

## COMMENTS

### GIVE ME EQUITY OR GIVE ME DEBT: AVOIDING A LATIN AMERICAN DEBT REVOLUTION

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#### 1. INTRODUCTION

The world debt crisis will not go away.<sup>1</sup> If ignored it will, at best, cloud Latin America's economic<sup>2</sup> and political<sup>3</sup> future. At the end of 1987, developing countries owed a total external debt in the range of \$1 trillion.<sup>4</sup> The three largest Latin American debtors, Brazil, Mexico and Argentina, together owed approximately \$270 billion.<sup>5</sup> Interest payments for Brazil and Mexico alone amounted to \$22 billion for fiscal

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<sup>1</sup> See generally D. DELAMAIDE, DEBT SHOCK: THE FULL STORY OF THE WORLD CREDIT CRISIS 232-51 (1985) (discussing the future of the Latin American debt); Kuczynski, *The Outlook for Central American Debt*, 66 FOREIGN AFF. 129-30, 137, 143 (1987) (reviewing the Latin American debt crisis as of the fall of 1987); Hernández Colón, *Sharing the Burden of Latin Debt*, N.Y. Times, Apr. 16, 1987, at A23, col. 1 (commenting on the lingering problems caused by the debt).

<sup>2</sup> There is no realistic way for countries to keep up their debt service obligations while maintaining economic growth. Current arrangements for servicing debt siphon away the capital a less developed nation needs in order to achieve healthy levels of economic growth. Without such growth, a nation with outstanding debts will not be able to meet its long-term financial obligations. Failure to alter existing debt obligations, therefore, will ultimately result in either a cycle of rescheduling or in default. D. DELAMAIDE, *supra* note 1, at 243-44; Kuczynski, *supra* note 1, at 140; Purcell, *War and Debt in South America*, 61 FOREIGN AFF. 660, 668 (1982).

<sup>3</sup> For a review of the relationship of the Latin American debt to Latin America's political future, see Roett, *Democracy and Debt in South America: A Continent's Dilemma*, 62 FOREIGN AFF. 695 (1983); see also Hernández Colón, *supra* note 1 (Governor of Puerto Rico warning "Washington that democracy in Latin America could be in grave danger if the debt problem is not brought under control").

<sup>4</sup> Farnsworth, *New Debt Relief Policy*, N.Y. Times, Dec. 31, 1987, at A1, col. 1; see also Kilborn, *Official Gloom on Third World Debt*, N.Y. Times, Sept. 28, 1987, at D1, col. 5. In 1987, Pedro-Pablo Kuczynski, Cochairman of First Boston International, estimated Latin American foreign debt at \$400 billion. Kuczynski, *supra* note 1, at 130.

<sup>5</sup> Truell & Murray, *Debt Breakthrough*, Wall St. J., Dec. 30, 1987, at 1, col. 1. As of December 31, 1986, Brazil, Mexico and Argentina owed external debt in the amounts of \$110.3 billion, \$100.3 billion and \$57.7 billion respectively. *Id.*

year 1985.<sup>6</sup> Even if net exports from Latin American nations remain high, it is estimated that the interest payments will consume between thirty-five and forty-five percent of those nations' yearly export earnings.<sup>7</sup> Any economic downturn in Latin America will exacerbate this debt domination; if exports are reduced, less money is available for national development while the financial obligation to service the existing debt remains unchanged.<sup>8</sup> Such a drop in available capital would create a pressing need for further borrowing.<sup>9</sup>

Even without a major economic downswing, no Latin American nation has proven that it can combine growth with the avoidance of unsound borrowing — a combination that is required if a nation is to grow out of its debt.<sup>10</sup> Moreover, the current disruption of the United

<sup>6</sup> Meltzer, *International Debt Problems 1* (July 1986) (unpublished abstract available from the Department of Economics, Carnegie-Mellon University). During the period from 1983 to 1986, Brazil paid over \$40 billion in interest to foreign banks. Mexico, Argentina, Venezuela and Brazil together paid a total of \$120 billion in interest during the same period. Henry, *Brazil Says: Nuts*, *NEW REPUBLIC*, Oct. 12, 1987, at 25, 29.

<sup>7</sup> Purcell, *supra* note 2, at 670; *see also* Hormats, *The World Economy Under Stress*, 64 *FOREIGN AFF.* 455, 476 (1985) (noting that in many Latin American countries debt service payments are growing more rapidly than export earnings); Rogers, *The U.S. and Latin America*, 63 *FOREIGN AFF.* 560, 576 (1984) (noting that, even with restructuring and adjustment, Latin America's debt will continue to consume a large fraction of total export earnings for the rest of the decade).

<sup>8</sup> *See* Bailey & Watkins, *Mexico's Dilemma*, *N.Y. Times*, Dec. 29, 1987, at A19, col. 2. The United Nations Economic Commission for Latin America estimates that from 1982 to 1986 repayment of principal and interest by Latin American nations to creditor nations amounted to approximately \$100 billion more than new loans from these nations. L. MALKIN, *THE NATIONAL DEBT* 87 (1987); *see also* Silk, *Economic Scene: Critical Puzzle for the I.M.F.*, *N.Y. Times*, Sept. 23, 1987, at D2, col. 1 (commenting on the unwillingness of commercial banks to lend new money to debt-plagued Latin nations); Rockefeller, *Let's Not Write Off Latin America*, *N.Y. Times*, July 5, 1987, at E15, col. 2 (discussing the continuing reluctance of commercial banks to lend additional funds).

<sup>9</sup> The reduction in capital is the result of less money being earned through foreign exchange. Because there is less money overall coming into the nation, a greater proportion of what is available must be devoted to servicing existing debt obligations. This, in effect, fuels the rescheduling fire. *See infra* text accompanying notes 81-91.

<sup>10</sup> United States experts predicted that the debt crisis would be successfully resolved when debtor nations grew out of their debts. These experts believed that encouragement of economic growth in Latin America through loans by a supranational lender, e.g., the World Bank or the International Monetary Fund [hereinafter IMF], coupled with national austerity programs, would produce sufficient growth to achieve this. *See* D. DELAMAIDE, *supra* note 1, at 234-38; Kuczynski, *supra* note 1, at 130; *see also* Bolin & Del Canto, *LDC Debt Crisis Management*, 61 *FOREIGN AFF.* 1099 (1983) (suggesting a system that would mobilize support from the export sectors of industrialized countries via joint financing by national export credit organizations, private commercial banks and the World Bank); Ipsen, *Can the Baker Plan Work?*, *INSTITUTIONAL INVESTOR*, Dec. 1985, at 279, 280-82 (discussing the solution proposed by United States Treasury Secretary James Baker).

This model, however, has failed to produce tangible results. *See* Rogers, *supra* note 7, at 576; Rotberg, *The World Bank Approach to Debt*, *EUROMONEY*, Dec. 1983, <https://scholarship.law.upenn.edu/jil/vol10/iss1/4>

States economy resulting from that nation's trade deficit<sup>11</sup> has had an adverse effect upon Latin American nations.<sup>12</sup> United States domestic pressure to raise protectionist barriers has resulted in the loss of markets long relied on by Latin American exporters.<sup>13</sup> These United States markets are the very ones which Latin American nations must sell to if they are to earn foreign exchange dollars to meet their debt payments.<sup>14</sup> Unfortunately, United States officials have not only tended to treat the trade deficit as a problem isolated from the Latin American debt,<sup>15</sup> but have also been slow to consider the problem of Latin America's debt as

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at 22; McCoy & Truell, *Lending Imbroglia: Worries Deepen Again on Third World Debt as Brazil Stops Paying*, Wall St. J., March 3, 1987, at 1, col. 6. See generally Roett, *supra* note 3, at 697-98 (discussing the general conditions that prevent Latin American nations from generating sufficient capital from exports to escape the debt cycle).

<sup>11</sup> For a general discussion of current United States economic ills, see D. HALBERSTAM, *THE RECKONING* (1986) (discussing the demise of United States competitiveness in international automobile markets); L. MALKIN, *supra* note 8, at 41-55, 90-130; R. REICH, *THE NEXT AMERICAN FRONTIER* (1983) (discussing the need for the United States to increase productivity and to find new areas for expansion); P. SIMON, *LET'S PUT AMERICA BACK TO WORK* 3-25 (1987) (exploring the relationship of United States productivity and unemployment); Diebold, *The United States in the World Economy: A Fifty Year Perspective*, 62 FOREIGN AFF. 81 (1983) (surveying the deterioration of international economic cooperation over the last 50 years and its effect on the United States); Fox & Cooney, *Protectionism Returns*, 53 FOREIGN POL'Y 74 (1983) (suggesting an attack on the erosion of the United States industrial base).

<sup>12</sup> In 1983, the United States had an \$8 billion trade deficit flowing to Latin America, compared with a \$3.8 billion surplus in 1982. This trend and the resulting drop in United States employment have spurred advocacy of protectionist measures directed against Latin American products. Roett, *supra* note 3, at 698; see also P. SIMON, *supra* note 11, at 98-103. For an in-depth discussion of the close economic and political ties between the United States and Latin America, see A. LOWENTHAL, *PARTNERS IN CONFLICT: THE UNITED STATES AND LATIN AMERICA* (1987).

<sup>13</sup> Roett, *supra* note 3, at 697-98.

<sup>14</sup> *Id.* at 698. In addition, the economic ills of Latin America have resulted in the loss of traditional United States export markets. In 1981, the United States exported approximately \$42 billion worth of goods to Latin America; in 1984-1986, sales fell to about \$30 billion per year. Kuczynski, *supra* note 1, at 136. One former United States Treasury Department official has noted that failure to reinvigorate the Third World economy will result in increasing losses of United States manufacturing jobs. Broad, *How About a Real Solution to Third World Debt?*, N.Y. Times, Sept. 28, 1987, at A25, col. 5.

