed suit later that year, in Toronto, where official creditors agreed on a set of guidelines for concessional relief for low-income severely indebted countries, thereafter known as the Toronto terms. The WDR of 1988, the first entirely under Fischer as Chief Economist, marks the Bank’s official jump from the Baker bandwagon, by including suggestions that some debt relief, and ‘reduction of the debt overhang’ could be important elements to facilitate the transition from adjustment to growth.\[18\] It was just in time to claim marginal precedence to the change in the US official position, which came with the Brady Plan in 1989, aimed at middle-income severely indebted countries, but considerably later than Dornbusch (1985) and Sachs (1986), which we suggested marked the rise of the solvency view and the debt overhang argument.

From then on, there appears to have been an increase in the liveliness of the debate on debt in the Bank, as well as in its sponsorship of research on the topic. The Debt and International Finance Department issued papers quite frequently, often focusing on issues connected with voluntary, market-based debt reduction schemes and the related incentive problems (e.g. Claessens 1988).

To this improvement in the Bank’s record as a follower of the theoretical debate since 1988, it must be added that one sphere of intellectual activity where the Bank had long been making a significant contribution to the study of LDC debt was the publication of comprehensive data on the direction, magnitude and effects of the debt flows. This was mostly through the World Debt Tables which, complemented by the World Development Indicators, provided the basis for much academic and policy work on the subject. Within the framework of the Brady Initiative, furthermore, the Bank’s role in helping countries to design and negotiate the menus for debt reduction with their creditors provided new scope for application of the ideas being researched and debated throughout the profession. By the end of 1990, Brady deals had been concluded with Costa Rica, Mexico and the Philippines, and other countries
were negotiating their own packages. The Mexican example, besides being the earliest, is also probably the most studied (see van Wijnbergen 1991; Armendariz de Aghion and Armendariz de Hinestrosa 1994).

CONCLUSIONS

As Fischer’s quote (pp. 225–6) suggests, a comparative review of the academic writings on LDC debt and of the evolution of opinion at the Bank in the 1980s must lead us to conclude that this was not an area of strong intellectual performance by the World Bank. There are, as we indicated in the introduction, a number of alleviating circumstances, notably the justifiable perception that this subject fell more naturally within the realm of responsibility of the IMF, and the political pressures and constraints that clearly hampered free enquiry and debate into some aspects of the problem in official circles. Nevertheless, given the wealth of advice and predictions which the WDRs, among other vehicles for dissemination of Bank thinking, published on managing the current account deficits, and later the debt itself, it is clear that the issue was understood to be important.

There are three main conclusions which can be drawn from the evidence discussed above. First, it appears to us that the Bank’s attitude towards the rapid growth in the level of the external obligations of many developing countries in the late 1970s was misguided. Their view that deficits implied resource transfers, whilst definitionally correct, could very well be taken as an endorsement of the high borrowing strategy which led so many countries to be viewed as financial pariahs in the 1980s. Second, from 1982 to their Conference on Debt in 1984 and the advent of the Baker Strategy in March 1985, the Bank was unoriginal in terms of proposing solutions to what had by then become the greatest immediate obstruction to a resumption of growth and development in a large number of countries. It shared the concerns of most of the profession with insufficient levels of lending due to free riding in a multi-lender framework.

Finally, from 1985 to around 1988, there was a further worsening of the Bank’s record as a follower of the debate. This was a time when the balance of academic opinion was changing towards recognising the necessity of some debt relief, or forgiveness. This was heavily influenced by Dornbusch’s (1985) suggestion that the crisis did, in a sense, reflect a solvency problem, and even more so by Sachs (1986), which contained an early discussion of the debt overhang hypothesis. That was a time of growing recognition that the early proposals to create institutional mechanisms aimed to reduce the present value of LDC external obligations might at least have been pointing in the right direction. Not so at the Bank, however. As we have seen, very senior officers at the Bank were quite prepared to recognise, at the 1989 Conference, that the institution had been confined to the role of supporting the Baker Strategy at a
time when it was becoming abundantly clear to the informed public that debt reduction was an urgent necessity.

