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1. *AKH*
2. *NBP*

Dear David,

CHANCELLOR'S SPEECH ON INTERNATIONAL DEBT, 22 JULY

... You may like to have the attached copy of the Chancellor's speech about International Debt, to the All Party Parliamentary Group on Overseas Development.

I am copying this letter to Tony Galsworthy (FCO), Paul Steeples (Department of Trade and Industry), Shirley Stagg (MAFF), and Martin Dinham (Overseas Development Administration).

Yours sincerely,

Andrew Hudson

A P HUDSON

**CHANCELLOR OF THE EXCHEQUER'S SPEECH TO ALL PARTY PARLIAMENTARY
GROUP ON OVERSEAS DEVELOPMENT, 22 JULY**

The debt problem has been with us for almost five years now. While there is no magic solution, some useful progress has been made, and more is in prospect. Today, I want to look ahead at what the next steps should be, and what action should be taken by governments, by the commercial banks, and by the debtor countries themselves.

When the crisis broke in the autumn of 1982, the immediate need was to buy time, so that the banks could strengthen their capital base, and the debtor countries could begin the process of putting their economies on a better footing. This has been done successfully. Earlier fears about a systemic threat to the world banking system have receded. Many debtor countries have implemented long overdue reform policies. And the world economy generally is in better shape than it was five years ago.

With the worst of the crisis behind us, the job is to look forward to what needs to be done to enable the debtor countries, in time, to bring their debt burdens down to more manageable and sustainable levels. And, as I shall argue, the solution is not necessarily the same for the different groups of debtors.

Most of the discussion about the debt problem has understandably been focussed on the so-called middle income debtors, notably in Latin America. Certainly, these countries have the greatest overseas indebtedness - at the end of 1985, Brazil owed no less than \$105 billion and Mexico \$95 billion. But at the same time they are for the most part rich in natural resources, and have a fairly well developed industrial structure. In short, they are in a position to pull their economies round and to reduce their debt burdens, by their own actions.

The first requirement for these countries is therefore to put the right economic policies in place. This means, first and foremost, allowing markets to work more freely. It means, in many cases, cutting back a bloated State sector. And it means keeping interest

rates and the exchange rate at realistic levels - otherwise the capital flight which so damaged the debtor countries in the early 1980s will persist. It has been estimated that over \$100 billion left the problem debtors between 1978 and 1985, equivalent to more than a third of the additional debt they incurred over that time. But Mexico has shown recently that it is possible to encourage significant capital inflow, provided sensible policies are pursued.

The overwhelming majority - some two thirds - of the debts owed by the middle income debtors are owed to the commercial banks. It is clearly the joint responsibility of the debtor countries and the commercial banks to manage these debts.

Throughout the past five years, a variety of schemes have been put forward under which the governments of the industrial countries would step in and take it upon themselves to "solve" the debt problem. People argue that the magnitude of the problem is such that it demands government action.

I am not attracted to any of these schemes. They all boil down, directly or indirectly, to the taxpayers bailing out the banks.

To do this would not only be a misuse of public money. It would also encourage bad banking.

The banks embarked on sovereign lending chiefly because it looked to be a profitable business. For some years, it was. But the banks knew all along that the returns were in no sense underwritten - by taxpayers or anybody else. They knew they were in the risk business. If they did not know that, they should have done. And there is certainly no case for taxpayers to pick up a disproportionate share of the bill for commercial misjudgements.

Thus the way forward for the banks is to treat sovereign debt as they would other types of debt. This has already meant a good deal of rescheduling of debts. And now, one by one, the major banks are announcing substantial increases in the specific provisions made against sovereign debt. In the immediate future, at least, this increase in provisioning is bound to mean a significant cost to the

taxpayer, since more tax relief will be due to the banks. This occurs under the normal rules for provisions against bad or doubtful debts. If any company's profits are cut back, the Exchequer is likely to get less revenue. That is wholly proper: indeed the only proper role for the taxpayer in this context.

Large though the tax cost is likely to be, I unhesitatingly commend the way the banks are now dealing with the debt problem on their books. By strengthening their balance sheets, and increasing provisioning, they are moving further down the road from involuntary lending back to lending based on proper commercial decisions, and from make-believe to realism.