<sup>15</sup> See P. SIMON, *supra* note 11, at 99. To the contrary, the United States federal deficit is intimately wedded to the Latin American debt crisis. The large deficits that are consistently incurred by the United States Government make credit a scarce resource and result in increased interest rates. As Latin America's need to borrow continues, these higher interest rates further compound the debt burden and make prompt or manageable repayment more problematic. Roett, *supra* note 3, at 717. It has been suggested that this problem could be alleviated by a cap on interest rates on loans to developing countries. Although debtor nations generally favor such a plan, and Council of Economic Advisers Chairman Martin Feldstein gave it a qualified endorsement in 1984, Treasury Secretary Donald Regan ultimately rejected it as impractical. See Feldstein, *Regan Disagrees on Wisdom of Capping Interest Rates to LDCs*, 20 Int'l Trade Reporter's U.S. Export Weekly (BNA) No. 33, at 980 (1984).

anything more than a temporary condition that ultimately will self-correct.<sup>16</sup>

Despite this official neglect, the high volume of trade between the United States and its southern neighbors makes Latin American economic health vital to that of the United States.<sup>17</sup> Moreover, on account of its unique historical ties to Latin American nations, the United States has long considered the nations as existing in "America's backyard."<sup>18</sup> Thus, not only does the United States have an economic interest of the type common to all nations with outstanding loans in the region,<sup>19</sup> the United States additionally defines Latin American political stability as a major tenet of its foreign policy.<sup>20</sup>

<sup>16</sup> The Reagan administration and most United States bankers denied any need for far-ranging solutions. They maintained that the problem was a temporary liquidity crisis and did not require a fundamental change in the status quo. D. DELAMAIDE, *supra* note 1, at 234-41; see also P. SIMON, *supra* note 11, at 99 (describing years of United States attitude of benign neglect); Rogers, *supra* note 7, at 577 (contrasting the heavy political and military engagement of the United States in Central America with its policy that Latin America's financial problems should be left, as far as possible, to private banks and the IMF). *But see* Bogdanowicz-Bindert, *World Debt: The United States Reconsiders*, 64 FOREIGN AFF. 259, 267-68 (1986) (noting that United States administration officials finally have recognized that the debt crisis is here to stay); Ipsen, *supra* note 10, at 280 (United States Treasury Secretary James Baker hinting that dramatic policy changes may be in order).

<sup>17</sup> See *infra* notes 92-103 and accompanying text.

<sup>18</sup> The United States has perceived Latin America as an area of vital national interest since 1823 when the United States adopted the Monroe Doctrine, which warned European countries against intervention in Latin America. W. LANGER, AN ENCYCLOPEDIA OF WORLD HISTORY 644, 770 (1948). Compare Rogers, *supra* note 7, at 560-76 (discussing modern United States interest and intervention in Latin America) with Maviglia, *Mexico's Guidelines for Foreign Investment: The Selective Promotion of Necessary Industries*, 80 AM. J. INT'L L. 281, 282-83 (1986) (surveying Mexican response to foreign dominance). It should also be remembered that the immense differences among Latin American nations (in size, wealth, geopolitical capacity, character of government and independence from United States influence) along with the varying United States policies towards different countries, make it difficult to speak of the region in unitary terms. Katznelson & Prewitt, *Constitutionalism, Class, and the Limits of Choice in U.S. Foreign Policy*, in CAPITALISM AND THE STATE IN U.S.-LATIN AMERICAN RELATIONS 25 (R. Fagen ed. 1979).

<sup>19</sup> The extension of credit to developing countries is indispensable to world economic recovery. See Bolin & Del Canto, *supra* note 10, at 1100.

<sup>20</sup> The United States traditionally has encouraged democracy south of its own border. However, from the administration of President Kennedy through that of President Carter, United States policy toward Latin America came to involve less overt intervention, some economic disengagement, and increased concern over human rights and quality of life. Katznelson & Prewitt, *supra* note 18, at 25. President Reagan's administration returned to a more traditional "backyard" policy in both Central America and the Caribbean and reasserted the vital interest of the United States throughout the region. But even with news in the 1980s of the collapse of military regimes (Argentina), further liberalization (Brazil) and popular pressures to restore democracy (Uruguay and Chile), Latin American stability has been threatened by the growing social and political implications of economic difficulties. See Henry, *supra* note 6, at 28-29; Roett, *supra* note 3, at 695-97; Rogers, *supra* note 7, at 573-76; Fishlow, *Coming to Terms with the*

After a half decade of analysis and commentary, a solution to the debt crisis is no closer than it was when the threat of Mexican default was first publicly acknowledged.<sup>21</sup> If the world economy is ever to move beyond the stage of perpetual crisis<sup>22</sup> posed by the current debt,<sup>23</sup> new tactics must be openly explored, and the status quo must be reexamined.<sup>24</sup>

This Comment will review the origins of the current Latin American debt crisis<sup>25</sup> and the rise of loan rescheduling.<sup>26</sup> Next, it will discuss the financial restrictions caused by rescheduling<sup>27</sup> and the relationship between rescheduling and the United States balance of trade.<sup>28</sup> The need for solutions and incentives to alleviate the debt crisis will then be explored,<sup>29</sup> with emphasis on international barter (countertrade)<sup>30</sup> and debt-for-equity exchanges.<sup>31</sup> Debt-for-equity is a new con-

*Latin Debt*, N.Y. Times, Jan. 4, 1988, at A19, col. 5.

<sup>21</sup> Alpern & Emerson, *Making Life Easier for Debtor Nations*, N.Y. Times, Feb. 7, 1987, at A27, col. 1; see also L. MALKIN, *supra* note 8, at 77; Heinemann, *World Debt Crisis, on Back Burner, Still Simmers*, AM. BANKER, May 28, 1985, at 6; Makin, *Facing the Facts About Global Debt*, BUS. WK., Nov. 18, 1985, at 22; Fishlow, *supra* note 20, at A19, col. 1; Broad, *supra* note 14, at A25, col. 2.

<sup>22</sup> One commentator has characterized the international debt crisis as a "chronic disease." L. MALKIN, *supra* note 8, at 77.

<sup>23</sup> The debt crisis threatens economic stability not only in the Third World but also in all nations. See generally Bolin & Del Canto, *supra* note 10, at 1099-112 (focusing on the long-term aspects of the debt problem and on the threat posed by reductions in future sources of credit).

<sup>24</sup> Ironically, the most creative thought aimed at rescue of Latin American borrowers has come from outside the circle of direct participants. *Id.* at 1100; see also Lissakers, *A Lesson from Japanese Banks*, N.Y. Times, March 24, 1987, at A31, col. 1. However, a new proposal by Mexico and the Morgan Guaranty Trust Company may change this trend. For a discussion of this plan, see *infra* note 105; see also Bennett, *Big Bank Proposes a Plan for Easing Third-World Debt*, N.Y. Times, Dec. 30, 1987, at A1, col. 6; Truell & Murray, *supra* note 5, A1, col. 1.

<sup>25</sup> See *infra* notes 36-46 and accompanying text.

<sup>26</sup> See *infra* notes 47-73 and accompanying text.

<sup>27</sup> See *infra* notes 74-91 and accompanying text.

<sup>28</sup> See *infra* notes 92-103 and accompanying text.

<sup>29</sup> See *infra* notes 104-10 and accompanying text.

<sup>30</sup> See *infra* notes 111-50 and accompanying text. A countertrade transaction usually consists of a parallel set of obligations by which each party undertakes to sell goods and services to the other in separate but related transactions. Countertrade is essentially a set of rules which are imposed by one nation on trading partners of other nations who must comply with the rules if they wish to transact business. Lochner, *Guide to Countertrade and International Barter*, 19 INT'L LAW. 725, 727 (1985); see also McVey, *Countertrade and Barter: Alternative Trade Financing by Third World Nations*, 6 INT'L TRADE L.J. 197 (1980-1981).

<sup>31</sup> See *infra* notes 151-76 and accompanying text. Debt-for-equity exchanges involve the conversion of debt to equity in corporations in the debtor nation, national holdings or some form of national financial credit. See Debt-Equity Swaps, Bull. No. 1, at 2 (Aug. 1987) (available from Coopers & Lybrand, New York, N.Y.); see also Dornbusch, *Impact on Debtor Countries of World Economic Conditions*, in EXTERNAL DEBT, SAVINGS AND GROWTH IN LATIN AMERICA 79-82 (A. Martirena ed. 1987);

cept,<sup>32</sup> barter is an ancient one.<sup>33</sup> Although neither device has been formally recognized in United States economic policy, both have begun to play a role in international financial markets and Latin American policy.<sup>34</sup> By analyzing these two financial tactics and exploring possible refinements of them, proposals can be developed for improving United States policy.<sup>35</sup>

## 2. THE WORLD DEBT CRISIS

In August of 1982,<sup>36</sup> the world banking community became acutely aware of its vulnerability to default by Latin American debtors. Mexico, whose outstanding foreign debt exceeded \$80 billion, thirty percent of which was due within the year,<sup>37</sup> had exhausted its foreign exchange reserves. The Mexican Government notified the International Monetary Fund (IMF), the United States Secretary of the Treasury and the Chairman of the Federal Reserve Board that it could not meet its immediate financial obligations.<sup>38</sup> As a result, Mexico would be

Kuczynski, *supra* note 1, at 133; Meltzer, *supra* note 6, at 7.

<sup>32</sup> See Meltzer, *A Way to Defuse the World Debt Bomb*, FORTUNE, Nov. 28, 1983, at 137 (an early discussion of debt-for-equity exchanges).

<sup>33</sup> Most anthropologists and economic historians agree that barter evolved quite naturally from the exchange of gifts. M. GERSHMAN, SMARTER BARTER 14-21 (1986) (surveying the successive stages of barter). The Bible records an early example of barter when Esau exchanged his birthright for "bread and pottage of lentiles." *Genesis* 25:31-34 (King James ed.).

<sup>34</sup> See *infra* notes 111-25, 151-207 and accompanying text.