This urgency was only recognised at the Bank from 1988/89, following Japanese, French and finally American policy changes which culminated in the Brady Plan. From 1989 onwards, as we briefly suggested above, the Bank was free to follow the academic debate more closely, and to contribute to it through what it does best: applied country work, this time mostly advising countries in the design and negotiation of their debt reduction menus with commercial creditors.

On the whole, however, it is not possible to claim that the Bank displayed intellectual leadership on issues relating to the debt crisis of the 1980s. As Fischer admits from the Bank:

"academic research, writing and opinion have been far more influential on the debt issue than the academics may believe, or than officials like to pretend, for the academics are unencumbered by the official need to support the official strategy. It was academics who were first to point out that the stabilization focus of the programs imposed on debtors to deal with the debt crisis from 1982 to 1985, while necessary, was not sufficient for growth."

(Fischer, in Diwan and Husain 1989)

NOTES

1 Average GDP per capita growth in LDCs fell from 2.7 per cent in 1970–80 to 1.2 per cent in 1980–90. In the fifteen most heavily indebted countries the 1980s actually saw a 0.4 per cent fall in GDP per capita (from data in the World Development Reports 1981 and 1992). The percentage of the population living below the poverty line in, for example, Mexico, was 17 per cent higher in 1984 than in 1970 (see Cardoso and Helwege, 1992).

2 See for example, Cuddington and Smith (1985), Dornbusch and Fischer (1987) and Sachs (1989) for detailed expositions of the origins of the crisis.

3 The real US prime rate rose from –0.6 per cent in 1977 to 12.8 per cent in 1981 (Dornbusch and Fischer 1987).

4 A weighted index of non-oil commodity prices fell from 121 in 1977 to 81 in 1982 (1980 = 100) (see Dornbusch and Fischer 1987).

5 A first version of the paper was received by the RES in April 1978 (see also Eaton et al. 1986).

6 Eaton and Gersovitz (1981) have one period maturities; \( b(t) \) denotes new lending and \( d(t) \) denotes repayment obligations at period \( t \).

7 Human development, broadly understood to mean poverty reduction and an improvement in the social indicators and living standards of all – but principally the poorest – segments of developing country populations, was then, and had been since McNamara’s Nairobi speech in 1973, the paramount articulated policy objective of the Bank.

8 On evidence of capital flight from Latin America in the 1980s, see also Pastor (1990).

9 Dornbusch often emphasised that in the aftermath of the defaults of the 1930s the creditors had negotiated substantial write downs in the face value of their claims
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with the LDCs. For more on historical experiences of debt settlements, see Eichengreen and Portes (1989).

10 Kenen was not the only person to have anticipated in the early 1980s the direction of the debate among academics. Felix Rohatyn proposed to the US Senate that LDC debt could be stretched out to longer maturities (15 to 30 years) and interest reduced to something like 6 per cent. Norman Bailey, of the US National Security Council suggested that the debt be swapped for a form of equity asset that would entitle the holder to a fraction of the country’s export earnings (see Cline 1983, for a more complete survey of these early proposals).

11 The terms of the Toronto Agreement apply to official debt (Paris Club debt), owed by low-income, predominantly African, countries. See p. 226 for more on Toronto.

12 The reasons are twofold. First because they reward the least reliable, and second because of moral hazard reasons, i.e. countries will be encouraged to default in order to lower the price of their debt to then undertake the buy-back (see Krugman 1988).

13 One exception is Chile, where the debt-for-equity swaps have been substantial (see Armendariz de Aghion 1991).

14 As President and Vice-President for the Economics Research Staff, respectively.

15 We find this to be the case despite the fact that Dornbusch, an early advocate of the solvency view as discussed above, was present at the Conference (see Dornbusch 1985).

16 Both were economists at the Debt and International Finance Division of the International Economics Department of the World Bank.

17 It is quite likely that the reasons for the Bank’s lack of enthusiasm for debt forgiveness are not entirely political. It has been privately suggested by a senior Bank official that, as an intermediary that raises finance from the market, and whose ability to do so is affected by its credit rating, the Bank was naturally hesitant to propose policies which, if applied to its own loans to developing countries, might lead to asset write-offs.

18 The World Debt Tables 1987–88 (World Bank 1988) contained some consideration of the need for partial forgiveness, but still pledged official allegiance to the rationale of the Baker Strategy. We are grateful to Ishrat Husain for bringing this to our attention.