They are also paving the way for a more market-orientated approach to the way in which the middle income debtors can in future meet their financial needs. So far, most funds have been provided through syndicated loans involving a number of banks. But other approaches have a role to play, particularly those involving a more explicit sharing of risk between lenders and borrowers. There needs to be more direct investment, both through new equity investment, and debt-for-equity swaps. This shift of emphasis will, however, require a more welcoming attitude from some of the debtor countries themselves, some of which are, for example, still resisting the idea of debt-equity swaps.

The debt problems of the middle income debtors will not be solved quickly. But the way forward is clear. The banks are adopting a more realistic approach towards provisioning. If the debtor countries themselves pursue sound policies, there is no reason why the middle income debtors should not, in time, make real progress towards full creditworthiness.

But the same cannot be said for the poorest countries of Sub-Saharan Africa.

The concentration on the middle income debtors has meant that, until recently, the plight of those in Sub-Saharan Africa has been neglected. But although the volume of debt there is not so great, their problems are even more acute.

These countries are very poor indeed: in 1985, their GNP per head was only about \$280, less than one-fifth of that in the middle income debtor countries. And they are getting poorer. In many cases, their GNP per head is actually lower, in real terms, than it was twenty years ago.

Unlike the major debtors of Latin America, the poorest and most heavily indebted countries of Sub-Saharan Africa have no chance whatever of returning to viability by their own efforts. Although the amount of debt per head of population may be a good deal lower than in the middle income debtors, the ratio of debt to national income is much higher. And their problems are getting steadily worse. Sub-Saharan Africa's debt has risen by well over 70 per cent since 1980, while its exports are even lower now, in dollar terms, than they were then.

There is certainly a great deal of scope for the Sub-Saharan countries to start to improve the health of their own economies. And that they must do. But that by itself will not be enough to reduce their debt burden.

At the same time, in contrast to the middle-income debtors, two-thirds of the Sub-Saharan African countries' debt is owed to other governments and to international institutions, rather than to the commercial banks. Responsibility for tackling this side of the debt problem therefore lies fairly and squarely with governments. And just as I expect the banks to face up to their responsibilities for the middle income debtors, so governments must do the same for these very poor countries.

That is why I proposed, in Washington last April, a three point international plan to support those of the poorest and most heavily-indebted Sub-Saharan African countries which are pursuing satisfactory economic policies.

- First, the creditor nations should convert aid loans into outright grants.

- Second, longer repayment periods, with generous grace periods, should be allowed in rescheduling other official loans.
- And third, and of crucial importance, the creditor countries should reduce the interest rates payable on these debts to well below market levels.

Since this British initiative, there has been growing recognition - for example, at the Venice Summit - that the basic analysis is inescapable. And the reason for singling out the poorest countries of Sub-Saharan Africa for special treatment has been generally acknowledged. What is needed now is action.

The United Kingdom has in fact almost completed already the process of converting aid loans to grants for Sub-Saharan Africa. Denmark and the Netherlands have also made good progress on this front. I hope the other industrialised countries that have not yet done so will follow suit.

The industrialised countries generally, meeting together as the so-called Paris Club, have made useful progress in rescheduling debts on more generous terms. New arrangements have already been agreed for four African countries - Mozambique, Mauritania, Uganda and Zaire. Mozambique, for example, where new adjustment measures are just beginning to have their effect, was given twenty years to repay its rescheduled debts, instead of the conventional ten years. More such arrangements are in prospect.

However, there has not yet been sufficient support from other creditor countries for my proposal for an interest rate reduction on these debts. This is certainly a new departure in the handling of the debt crisis. But it is absolutely essential if we are to make any real progress in the case of Sub-Saharan Africa.

The plain fact is that, without some reduction of interest rates, the debt burden on the Sub-Saharan countries will continue to get worse, rather than better, as indeed has been happening since 1980. Many of these countries have no realistic prospect of meeting even

their full interest payments at present, let alone repaying capital. The interest is therefore capitalised and added to the total burden of the debt. As long as this process goes on, the debt burden will rise exponentially. The only way out of this vicious spiral is if the interest charges are reduced, so that the debtor countries can meet their current obligations and start to make inroads into the capital they have to repay.

Some creditor countries profess to be reluctant to incur the budgetary cost involved in the proposal. Clearly, this is not to be undertaken lightly. But since there is no realistic prospect of actually securing anything like full repayment if rates are not reduced, we have to regard the cost as one that has been incurred already. The question is how we face up to it. My proposal is that we should do so in an orderly way over a reasonable period of years.