<sup>35</sup> See *infra* notes 141-50, 208-47 and accompanying text.

<sup>36</sup> Commentators trace the emergence of a full-fledged debt crisis to a variety of dates and events. However, it was the announcement by Mexico of its inability to meet its debt obligations that brought the monetary and fiscal crisis to a head. From August of 1982 until the spring of 1983, 15 countries initiated renegotiation of the terms of more than \$90 billion of debt. See D. DELAMAIDE, *supra* note 1, at 6-8; W. GREIDER, SECRETS OF THE TEMPLE 483-85, 503, 517-19 (1987). But see Clark, *Sovereign Debt Restructurings: Parity of Treatment Between Equivalent Creditors in Relation to Comparable Debts*, 20 INT'L LAW. 857, 857 (1986) (asserting that the modern sovereign debt crisis began in Poland in 1981).

<sup>37</sup> Bogdanowicz-Bindert, *supra* note 16, at 262. The Third World and Eastern Europe together owed \$626 billion of outstanding foreign debt by 1982. D. DELAMAIDE, *supra* note 1, at 7.

<sup>38</sup> Bogdanowicz-Bindert, *supra* note 16, at 262. For the most part, the debt owed by Mexico, as well as that owed by Brazil and Argentina, is bank debt. Although banks are private, profit-oriented institutions, they nevertheless acquire the political alignment of the nation in which they are headquartered. For example, during the 1982 Falkland Islands dispute between Britain and Argentina, Argentina withheld debt payments from British banks. During the 1979-1981 United States-Iran hostage crisis, United States banks froze Iranian assets. Political crises thus reveal the political character of banks.

In addition, the size of the debts and the importance of the banks involved mean that the world debt crisis threatens the entire world financial structure. See D. DELAMAIDE, *supra* note 1, at 226-27; W. GREIDER, *supra* note 36, at 517; L. MALKIN,

forced to suspend all debt payments for three months and, in the interim, to reach an agreement on rescheduling payments.<sup>39</sup>

The failure of a country to meet its debt obligations was not without precedent.<sup>40</sup> For example, in 1976 Mexico had faced a similar problem in meeting its foreign obligations.<sup>41</sup> Zaire, Peru and Turkey had each faced the prospect of default in the mid-1970s,<sup>42</sup> and, as early as 1890, financial difficulties in Argentina nearly bankrupted a major British bank.<sup>43</sup> The history of Latin American debt, with the accompanying threat of default, dates back to the rise of independent Latin American nations in the 1820s.<sup>44</sup> The incidents of economic crisis prior to 1982 were, however, relatively isolated events; in comparison, the world debt problem, to which Mexico's 1982 difficulties were but a prelude, threatens far greater economic repercussions than anything previously encountered.<sup>45</sup> No prior economic crisis has involved such a large amount of debt owed to so many creditors in so many countries.<sup>46</sup>

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*supra* note 8, at 77.

<sup>39</sup> D. DELAMAIDE, *supra* note 1, at 3; see L. MALKIN, *supra* note 8, at 86; see also Broad, *supra* note 14, at A25, col. 6.

<sup>40</sup> See generally L. MALKIN, *supra* note 8, at 68-75 (discussing the relationship between sovereign debtors and their creditors over a seven-century period).

<sup>41</sup> Bogdanowicz-Bindert, *supra* note 16, at 262. For a description of the role of loans in the overall modern world financial order, see D. DELAMAIDE, *supra* note 1, at 53-69.

<sup>42</sup> D. DELAMAIDE, *supra* note 1, at 56-69.

<sup>43</sup> Baring Brothers, a renowned British merchant bank, took part in the late nineteenth-century wave of private investment in developing countries. Creditors bought shares in, and bonds of, railroads and other industries in developing nations. Only a massive bailout saved the bank from failure when Argentina failed to meet its obligations. *Id.* at 53-54; L. MALKIN, *supra* note 8, at 71.

<sup>44</sup> Latin American countries began borrowing and defaulting as soon as they gained independence in the 1820s. By 1827, all of the more than £20 million in Latin American bonds floated in London were in default. D. DELAMAIDE, *supra* note 1, at 96; see also L. MALKIN, *supra* note 8, at 69.

It is also instructive to note that, during the 1920s, Latin American nations engaged in a round of borrowing which led to default during the 1930s. In the 1940s, the United States and Britain wrote-off much of the accumulated debt which, in effect, opened the door to investment and rapid economic growth. Lissakers, *supra* note 24, at A31, col. 6.

<sup>45</sup> See Bogdanowicz-Bindert, *supra* note 16, at 262; Tapia, *Mexico's Debt Restructuring: The Evolving Solution*, 23 COLUM. J. TRANSNAT'L L. 1, 1 (1984); see also Kuczynski, *supra* note 1, at 137.

<sup>46</sup> See D. DELAMAIDE, *supra* note 1, at 1-5 (discussing the long weekend of negotiations that began on August 12, 1982, when Jesus Silva Herzog, Mexico's Minister of Finance, notified Donald Regan that Mexico was facing "a number of problems"); L. MALKIN, *supra* note 8, at 72-73 (noting that current Latin American interest payments "are at least double the level of reparations that Germany found intolerable in the prewar era that produced Hitler"); Tapia, *supra* note 45, at 1. For contemporary reports on the crisis appearing in the popular press, see *The Crash of 1982?*, ECONOMIST, Oct. 16, 1982, at 13; *The Debt Bomb*, TIME, Jan. 10, 1983, at 42; Quirk, *Busted Flat on Wall Street*, NEW REPUBLIC, Aug. 16/23, 1982, at 19 (discussing the effect of

## 2.1. *The Rise of Rescheduling*

In the fall of 1982, the world financial community responded to the Mexican crisis with stopgap measures.<sup>47</sup> The short-term program devised by the concerned parties consisted of three elements. First, Mexico's commercial bank creditors would commit \$5 billion to a new money facility for 1983.<sup>48</sup> Second, the public Mexican debt<sup>49</sup> of approximately \$23 billion<sup>50</sup> owed to commercial lenders and due between August 22, 1982 and December 31, 1984 would be restructured over an eight-year period.<sup>51</sup> Third, the IMF would disburse \$3.9 billion over a three-year period as part of an Extended Fund Arrangement for Mexico.<sup>52</sup>

This restructuring did not alleviate the long-term financial burden posed by the debt,<sup>53</sup> nor did it allow Mexico to return to the normal international credit markets.<sup>54</sup> Although, in retrospect, the 1982-1984 restructuring effort can only be regarded as a transient solution, the Mexican rescheduling arrangement has been the model used by most

Mexico's debt crisis on Citibank); Shearlock, *The Day the World Ran Out of Credit*, *The Sunday Times* (London), Sept. 5, 1982, at 53, col. 1.

<sup>47</sup> For a general review of the first round of Mexican debt restructuring, see Tapia, *supra* note 45, at 5-7; see also Bogdanowicz-Bindert, *supra* note 16, at 263 (discussing the joint cooperation in the fall of 1982 that produced a quick response to Mexico's inability to meet its payments).

<sup>48</sup> Tapia, *supra* note 45, at 5. This new money facility was basically an involuntary lending operation that provided the only means by which Mexican public sector borrowers could remain current on their interest payments to foreign creditors. In addition, 13 banks were invited to form a Bank Advisory Group for Mexico. The Advisory Group, in addition to its role as representative of the international banking community, would act as regional coordinator in connection with the syndication of the \$5 billion. *Id.* at 5-6; see also Bogdanowicz-Bindert, *supra* note 16, at 263.

<sup>49</sup> Public debt is the debt owed by a government and its various components as distinguished from debt owed by private corporations and individuals. In 1982, the combined public and private Mexican debt exceeded \$80 billion, 30% of which was due in a single year. W. GREIDER, *supra* note 36, at 517; Bogdanowicz-Bindert, *supra* note 16, at 262. It should be remembered that the distinction between public and private debtors within a nation is largely irrelevant to the subject of this Comment. Both types of debt are a matter of political interest for the borrowing nation. The overall development policy of debtor nations relies equally on financing for private and public institutions. D. DELAMAIDE, *supra* note 1, at 226-27.

<sup>50</sup> Tapia, *supra* note 45, at 6.

<sup>51</sup> *Id.* at 5. At the end of 1984, a new restructuring agreement was implemented and the establishment of a second new money facility became necessary. The 1984 new money facility was in the amount of approximately \$3.8 billion. *Id.* at 7-8.

<sup>52</sup> *Id.* at 5.

<sup>53</sup> See D. DELAMAIDE, *supra* note 1, at 227; W. GREIDER, *supra* note 36, at 517; Broad, *supra* note 14, at A25, col. 2. In view of the uncertainties that prevailed in the international financial markets at the time, there was no consensus regarding how Mexico's debt problem would be resolved in the long run. Tapia, *supra* note 45, at 7.

<sup>54</sup> Tapia, *supra* note 45, at 7.



Latin American nations in renegotiating their debts.<sup>55</sup> The Mexican crisis altered the way in which banks and governments dealt with international debt problems.<sup>56</sup> From August of 1982 until the spring of 1983, fifteen countries began renegotiating the terms of more than \$90 billion in debt owed to commercial banks.<sup>57</sup> Since 1982, over forty countries have either rescheduled their debts or are in the process of doing so.<sup>58</sup> In almost every case, the Mexican agreement is the model relied upon.<sup>59</sup> Though the Mexican solution was only short-term,<sup>60</sup> the procedures and forms of documentation used by Mexico for restructuring have become the model for several other sovereign renegotiations.<sup>61</sup> A "rescheduling market" based on Mexican procedures has emerged. The prevailing terms and conditions of rescheduling are now generally determined based on credit ratings relative to Mexico's most recent agreement.<sup>62</sup>

The rescheduling of foreign debt is now an essential element of the world economy.<sup>63</sup> By offering new credit while extending the time for repayment of principal,<sup>64</sup> the creditor allows the debtor nation, at least

<sup>55</sup> *Id.* at 7; see also Bogdanowicz-Bindert, *supra* note 16, at 263-64; Robinson, *The Alpha and Omega of Rescheduling*, EUROMONEY, May 1984, at 136.

