ACCOUNTING PRACTICES AND THE THIRD WORLD DEBT CRISIS

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The debt crisis, particularly for the major borrowers among countries of the developing world, has caused much anxiety in international financial circles over the last two years. This situation has also given rise to questions on the accounting practices of the international money market. In this paper Dr. Hemal Jayasuirya with a PhD from Cambridge and an MA (Systems) and now working on computer operations in Britain, discusses the issues connected with the accounting practices of international money lenders. He illustrates how a developing country borrowing in the international market could end up by paying as much as, 61.3 percent of the loan as interest. One explanation is that the recipient of loans has to pay the growing short term interest rate for the entire duration of the loan- a system that could work well and be fair to all parties concerned only as long as there is no inflation. What is happening is that by the inclusion of the inflation rate in the interest rate (rather than using the real interest rate excluding the inflation rate) lenders are forcing borrowers to pay in the early years of a project rather than at a later time period, when the development project for which the loan is utilised, can be realistically expected to yield the necessary cash for the repayment of the principal due to inflation. He suggests that what is required to cope with inflationary conditions is a fixed "real" interest rate and variable amortisation payments which will enable LDCs to have the necessary breathing space in the early years of a project, in a financial sense, and enable them to repay their debts in later years as the project begins to generate the projected cash.

The debt crisis facing LDCs (Lesser Developed Countries) has been high-lighted by the predicament of Brazil and Mexico in recent months. This may be due to faulty accounting practices of the international money market, according to some development economists.

In view of the uncertain international financial environment, major lending institutions have evolved a method for overcoming problems concerned with long term lending to LDCs at fixed interest rates, which can prove to be disastrous, if the short term interest rates prevailing in the money markets are several times greater than the rate agreed with the recipient country (e.g. 20% against a 2% fixed interest rate). Hence recipients have to pay the going short term interest rate which is defined as the average interest rate for a day on the London or New York markets, for the entire duration of the loan.

This system works well and is fair to all parties concerned as long as there is no inflation. However in an inflationary economy the interest rate tends to float upwards and "get stuck" If we consider an interest rate of 20% in an inflationary economy, the real interest rate may be 2%, the remaining 18% corresponds to the inflation rate at the time concerned (it should be noted that there is no such thing as a real interest rate of 20% or more except in "loan sharking", such as might occur in desperate or war-time situations). But most bankers have ignored this central fact. Most LDCs have agreed to pay for their borrowings assuming a historical figure varying between 0.5 and 5.0 per cent. They would also have agreed to repay the principal in equal amortisations over a fixed number of years, given a mutually agreed initial grace period. The cash flows of development projects for which the loan is utilised would also have been based on the above mentioned assumptions.

Table 1 shows calculations based on present procedures adopted by lending institutions. The formula P=S/1+r)n where P is the constant 1982 dollar value of a sum of dollars in any subsequent year, r the interest rate, and n the number of years beyond 1982 under consideration, has been used for the correction of cash flows.

If we look at Table 1 for a hypothetical LDC which borrowed $ 85 million in 1982 to be repaid over a period of 7 years, then in the two years 1982 and 1983 it has to pay interest to the tune of $ 34 million or 40% of the original loan, in what is supposed to be the grace period (the time which is considered to be essential for the project to start generating the requir-

TABLE 1

$ 85 million loan, prime rate of 20 per cent, inflation 18 per cent)

	CURRENT DOLLARS		CONSTANT 1982 DOLLARS	
Year	Interest (millions)	Amortisation (millions)	Interest (millions)	Amortisation (millions)
1982	17.0	Grace	14.4	Grace
1983	17.0	Grace	12.2	Grace
1984	17.0	17.0	10.4	10.4
1985	13.6	17.0	7.0	8.8
1986	10.2	17.0	4.6	7.4
1987	6.8	17.0	2.5	6.3
1988	3.4	17.0	1.1	5.3
TOTAL	85.0	85.0	52.1	38.2

ed cash.) When considered in this light it seems that the sounding of alarms in international monetary circles about de-faulting on the part of LDCs is not justified. Default results from the in-built features of the lending practices of lending institutions and not as a result of the managing practices of the recipient countries. However it must be emphasised that limitations of infracturcture, skilled manpower, communications etc. necessarily make the utilisation of any given quantum of money for a chosen project by a LDC less efficient than a comparable project in a developed country or a multinational company. But this is a different problem, not directly related to financing, which the lending institutions are attempting to rectify by lending money in the first instance to LDCs, in order to promote development and increase efficiency, and thus help break the vicious circle.

Another striking feature (as seen from Table 1) is that the LDC ends up by paying 61.3% of the amount of the loan in interest, having borrowed from helpful and respectable international banking institutions and not from unscrupulous financial intermediaries or loan sharks.

If we study Table 1 in detail, it will be noticed that the repayment of the principal adds upto only $ 38.2 million, less than half the original loan. However bankers will be satisfied that the terms of the loan have been fully met. But what has happened to the remainder of the principal? The answer to this lies in the fact that the sum of the interest payments of $ 52.1 million plus $ 38.2 million repayments of the principal add upto $ 90.3 million. The bankers are thus satisfied that they have recovered their principal in full and also have received interest on the loan, although their accounting methods may be far from satisfactory (as will be shown later).

What is happening is that by the inclusion of the inflation rate in the interest rate (rather than using the real interest rate excluding the inflation rate), the lenders are forcing the borrowers to pay in the early years of the project (rather than at a later time period, when the development project for which the loan is utilised, can be realistically expected to yield the necessary cash for the repayment of the loan) the loss of purchasing power of the principal due to inflation.

On the other hand if the procedure shown in Table 2 were adopted by the lenders, it can be shown that the total sum recouped by the bankers would be much larger, $ 214.74 million, consisting of $ 199.7 million (as opposed to $ 38.2 million under the existing procedure) so as to maintain the purchasing power of the principal plus $ 15.04 million from fixed interest rate payments, giving the recipients financial relief in the difficult early years of the project.

According to this scheme, loan repayments are made according to real interest rates, and amortisations are assumed to have clauses that guarantee their purchasing power. The principal would be corrected for the prevailing inflation rate (assumed to be 18% in Table 2 calculations) as measured by some mutually agreed price index during the period between the loan and its amortisation.

Most loans negotiated by LDCs prior to 1971 were based on the assumption that inflation rates would be rather low (certainly less than double-digit inflation which became commonplace throughout much of the seventies). The subsesequent high inflation put the LDCs into the so called "debt trap" requiring further borrowing merely to pay the interest on existing loans, leading to a vicious spiral. On the other hand, the present system also penalises the lenders as the principal is not inflation linked. Hence it would make it easier for LDCs to pay their debts at a future date with inflated dollars, provided the anticipated cash flows from the development projects were realised.

In conclusion, it can be said that what is required to cope with inflationary conditions is a fixed "real" interest rate and variable amortisation payments. This will enable LDCs to have the necessary breathing space in the early years of a project, in a financial sense, and enable them to repay the debts in later years as the project begins to generate the projected cash.

TABLE 2

	CURRENT DOLLARS		CONSTANT 1982 DOLLARS	
Year	Interest	Amortisation	Interest	Amortisation
1982	1.70	Grace	2.01	Grace
1983	1 70	Grace	2.35	Grace
1984	1.70	17.0	2.79	27.9
1985	1.36	17.0	2.64	32.9
1986	1.02	17.0	2.33	38.9
1987	0.68	17.0	1.84	45.9
1988	0.34	17.0	1.08	54.1
TOTAL	8.50	85.0	15.04	199.0