Another concern that has been voiced is that debtor countries which accept such concessionary terms might be cutting themselves off from future commercial lending. Eventually, of course, the Sub-Saharan countries should indeed look to the market for the funds they need. But at present, and for some time to come, the brutal truth is that most of these countries are unbankable. For the foreseeable future, they will depend largely on concessional aid flows of various kinds. Lightening the burden of servicing the existing stock of debt will help, rather than hinder, a return to normal financing. It should also encourage more direct investment by the private sector.

I understand the concern that allowing interest rate relief would give the wrong signal to the countries in question. However, it has always been an integral part of my proposal that this facility should only be made available to countries which are implementing satisfactory economic reform policies. The Sub-Saharan countries should have no doubt of our determination on that score.

This is a specific measure designed to deal with the specific case of Sub-Saharan Africa. It is not a model for the debtor countries more generally. Nor, indeed, could it be. As I have said, the middle income countries owe their debts, predominantly to the

commercial banks, and it would be quite wrong for governments to dictate terms to the banks.

I have to say that I have little patience with the objections that have been raised to my proposal for concessional interest rates in these circumstances. The basic analysis has not been questioned, and it leads inexorably to the conclusion I have outlined. The job now is to take action, before the problem gets worse.

I therefore urge those countries which have so far been dragging their feet to join in this initiative, so that we can agree a timetable for action at the international meetings this autumn. We have a moral responsibility, as well as an economic one, to some of the poorest countries in the world.

I am glad to say that the IMF and the World Bank have now joined in recognising the need to tackle the problems in this area. The Managing Director of the Fund has proposed that more concessional funds should be provided for low income countries, and this initiative was welcomed at the Venice Summit. Discussions are under way to decide how best to achieve the objective of providing more help from the Fund and Bank for the poorest countries. The UK is playing a full part in these discussions, and I hope to see us make parallel progress in this area, too.

The Wider Context

In the longer run, the aim for the Sub-Saharan countries must be the same as for the middle income debtors: that they should be able to play a full part in the world economy. They need to capitalise on those products in which they do have a comparative advantage - typically, agriculture and minerals.

This depends on two things. First, the African countries need to restructure their own economies, to shift the emphasis back towards agriculture, rather than bolstering an inefficient manufacturing industry - often supported by a highly protective trade regime - and a bloated public sector. Some of the poorer countries do not help themselves by overtaxing farmers, or not paying producers the world market price for their products, out of a misguided wish to

cushion the effects of world prices on the urban poor. But, second, the already overwhelming arguments for reform of agriculture in the developed countries are strengthened by the effects present policies are having on the developing countries.

The case for agricultural reform is by now well understood. The present system entails spending large sums of money on storing and disposing of surplus food. This imposes a direct burden on the rest of the economy. But the burden does not stop there. Consumers have to pay much more in the shops than if they were able to buy freely. And many of the poorer farmers are scarcely benefiting at all from a system which was originally designed to maintain farm incomes.

I have made these points repeatedly in international meetings. They underly our wholehearted opposition to increasing the EC Budget until the excesses of the Common Agricultural Policy are brought under control. The analysis of the problem is increasingly widely accepted. The question is how to tackle it. Earlier this month, the United States, which also subsidises its agriculture to a massive extent, as indeed does Japan, launched a radical proposal for the elimination of all subsidies over a ten year period, and this will be considered at the next GATT meeting. This is certainly an area where we must not be afraid of radical solutions. And we need to keep firmly in mind the damage which the present system is doing not only to our own economies but also to the very poorest countries in the world.

Of course, the need to make markets more, rather than less, free - and to give the poorer countries continued access to developed countries' markets - does not apply only to agriculture. It applies to trade of all kinds. That is why the Geneva talks in GATT need to be brought to a successful conclusion in other areas, such as services, too. But agriculture is of central and increasing importance in this context. We cannot preach free trade to the developing countries and practise something very different ourselves.

Conclusion

There are no panaceas for the debt problem. As in so many areas of economic policy, we have to put the right policies in place and pursue them with determination. And as in other areas, it is important for governments to concentrate on problems which are properly theirs.

In particular, this means that governments have to shoulder their share of responsibility for finding a solution to the problems of Sub-Saharan African debt, and act accordingly. We in this country have given a lead. I hope that others will follow.