<sup>56</sup> See generally Lissakers, *Dateline Wall Street: Faustian Finance*, 51 FOREIGN POL'Y 160 (1983) (describing the systematic changes brought about by Mexico's liquidity crisis).

<sup>57</sup> D. DELAMAIDE, *supra* note 1, at 7; see also W. GREIDER, *supra* note 36, at 519.

<sup>58</sup> Bogdanowicz-Bindert, *supra* note 16, at 263; see also D. DELAMAIDE, *supra* note 1, at 121-23 (discussing Brazil's rescheduling negotiations); Robinson, *supra* note 55, at 136.

<sup>59</sup> Bogdanowicz-Bindert, *supra* note 16, at 263.

<sup>60</sup> *But see* Bolin & Del Canto, *supra* note 10, at 1101-04 (suggesting that rescheduling the debt does not postpone the problem).

<sup>61</sup> Tapia, *supra* note 45, at 7; see also Robinson, *supra* note 55, at 136.

<sup>62</sup> The use of Mexico as a yardstick is logical from the banks' point of view. It also means, however, that those debtors needing the most help must pay the greatest price for assistance. Bogdanowicz-Bindert, *supra* note 16, at 263-64.

<sup>63</sup> See Beim, *Must We Torpedo Our Banks?*, N.Y. Times, May 4, 1987, at A25, col. 1 (noting that negotiations between the world's major banks and less developed countries have become "a constant").

Nowadays, any debate regarding rescheduling generally concerns the terms and the time period under which extended repayment should occur. For example, in 1984, Martin Feldstein, Chairman of the Council of Economic Advisers, suggested that banks should consider not only extending automatic loans but also capping the interest rates on those loans. Anthony Solomon, then President of the Federal Reserve Bank of New York, also noted that techniques of limiting interest rates should be investigated by those involved in debt negotiations. Treasury Secretary Donald Regan, however, called such plans impractical and unacceptable to creditors. See Feldstein, *Regan Disagree on Wisdom of Capping Interest Rates to LDCs*, *supra* note 15, at 980.

<sup>64</sup> The current structure and size of outstanding debts has created a symbiotic relationship between debtors and creditors. The sheer size of outstanding loans means that any suspension of interest payments will be exceedingly costly to creditor banks.

As a result banks take the expedient course of extending further credit to debtor na-

theoretically, to increase national solvency and concentrate on economic growth through increased production and exports.<sup>65</sup> Through the rescheduling of the debt, the creditor continues to invest in the economic future of the debtor nation. The lender, however, has few alternatives. If the creditor bank refuses to reschedule the debt or to grant further loans, the debtor would not be able to maintain its repayments to the bank.<sup>66</sup> Unlike private borrowers, debtor nations cannot go bankrupt<sup>67</sup> and have no real means by which to liquidate their assets.<sup>68</sup> Refusal by

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tions, regardless of the risk, so that the debtor can meet its payments with the proceeds of new borrowing. Although this solution saves the banks from the necessity of immediately recognizing losses, it also subjects them to considerable leverage by debtor nations. See, e.g., Silk, *Economic Scene: Brazil's Battle Against Banks*, N.Y. Times, March 4, 1987, at D2, col. 1 (discussing suspension of interest payments as a threat to creditor banks); McCoy & Truell, *supra* note 10, at 1, col. 6 (announcing Brazil's suspension of interest payments); Riding, *Brazil to Suspend Interest Payments to Foreign Banks*, N.Y. Times, Feb. 21, 1987, at A1, col. 1. *But see* Rockefeller, *supra* note 8, at E15, col. 2 (arguing that there is no real fear of loan default).

<sup>65</sup> See Rockefeller, *supra* note 8, at E15, col. 2; see also *Latin American Debtors: Time Shifter Incorporated*, ECONOMIST, March 5, 1983, at 86; Bailey & Watkins, *supra* note 8, at A19, col. 2.

<sup>66</sup> The extension of new credit and the rescheduling of outstanding loans enable debtor nations to increase domestic savings and to accelerate production of revenue producing exports. This scenario, however, assumes favorable world economic conditions. Bogdanowicz-Bindert, *supra* note 16, at 263. Compare Fine, *Banks Are Urged to Lend More to Third World to Recover Debt*, AM. BANKER, May 20, 1986, at 2. (arguing that increased investment is necessary to assure creditor recovery of outstanding loans) with Horowitz, *Bankers Apprehensive on Further Loans to LDCs*, J. Com., May 20, 1986, at 2A, col. 5 (noting rising concern that creditors may be throwing good money after bad).

<sup>67</sup> One observer has stated that it "had become axiomatic in the 1970s to assert that sovereign states cannot go bankrupt." Clark, *supra* note 36, at 858. Moreover, Clark has argued that the 1980s have demonstrated the validity of the axiom:

Clearly there are no formal insolvency or liquidation rules that apply to sovereign states. There is no method by which the assets of a sovereign state can be distributed among the creditors. Creditors have not scrambled to obtain security for their debts as they usually do in domestic work outs. Instead the creditors have resorted to long, patient negotiations to put their debts on a more orderly footing, essentially a footing on which interest payments will be maintained.

*Id.*; see also E. MALKIN, *supra* note 8, at 88 (noting that "[t]he banks' only real punishment for default would be the same as it was in the nineteenth century: closing the financial markets to new credit for the debtor countries and thus blocking their trade"); Kuczynski, *supra* note 1, at 143 (commenting that "[a]mong the debtors the siren song of default is gaining new support"). *But see* *Western Banks Declare North Korea in Default*, Wall St. J., Aug. 24, 1987, at 20, col. 2 (reporting that western bankers have declared North Korea to be in "total default" on its loans).

<sup>68</sup> A bankrupt company liquidates its assets to repay its creditors. Countries cannot do this. The only means a country has to liquidate assets is to lower the standard of living of its citizens. D. DELAMAIDE, *supra* note 1, at 9-10. To some degree, this has been the approach advocated by the IMF and a variety of United States economists. This strategy calls for increased loans and rescheduling tied to austerity programs. See Bogdanowicz-Bindert, *supra* note 16, at 267-69. However, such programs can also create political instability. See Purcell, *supra* note 2, at 671; Roett, *supra* note 3, at 698-

the creditor bank to extend new credit, therefore, would only result in the bank not being repaid,<sup>69</sup> and, ultimately, being forced to write the loan off as a loss.<sup>70</sup> Because many banks have extended loans to Latin America that are larger than their net assets,<sup>71</sup> a write-off of the loans would threaten the banks with bankruptcy.<sup>72</sup> Therefore, banks are virtually forced to enter into multibillion dollar workouts of the type represented by the Latin American debt rescheduling.<sup>73</sup>

## 2.2. *The Financial Restrictions Caused by Debt Rescheduling*

Although the actions taken to avert disaster in 1982,<sup>74</sup> and those subsequently taken whenever a debtor country threatened to default on its obligations,<sup>75</sup> have prevented the financial collapse of countries and banks, several problems have been created by the system of reschedul-

702; see also L. MALKIN, *supra* note 8, at 87.

<sup>69</sup> See, e.g., D. DELAMAIDE, *supra* note 1, at 194-212 (surveying modern fears of bank failure); L. MALKIN, *supra* note 8, at 89; Quirk, *supra* note 46, at 19 (discussing the effect of Mexico's debt crisis on Citibank).

<sup>70</sup> When the risk of nonpayment is sufficiently great, the International Lending Supervision Act of 1983, 12 U.S.C. §§ 3901-3912 (Supp. 1986), mandates the establishment of special reserves by United States lenders. For regulations by which the Federal Reserve Board [hereinafter FRB or Board], the Comptroller of the Currency and the Federal Deposit Insurance Corporation determine which loans require such reserves, see 12 C.F.R. § 211.41-43 (1987). For a discussion of possible write-offs of Brazilian loans, see Henry, *supra* note 6, at 25; Riding, *supra* note 64, at A1, col. 1.

<sup>71</sup> This principle has recently been demonstrated where the financial futures of extremely large corporations were at risk. The most notable example was the bailout of the Chrysler Corporation, a firm which was considered to be too important to the United States economy to be allowed to fail. See generally D. DELAMAIDE, *supra* note 1, at 177-93 (discussing Chrysler and other companies that are too big for bankruptcy).

<sup>72</sup> *Id.* at 194-95; L. MALKIN, *supra* note 8, at 88, 130; see *Some Big Banks Plan to Shun Mexican Plan*, Wall St. J., Jan. 8, 1988, at 3, col. 2. Such concerns have led several major banks to increase reserves. For example, in the spring of 1987, Citicorp increased its reserves by \$3 billion. Overall, banks have set aside approximately \$20 billion in new reserves since May of 1987. These increases were specifically designed to cover potential losses from Latin American loans. See Rowe, *Bank's Decision Seen as Sign of Strength*, Wash. Post, May 21, 1987, at F1, col. 4; Swardson, *Citicorp Move Brings New Era: Huge Reserve Raises Stakes in Debt Talks*, Wash. Post, May 21, 1987, at F1, col. 3; see also *Rules on Debt Recast by Reed and Preston*, N.Y. Times, Jan. 4, 1988, at D2, col. 4; Makin, *Helping Banks and the Third World, Too*, N.Y. Times, May 26, 1987, at A23, col. 2.

Several commentators, however, have argued that the increased reserves are of little practical significance. See, e.g., Henry, *supra* note 6, at 25 (arguing that the new reserves could easily be erased by default of a single Latin American debtor); Rockefeller, *supra* note 8, at E15, col. 2 (noting that the new reserves have not in any significant way altered or alleviated the status quo).

<sup>73</sup> D. DELAMAIDE, *supra* note 1, at 194-95; Bolin & Del Canto, *supra* note 10, at 1100-01.

<sup>74</sup> See *supra* text accompanying notes 47-52.

<sup>75</sup> See, e.g., Riding, *supra* note 64, at A1, col. 1, A35, col. 1 (reporting on Brazil's most recent announcement of interest payment suspension).

ing and by the loans that were extended in the wake of Mexico's 1982 rescheduling.<sup>76</sup>

Additional credit has been extended, out of necessity, to debtor nations in financial distress.<sup>77</sup> Creditor banks have increased their exposure in the countries most heavily in debt.<sup>78</sup> Additionally, the repayment schedules of these nations have been extended,<sup>79</sup> thus assuring that financial resource transfers from the debtor to the lender will continue well into the future.<sup>80</sup> This extended repayment obligation hinders future economic development in the debtor nation by assuring that financial gains will be utilized to service the debt.<sup>81</sup> The debtor nation thus faces dual and conflicting objectives: growth and debt service.<sup>82</sup>

Debt rescheduling has led to a drop in net new lending throughout Latin America.<sup>83</sup> Because the amount of capital available for loans is

<sup>76</sup> See DeWitt, *Credit Analysis and International Loans*, MGMT. INT'L REV., Winter 1986, at 56; Meltzer, *supra* note 32, at 137 (describing the IMF's debt policy as tantamount to "ordering up a policy of mutual [economic] contraction"); Purcell, *supra* note 2, at 668-72; Meltzer, *supra* note 6, at 1-3.

<sup>77</sup> L. MALKIN, *supra* note 8, at 87; Kuczynski, *supra* note 1, at 131; Lissakers, *supra* note 56, at 172.

<sup>78</sup> *But see* sources cited *supra* note 72. For a discussion of the debt crisis from the vantage point of creditors, see Trouvain, *International Indebtedness*, MGMT. INT'L REV., Fall 1984, at 4.

<sup>79</sup> Meissner, *Debt: Reform Without Government*, 56 FOREIGN POL'Y 81, 81 (1984).

<sup>80</sup> *Id.* at 82.

<sup>81</sup> See Kuczynski, *supra* note 1, at 140; Broad, *supra* note 14, at A25, col. 1; see also Bailey & Watkins, *supra* note 8, at A19, col. 2; Fishlow, *supra* note 20, at A19, cols. 1-2. The problems caused by interest payments on government indebtedness have recently been discussed in relation to the United States national debt. See, e.g., P. SIMON, *supra* note 11, at 88-103. Senator Simon notes (speaking of the United States national debt) that the interest on a national debt forces interest rates up and at the same time requires an increase in taxes. This has resulted in the "most massive redistribution of wealth in the history of nations." *Id.* at 92-93 (paraphrasing a comment by Senator Dale Bumpers of Arkansas). Chronic national indebtedness and high interest rates have a similar effect on any nation. See Roett, *supra* note 3, at 717.

<sup>82</sup> Kuczynski, *supra* note 1, at 129-31, 140; Meissner, *supra* note 79, at 82-83; Bailey & Watkins, *supra* note 8, at A19, cols. 3-4; Rockefeller, *supra* note 8, at E15, col. 1. An additional obligation often placed upon the debtor nation (usually as a condition of a loan by the IMF) is implementation of an austerity program. See L. MALKIN, *supra* note 8, at 87; Kuczynski, *supra* note 1, at 130; see also W. GREIDER, *supra* note 36, at 520-21. These programs are often implemented through reduction of imports with the intention of achieving a favorable trade surplus and thus gaining enough foreign exchange to service debt obligations. This policy becomes counterproductive, however, when too many nations apply it simultaneously. As the overall level of imports falls, debtor nations cannot find buyers for their exports and hence fail to earn adequate foreign exchange. Meltzer, *supra* note 32, at 138.

<sup>83</sup> The net loan amount equals the amount of credit extended less the repayments on existing loans. Kuczynski, *Latin American Debt: Act Two*, 62 FOREIGN AFF. 17, 20 (1983). Private commercial banks have reduced the net flow of capital to Latin America at a time when greater flows are needed. Roett, *supra* note 3, at 697-98; see also Henry, *supra* note 6, at 29; Broad, *supra* note 14, at A25, col. 4; Silk, *supra* note

finite, any increased commitment to debt rescheduling must result in proportionate decreases in new lending<sup>84</sup> and trade financing.<sup>85</sup> Although lending continues on a limited basis,<sup>86</sup> new loans are linked to debt rescheduling,<sup>87</sup> the added capital is thus committed to servicing the debt.<sup>88</sup> Beyond the cutback in trade financing, this lack of capital inhibits the industrial development which is needed to eventually retire the debt by means of economic growth.<sup>89</sup> Moreover, the commitment of cash by debtor nations to servicing debt reduces funds available for needed imports and minimizes the potential for industrial development. Conversely, it also harms developed nations, such as the United States, which are benefited by trade with Latin American partners.<sup>90</sup> Exporters in developed countries cannot reach traditional markets in developing countries because those countries lack the necessary financing to purchase goods.<sup>91</sup>

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8, at D2, col. 1; Rockefeller, *supra* note 8, at E15, col. 1.

In 1986-1987, Bank of Boston considered Mexico such a bad credit risk that it decided against lending any new money. Bank of Boston reconsidered, however, following the intervention of Federal Reserve officials and other banks, including Citicorp. McCoy & Truell, *supra* note 10, at 26, col. 2.

<sup>84</sup> The reduction of net new lending in 1982 led directly to the inability of Brazil to meet its principal repayments. Similar problems have plagued Venezuela, Chile, Ecuador, Peru and Uruguay, as well as Mexico and Argentina. Kuczynski, *supra* note 83, at 21, 26.

<sup>85</sup> Lenders, particularly smaller banks, have reduced their lines of credit for export and import financing. *Id.* at 21.

<sup>86</sup> During 1983-1986, Brazil paid over \$40 billion in interest to its foreign bank creditors, yet it was unable to obtain any fresh loans. In the same period, Brazil, Mexico, Argentina, and Venezuela together paid a total of \$120 billion in interest, over a third of the face value of their debts, while they received less than \$9 billion in new loans from private banks. Henry, *supra* note 6, at 29.

<sup>87</sup> See, e.g., Rotberg, *supra* note 10; see also Kuczynski, *supra* note 1, at 131.

<sup>88</sup> In extreme cases loans are specifically designated as "recycling loans." These serve to finance consumption and only postpone default. D. DELAMAIDE, *supra* note 1, at 55.

<sup>89</sup> For a discussion of this proposition, see Holden, *International: More Debt or Investment?*, U.S. BANKER, Oct. 1985, at 76; see also Fine, *supra* note 66, at 2, col. 3; Bailey & Watkins, *supra* note 8, at A19, col. 2; Rockefeller, *supra* note 8, at E15, col. 1. *But see* Horowitz, *supra* note 66, at 2A, col. 5.

<sup>90</sup> See W. GREIDER, *supra* note 36, at 521; Meltzer, *supra* note 6, at 5-6; see also *supra* notes 12 & 14. Additionally, such economic troubles in Mexico have a direct effect on United States employment. Treasury Secretary Regan has pointed out that one out of every eight jobs in United States manufacturing depends on exports and that four out of every five new jobs in recent years were the result of new exports. It has been estimated that every \$1 billion in exports represents 24,000 jobs in the United States. See D. DELAMAIDE, *supra* note 1, at 12 (author paraphrasing Secretary Regan's views); see also P. SIMON, *supra* note 11, at 98-99; Broad, *supra* note 14, at A25, col. 5. It also should be noted that world markets are generally inhospitable to the goods that Latin America must export in order to earn enough foreign exchange to meet its debt service obligations. Roett, *supra* note 3, at 698.

<sup>91</sup> This is the underlying rationale for countertrade. See *infra* text accompanying notes 11-25. See Legal Scholarship (The Costs of Bearing Down on the Third World, Bus.

### 2.3. *Debt and United States Trade*

Because Latin American nations rely heavily on industrial development and increased exports to create economic growth,<sup>92</sup> locating and maintaining markets for Latin American goods is essential to alleviating the debt problem.<sup>93</sup> However, because programs calling for increased exports are generally accompanied by the required implementation of a program of national austerity,<sup>94</sup> a large number of nations are immediately eliminated as export purchasers. This occurs because those nations with austerity programs in place are forced to decrease imports<sup>95</sup> and are, therefore, eliminated as potential export purchasers.<sup>96</sup> As a result these exports will have to be absorbed by developed nations such as the United States.<sup>97</sup> From the standpoint of the United States and other nations importing Latin American goods, there exists the potential for a serious trade imbalance. Because funds that a debtor nation would ordinarily use to import goods from developed nations, thereby offsetting the developed nations' own imports,<sup>98</sup> are devoted to servicing debt, a net trade imbalance results.<sup>99</sup>

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Wk., July 28, 1986, at 16.

<sup>92</sup> See *supra* notes 10-12 and accompanying text.

<sup>93</sup> Debtor nations require export surpluses if they are to repay their loans without simply borrowing more to do so. The more the debt grows, the faster net exports need to grow. Meltzer, *supra* note 6, at 3; see also Hormats, *supra* note 7, at 476 (warning that in many countries debt service payments are growing more rapidly than export earnings and greatly exceed new capital inflows).

<sup>94</sup> The extension of additional loans and grants is often conditioned on the successful implementation of such an austerity program. See *supra* note 82; L. MALKIN, *supra* note 8, at 87; Kuczynski, *supra* note 1, at 130; Meltzer, *supra* note 32 (discussing IMF policy); Purcell, *supra* note 2, at 670-72 (questioning the effectiveness of implementing austerity programs).

<sup>95</sup> The imposition of import restrictions in response to IMF policy inadvertently creates incentives for domestic producers to seek alternatives to currency-based transactions, e.g., countertrade. See UNITED STATES INT'L TRADE COMM'N, PUB. NO. 1766, ASSESSMENT OF THE EFFECTS OF BARTER AND COUNTERTRADE TRANSACTIONS ON U.S. INDUSTRIES 40 (1985) [hereinafter ASSESSMENT].

<sup>96</sup> See Meltzer, *supra* note 32.

<sup>97</sup> See P. SIMON, *supra* note 11, at 98-103 (reviewing the current predicament of United States trade policy); see also Kilborn, *U.S. Trade Deficit Set Record in 1984*, N.Y. Times, Jan. 31, 1985, at A1, col. 3.

<sup>98</sup> Lack of trade finance hampers a developing nation's production of exports as well as its purchase of imports. Not only is a nation unable to pay for its imports, it is also unable to purchase raw materials for its export industries. The net result is usually an increased reliance on barter. See *infra* text accompanying notes 111-25.

<sup>99</sup> See Kuczynski, *supra* note 1, at 140. This problem has generally been treated as part of the overall imbalance of United States trade. Recently, pressure has increased to either achieve trade parity or to end United States free trade policies. It is generally agreed that the asymmetry in United States trade policy must be corrected. See P. SIMON, *supra* note 11, at 101-03. The President's Commission on Industrial Competitiveness has noted that "[f]ragmented trade policy . . . seriously limits [the United States'] ability to respond to growing volume and complexity of international trade."

These trends ultimately result in the loss of reciprocal trading partners for developed nations such as the United States and increased pressure for United States protectionist measures; the application of which will make it more difficult for debtors to service their debts.<sup>100</sup> For example, in 1984, economic growth in the United States slowed.<sup>101</sup> The United States had absorbed most of the recent export growth from developing nations, but the economic downswing intensified demands for greater restrictions on inexpensive foreign imports as a means of protecting United States industry.<sup>102</sup> Such protectionist measures close the few markets which remain open to debtor nations and are necessary to their economic growth. Ultimately, it is the creditor who feels the strain, because the inability of debtor nations to obtain foreign exchange for their goods increases the need to engage in further debt rescheduling.<sup>103</sup>

### 3. SOLUTIONS AND INCENTIVES FOR LIMITING THE DEBT CRISIS

Although the debt crisis is chronic and no single solution is likely to cure the world's credit ills,<sup>104</sup> a variety of strategies have arisen to deal, at least in part, with the problem of Latin American debt.<sup>105</sup> The

*Report of the President's Commission on Industrial Competitiveness* (1985), vol. 1, p. 39.

<sup>100</sup> See Fox & Cooney, *supra* note 11, at 74-75, 78; see also Hormats, *supra* note 7, at 476 (warning that in many countries debt service payments are growing more rapidly than export earnings and greatly exceed new capital inflows); Meltzer, *supra* note 6, at 3.

<sup>101</sup> See Hormats, *supra* note 7, at 473; see also Kilborn, *supra* note 97.

<sup>102</sup> See Hormats, *supra* note 7, at 473.

<sup>103</sup> See *supra* notes 74-85 and accompanying text; see also L. MALKIN, *supra* note 8, at 89.

<sup>104</sup> See Heinemann, *supra* note 21, at 6, col. 1; Kuczynski, *supra* note 1, at 143; Kuczynski, *supra* note 83, at 29-30; Makin, *supra* note 21. *But see* Bolin & Del Canto, *supra* note 10, at 1102-05; Alpern & Emerson, *supra* note 21, at A27, cols. 2-3; Beim, *supra* note 63, at A25, cols. 1-2.

<sup>105</sup> See, e.g., Henry, *supra* note 6, at 25, 28 (commenting on Brazil's proposal to convert part of its foreign debt into long-term bonds); Kuczynski, *supra* note 1, at 137-49 (discussing "deferral schemes" and debt-for-equity options); Riding, *Brazil Has a New Plan for Converting Its Debt*, N.Y. Times, Sept. 24, 1987, at D2, col. 4 (discussing the Brazilian bond proposal); Makin, *supra* note 72, at A23, col. 2 (proposing creation of a multinational institution which would facilitate the secondary debt market).

In April 1987, Treasury Secretary James A. Baker adopted a "menu of alternatives" approach to the debt problem. Baker, at the semiannual meeting of the IMF's Interim Committee called on commercial banks to develop a "menu of alternative new money options" for debtor nations. See Kuczynski, *supra* note 1, at 132; see also Kilborn, *supra* note 4, at D4, col. 6.

Most recently, Mexico and the Morgan Guaranty Trust Company announced plans to exchange existing bank loans for marketable Mexican bonds at an estimated rate of 60 cents on the dollar. See, e.g., Moffett & Truell, *Mexican Aides Estimate*

most intelligent strategies do not seek simply to eliminate the debt by a single stroke;<sup>106</sup> rather, they attempt to stimulate growth either by lessening the debtor nation's current repayment obligations or by creating incentives for investment.<sup>107</sup> The cycle of rescheduling alone will not solve the worldwide debt crisis.<sup>108</sup>

A long-term solution to the international debt crisis can only occur when debtors are able to return permanently to the marketplace and to borrow and repay loans in a normal, healthy fashion without either the intervention of debt committees or the granting of conditional loans from international institutions.<sup>109</sup> For this to occur, debtor nations must earn enough dollars from exports to pay for imports of goods, to pay

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*Result of Debt Plan*, Wall St. J., Jan. 11, 1988, at 23, col. 1. The bonds offer two principal attractions to investors: (1) they would pay interest at a higher rate than the existing debt, and (2) their principal would be backed by zero-coupon United States Treasury bonds as a guarantee against default. Farnsworth, *supra* note 4, at A1, col. 1, D3, col. 1; Guenther, *Here Are Main Points of Plan for Mexico to Reduce Its Debt by Billions of Dollars*, Wall St. J., Dec. 30, 1987, at 6, col. 1. Commentators initially greeted the plan as a major breakthrough. See, e.g., *A New Handle on Third World Debt*, N.Y. Times, Jan. 11, 1988, at A18, col. 1; *A Breakthrough on Latin Debt*, N.Y. Times, Jan. 2, 1988, § 1, at 22, col. 1; Bailey & Hill, *Regional Banks May Be Eager for Mexican Plan*, Wall St. J., Dec. 31, 1987, at 2, col. 1; Rohter, *Latin America Hails Proposal on Mexican Debt*, N.Y. Times, Dec. 31, 1987, at D3, col. 1. Subsequent analysis, however, suggests that this proposal is likely to be no more than one of the several options available in the "menu of alternatives" scheme. See, e.g., Truell, *Some Banks Are at Odds with Mexico*, Wall St. J., Jan. 13, 1988, at 2, col. 3; *Mexico's Debt Plan, Will It Work?*, N.Y. Times, Jan. 10, 1988, § 3, at 1, col. 1; *Some Big Banks Plan to Shun Mexican Plan*, *supra* note 72.

<sup>106</sup> For example, it has been suggested that the loans should simply be written-off at a loss. The debtor nations would then be able to start anew without having to contend with the burden of their former debts. Similarly, a debtors' cartel has been suggested which would simply declare a moratorium on interest payments. Although these solutions may possess theoretical appeal, they are impractical. One major obstacle to simply wiping out the obligations of debtor nations is that their creditors may have insufficient reserves to cover losses. See D. DELAMAIDE, *supra* note 1, at 232-33; Kuttner, *supra* note 91; Makin, *supra* note 21; see also *supra* notes 69-72 and accompanying text.

An additional objection to simple elimination of the debts is jurisprudential. Regardless of the economic hardships that the initial loan agreements are now creating in debtor nations, these agreements represent legal obligations entered into by mutual consent. Allowing a write-off would diminish respect for all international contracts. For a discussion of the western legal notion of contracts as moral obligations, see C. FRIED, *CONTRACT AS PROMISE* 14-17 (1981); see also Roett, *supra* note 3, at 714-15; Rockefeller, *supra* note 8, at E15, col. 4; Beim, *supra* note 63, at A25, col. 4. *But see* D. DELAMAIDE, *supra* note 1, at 233 (stating that "[m]ost of the shilly-shally in rescheduling loans [is] simply a shell game to preserve legal fictions").

<sup>107</sup> See, e.g., Kuczynski, *supra* note 83, at 27-30; Meltzer, *supra* note 32; Roett, *supra* note 3, at 714-20; see also DeWitt, *supra* note 76. Laulan, *A New Approach to International Indebtedness*, *BANKER*, June 1983, at 25.

<sup>108</sup> See Kuczynski, *supra* note 83, at 27-29. *But see* Bolin & Del Canto, *supra* note 10, at 1103.

<sup>109</sup> See Meltzer, *supra* note 32, at 138, 143; see also Kuczynski, *supra* note 1, at 137-40.



interest on the outstanding debt and to finance net capital flow.<sup>110</sup>

### 3.1. *The Rise of Barter and Countertrade*

When a debtor nation lacks the capital necessary for trade, it will often rely upon international barter or countertrade. In the past few years, barter has become a significant trade practice in virtually all Latin American countries.<sup>111</sup> The use of barter avoids the need for a monetary exchange in transactions for goods. There are various trading agreements,<sup>112</sup> generically termed barter, by which such non-monetary exchanges can be entered into: international barter,<sup>113</sup> swaps,<sup>114</sup> counterpurchase,<sup>115</sup> compensation<sup>116</sup> and switch trading.<sup>117</sup> There are several benefits derived from reliance on barter, including the preservation of cash reserves,<sup>118</sup> an improvement in the balance of trade<sup>119</sup> and

<sup>110</sup> See Kuczynski, *supra* note 1, at 138; Meltzer, *supra* note 32, at 138, 143; see also Bailey & Watkins, *supra* note 8, at A19, col. 2.

<sup>111</sup> See ASSESSMENT, *supra* note 95, at 38-45, 54-56. The official policies and laws mandating or encouraging countertrade vary from nation to nation. Countertrade will arise even where there is no governmental policy mandating it. For example, although Mexico does not require countertrade, its December 1982 "Exchange Controls Decree" established needed legal standards for countertrade. *Id.* at 55 (citing Mexican Federal Official Gazette, Dec. 1982).

<sup>112</sup> The use of countertrade raises a myriad of policy considerations as well as both domestic and international legal issues. For a general survey of these aspects of countertrade, see McVey, *Countertrade: Commercial Practices, Legal Issues and Policy Dilemmas*, 16 LAW & POL'Y INT'L BUS. 1 (1984).

<sup>113</sup> International barter is usually defined as the direct exchange of one commodity or product for another without the use of cash. See M. GERSHMAN, *supra* note 33, at 123; Lochner, *supra* note 30, at 729-30.

<sup>114</sup> Swaps are essentially a type of barter in which similar products are exchanged in different locations to save on transportation costs. M. GERSHMAN, *supra* note 33, at 123.

<sup>115</sup> Counterpurchase agreements are a form of parallel barter that involves offsetting deliveries of unrelated goods. Each party usually pays cash for the goods or services received but agrees to make the counterpurchase. For example, in 1979, Yugoslavia insisted that General Motors buy \$4 million worth of its cutting tools as a condition to Yugoslavia's purchase of \$12 million worth of engines from General Motors. M. GERSHMAN, *supra* note 33, at 123; Lochner, *supra* note 30, at 730.

<sup>116</sup> Also known as "buyback," "offtake" and "coproduction," compensation involves the repayment of the original purchase through the sale of a resultant product. For example, a company sells factory machinery to a debtor nation and receives part of the factory's output as its compensation. Because payment is deferred and is in wholesale goods, the dollar value of most compensation agreements is very high. See M. GERSHMAN, *supra* note 33, at 123-24; Lochner, *supra* note 30, at 730-31.

<sup>117</sup> "Switch trading" or "clearings" involves a bilateral trade-and-payment agreement under which country Y does not actually pay for the value of goods it imports from country X, but, rather, gives country X a credit on a clearing account. Goods moving in the opposite direction result in offsetting credits to country Y. See M. GERSHMAN, *supra* note 33, at 124-25; see also Lochner, *supra* note 30, at 731-32.

<sup>118</sup> See ASSESSMENT, *supra* note 95, at 121.

<sup>119</sup> Because imports are tied to exports, usually through a counterpurchase agreement, a trade deficit will not result. See *infra* note 125 and accompanying text.

the expedition of industrial expansion.<sup>120</sup>

The international debt crisis has made barter and countertrade a growth industry with over \$600 billion worth of transactions occurring annually.<sup>121</sup> The economic difficulties that have arisen in many debtor nations have led those nations to utilize the only leverage available to them — their power as importers.<sup>122</sup> Many debtors saw countertrade as an opportunity both to halt the deterioration of their trade deficits by balancing every transaction, and to assure imports vital to the functioning of their economies.<sup>123</sup> Such proposals were accepted by trading partners out of fear of losing a share of valuable markets.<sup>124</sup> Most countries with debt problems have insisted on paying for goods and services with some form of barter and have often demanded as a condition of trade that foreign vendors accept payment through countertrade.<sup>125</sup>

### 3.1.1. *Problems Associated with Barter*

Although the widespread practice of international barter does not offer a solution to the underlying problems of world debt, it can alleviate many of the immediate and distressing symptoms of the crisis.<sup>126</sup> Nonetheless, countertrade has in fact been viewed with hostility within the United States.<sup>127</sup> Many United States commentators, as well as the Reagan administration, argue that countertrade is contrary to the principles of the open trading system<sup>128</sup> and that countertrade tends to

<sup>120</sup> See Lochner, *supra* note 30, at 745. See also M. GERSHMAN, *supra* note 33, at 6, 24-26, 115-17, 140-41.

<sup>121</sup> M. GERSHMAN, *supra* note 33, at 1. These figures include international but not domestic barter transactions.

<sup>122</sup> See Glynn, *Whatever Happened to the Debtors' Cartel*, INSTITUTIONAL INVESTOR, July 1986, at 228; see also L. MALKIN, *supra* note 8, at 88-89.

<sup>123</sup> By insisting on countertrade, debtor nations, and in some instances private firms, have channeled the financial pressure of debt repayment back upon their creditors. ASSESSMENT, *supra* note 95, at 40. In addition, developing countries are using countertrade to improve their competitive position, to increase exports and to obtain hard currency. *Id.* at 121.

<sup>124</sup> Western firms were compelled to comply with countertrade demands of debtor nations for fear of losing their share of shrinking markets in non-oil-producing countries after 1979. "Competition among western multinational firms and the ability of these companies to adjust to new situations and absorb inefficiencies helped proliferate international countertrade." *Id.* at 40. See generally H. COHEN, YOU CAN NEGOTIATE ANYTHING 55-58 (1980) (discussing the power of competition).

<sup>125</sup> Lochner, *supra* note 30, at 736.

<sup>126</sup> See, e.g., Maidenberg, *Bartering Aids Poor Nations*, N.Y. Times, Jan. 17, 1983, at D1, col. 3.

<sup>127</sup> See Lochner, *supra* note 30, at 742-45.

<sup>128</sup> *Countertrade: Group of 30 Says Practice More Prevalent, More Beneficial Than Generally Recognized*, 3 Int'l Trade Rep. (BNA) No. 10, at 320 (1986) [hereinafter *Countertrade*]; see also Lochner, *supra* note 30, at 743 n.103.

shrink and distort international trade markets.<sup>129</sup> Moreover, several United States critics complain that the importation of goods by a debtor nation through barter bypasses its foreign exchange reserves, and thereby minimizes the accumulation of balances considered available for use in servicing debt.<sup>130</sup>

It is true that, by insisting on countertrade, debtor nations channel financial pressures imposed upon them through debt obligations back to their creditors or creditor nations.<sup>131</sup> This reflects, however, the interrelated nature of the world debt crisis, rather than any problem unique to countertrade.<sup>132</sup> If United States economic policy is to respond to the needs of Latin America, it must recognize the economic realities that make countertrade a necessity.<sup>133</sup> Most Latin American nations that engage in wide-scale countertrade do so because of limited hard currency reserves, undervalued national currency or overvalued currency in exporting nations.<sup>134</sup> Countertrade has become an indispensable method by which debtor nations obtain essential goods<sup>135</sup> without which their economies would suffer further stagnation, and industrial growth and development would be prevented.<sup>136</sup>

A further argument against United States recognition of a legitimate role for countertrade is the assertion that countertrade is too com-

<sup>129</sup> See, e.g., *U.S. Firms at Conference Given Warning Not to Violate U.S. Customs, Trade Laws*, 20 Int'l Trade Reporter's U.S. Export Weekly (BNA) No. 10, at 393 (1983) [hereinafter *U.S. Firms Given Warning*]. Objections to countertrade arise not only from concerns about enforcement difficulties and possible distortion of trade, but also from the political nature of traditional countertrade partners. Traditionally, most international barter agreements involved nations such as Eastern Bloc countries which lacked sufficient dollars to purchase western goods and technology. As a result, barter played, and continues to play, an important role in meeting the needs of communist countries. Complaints over countertrade were thus based on political and ideological concerns. See H. COHEN, *supra* note 124, at 156-61; M. GERSHMAN, *supra* note 33, at 5, 117-21.

<sup>130</sup> For example, Robert V. Roosa, a partner of Brown Brothers, Harriman & Co., a commercial bank which provides banking and investment services, stated, "[i]mported goods obtained in effect through a direct exchange for a country's exportable goods would bypass the country's foreign exchange reserves and in that way minimize the accumulation of balances considered available for debt servicing." *Countertrade*, *supra* note 128, at 320.

<sup>131</sup> ASSESSMENT, *supra* note 95, at 40.

<sup>132</sup> See *supra* notes 74-103 and accompanying text.

<sup>133</sup> See Lochner, *supra* note 30, at 743 n.103.

<sup>134</sup> See *id.* at 736-37.

<sup>135</sup> See ASSESSMENT, *supra* note 95, at 41 (listing reasons for rise of countertrade); *Countertrade*, *supra* note 128, at 320 (noting that countertrade can play a limited helpful role); McVey, *supra* note 30, at 197-200 (surveying the needs served by the rise of countertrade); Maidenberg, *supra* note 126 (describing usefulness of countertrade).

<sup>136</sup> Moreover, such conditions tend to produce political instability. See L. MAL-KIN, *supra* note 8, at 87; Kuczynski, *supra* note 1, at 136-37; see also *supra* note 20.

plex to be properly overseen.<sup>137</sup> United States trade officials claim that it is impossible to determine which imports are the consequence of countertrade.<sup>138</sup> Currently, the level of United States imports resulting from countertrade can be verified only to the extent that private firms voluntarily provide details about their countertrade deals.<sup>139</sup> Critics are concerned that unreported countertrade could ultimately lead to a breakdown in United States customs and trade laws.<sup>140</sup>

### 3.1.2. A Domestic Model as a Solution

Barter exchanges within the United States present many of the same inherent control problems as international barter.<sup>141</sup> Yet, in enacting the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA),<sup>142</sup> Congress recognized that barter was an entrenched practice which would only expand in the future. Section 311 of TEFRA requires domestic trade exchanges to report each barter transaction among individual clients and to report barter transactions by corporations on an annual basis.<sup>143</sup> Additionally, section 311 gives barter organizations "third-party record-keeper status," similar to that enjoyed by banks, brokerages and credit card companies.<sup>144</sup>

Section 311 of TEFRA provides a suitable model for import/export legislation that would resolve the problems raised by the proliferation of countertrade.<sup>145</sup> Adoption of legislation which treated international transactions in a manner similar to that by which TEFRA treats domestic barter would overcome many of the problems which hinder the creation of a formal United States international barter policy. Basically, an adequate international barter statute would require: (1) corpo-

<sup>137</sup> Lochner, *supra* note 30, at 743 n.106.

<sup>138</sup> *Id.* at 743.

<sup>139</sup> See, e.g., *id.*; *U.S. Firms Given Warning*, *supra* note 129, at 393 (warning countertraders to be particularly cognizant of United States laws governing imports).

<sup>140</sup> See Zarin, *Countertrade and the Law*, 18 GEO. WASH. J. INT'L L. & ECON. 235 (1984).

<sup>141</sup> See generally M. GERSHMAN, *supra* note 33, at 35-45 (discussing domestic problems posed by barter and its regulation by the Internal Revenue Service).

<sup>142</sup> Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (codified in scattered sections of 26 U.S.C. & 42 U.S.C.) [hereinafter TEFRA]; see also M. GERSHMAN, *supra* note 33, at 35.

<sup>143</sup> TEFRA § 311(a)(1) (codified at 26 U.S.C. § 6045(a)-(c) (1982)).

<sup>144</sup> *Id.* § 311(b) (codified at 26 U.S.C. § 7609(a)(3)(G) (1982)); see also M. GERSHMAN, *supra* note 33, at 35-36.

<sup>145</sup> The problem was summed up, for example, by a senior Assistant United States Trade Representative who stated "[i]f all companies start setting up countertrade operations, the whole thing could become difficult to unravel. How can we maintain a sensible commercial policy if it becomes less and less clear what's happening out there."

Lochner, *supra* note 30, at 743 n.106.

rations or international traders dealing in barter transactions to report each barter transaction on an annual basis,<sup>146</sup> and (2) corporations and traders engaging in barter to assume a "third-party record-keeper status," similar to that possessed by banks, brokerages and credit card companies with respect to domestic exchanges.<sup>147</sup>

The United States has taken an initial step towards this type of regulation by formally cautioning United States firms that engage in countertrade to be aware of potential customs and trade law violations.<sup>148</sup> However, only legislative action will enable the United States to properly control countertrade and to effectuate a rational barter policy towards Latin America.<sup>149</sup> Unfortunately, the United States has continued to express publicly its unwillingness to establish any formal countertrade policy.<sup>150</sup>

### 3.2. Debt-for-Equity Exchanges

Debt-for-equity exchanges<sup>151</sup> originally arose as a specialized form of countertrade.<sup>152</sup> Economist Allan Meltzer first recognized that debt-for-equity exchanges offered a unique solution to the debt crisis. According to the plan originally developed by Meltzer, a debtor nation would exchange partial ownership in a national monopoly or other national holding,<sup>153</sup> and, in return, the creditor would retire a proportional amount of the outstanding debt.<sup>154</sup> The exchange would reduce

<sup>146</sup> See *supra* note 143 and accompanying text.

<sup>147</sup> See *supra* note 144 and accompanying text.

<sup>148</sup> See, e.g., *U.S. Firms Given Warning*, *supra* note 129, at 393.

<sup>149</sup> It should be noted that a variety of legislation has been introduced in Congress to deal with various countertrade issues. However, thus far, the bills deal with countertrade only from the standpoint of national security or protection of domestic agricultural producers. See *id.*

<sup>150</sup> See, e.g., ASSESSMENT, *supra* note 95, at 121; Lochner, *supra* note 30, at 743 n.103. See generally Oh, *The Need for a United States Countertrade Policy*, 7 Nw. J. INT'L L. & BUS. 113 (1985).

<sup>151</sup> See *supra* note 31 and sources cited therein.

<sup>152</sup> Specifically, debt-for-equity exchanges evolved out of countertrade involving currency. For example, one United States company sold breeding swine to a Latin American purchaser for pesos because the buyer had no United States dollars. The United States company then used the pesos to purchase sugar in the buyer's country and sold the sugar to a Chicago food processor for dollars. The next evolutionary step occurred when some companies began to use countertrade to collect debts. For example, when a foreign debtor lacked dollars to pay a United States creditor, the creditor accepted payment in a foreign currency, used the currency to purchase foreign goods and resold the foreign goods for dollars in the United States. Lochner, *supra* note 30, at 727 n.5; see also L. MALKIN, *supra* note 8, at 124-25; Meltzer, *supra* note 32.

<sup>153</sup> For example, Brazil has over 600 state-owned companies, which include its 25 largest nonfinancial companies and several banks. Henry, *supra* note 6, at 28.

<sup>154</sup> See *Defusing the Debt Bomb the Less Painful Way*, Wall St. J., Apr. 1, 1985, at 1, col. 5; Meltzer, *supra* note 32, at 143.

the interest burden on the debtor nation without the debtor having to expend foreign currency. Moreover, the currency retained could be used for industrial development or trade financing.<sup>155</sup> The creditor would benefit by having an opportunity either to convert a depreciating asset into a stable asset or simply to divest itself of unwanted debt, albeit at a discount.<sup>156</sup>

### 3.2.1. Types of Debt-for-Equity Transactions

Debt-for-equity exchanges can be structured in several ways. As originally envisioned, a debtor nation gives the creditor a minority stock position in a government-owned industry; for example, a petrochemical plant or a hydroelectric utility.<sup>157</sup> The rate of exchange, i.e., the value of the equity the debtor nation is willing to exchange for retirement of a given amount of debt, is established by means of negotiations.<sup>158</sup> Recognizing the impaired nature of the debt's value, the creditor generally is willing to acquiesce in the debtor nation's insistence on an exchange rate of less than 100 cents per dollar of debt.<sup>159</sup> An additional incentive, therefore, is created for the debtor to exchange debt.

An alternative type of transaction involves the exchange of the debtor nation's own currency for a proportional amount of outstanding debt.<sup>160</sup> Again, the debt is discounted, and the bank receives less than

<sup>155</sup> See Meltzer, *supra* note 32, at 143; see also Berg, *U.S. Banks Swap Latin Debt: Concerns Get Equity Stake*, N.Y. Times, Sept. 11, 1986, at D1, col. 3; *Defusing the Debt Bomb the Less Painful Way*, *supra* note 154; *infra* note 169 and accompanying text.

<sup>156</sup> See *infra* note 164 and accompanying text.

<sup>157</sup> Meltzer, *supra* note 32, at 143. For example, Bankers Trust Company exchanged \$60 million in outstanding debt in Chile for a 51% interest in a pension management concern and a 97% ownership in a Chilean insurance company. Berg, *supra* note 155; see also examples discussed *infra* note 167.

<sup>158</sup> For example, the current Mexican system determines the value to be offered for the debt according to the benefits the transaction offers to Mexico's development. Negotiations to determine the rate of exchange are the responsibility of the Ministry of Finance and Public Credit. *Operating Manual for Debt Capitalization and Public Debt Substitution by Investment (Mexico)* [hereinafter *Operating Manual*], reprinted in Council of the Americas Debt-Equity Seminar Workbook at V-8 & Annex C (Oct. 1987) (available from Council of the Americas, New York, N.Y.). The *Operating Manual* constitutes the official version of procedures to be employed by various agencies of the Mexican Government in approving debt-equity exchanges.

<sup>159</sup> The creditor's only alternative is to implement continued rescheduling by loaning yet more money to repay interest on earlier loans. Debt-for-equity exchanges avoid this situation and give the creditor an asset whose value is less likely to be diminished by inflation. Meltzer, *supra* note 32, at 138, 143.

<sup>160</sup> Interest and principal payments on debts are usually made in the currency of the lender bank's nation or in an internationally accepted currency such as the United States dollar. See generally D. DELAMAIDE, *supra* note 1, at 20, 37-40, 144-45, 229-31 (discussing the dominance of the United States dollar and the difficulties arising therefrom). In debt-for-equity exchanges, the debt is usually exchanged for the borrower's

100 cents per dollar. The equity received is initially in the form of national currency which the bank can then use to invest in enterprises within the debtor nation.<sup>161</sup> Banks, however, are generally not interested in acquiring equity holdings in Latin America,<sup>162</sup> therefore, the exchanges often involve a third party, usually a multinational corporation.<sup>163</sup>

Rather than exchanging debt for investment capital in the debtor nation, many banks have begun to sell their financial interest in the debtor nation to third parties at a discount.<sup>164</sup> The third parties then exchange the newly purchased interest for a discounted amount of the

currency or an equivalent credit. See Kuczynski, *supra* note 1, at 133. This approach has been criticized for its potentially inflationary effects. See Recent Development, *International Debt: Debt-to-Equity*, 28 HARV. INT'L L.J. 507, 515 (1987).

<sup>161</sup> Berg, *supra* note 155; see also *Argentina Plans to Swap Part of Its Debt for Equity*, Wall St. J., Aug. 14, 1986, at 26, col. 1 (reporting plan to issue bonds in long-term development projects in Argentina). Another alternative is to offer some form of shares in long-term development in the debtor nation. See Alpern & Emerson, *supra* note 21, at A27, col. 4 (proposing "Good Neighbor" bonds).

<sup>162</sup> However, in one transaction, Citicorp acquired 20% of the shares of a Brazilian subsidiary of Celanese Corporation in a public for private sector exchange. Berg, *supra* note 155, at D5, col. 1.

More accurately, United States banks are limited in their permissible participation in foreign nonfinancial institutions. Under the provisions of the Federal Reserve Board's Regulation K, 12 C.F.R. § 211 (1987), United States banking organizations can hold no more than 20% of the shares of nonfinancial companies. *Id.* § 211.5. However, in light of the interest United States banking organizations have expressed in acquiring controlling investments under debt-for-equity exchange programs, the Board has proposed a more liberal rule. See Final Rule and Request for Comment, Docket No. R-0610, 53 Fed. Reg. 30,912 (1987) (to be codified at 12 C.F.R. § 211.5(f)) (proposed Aug. 12, 1987). The amended rule would allow United States banking organizations to acquire as much as 100% of the ownership of a foreign nonfinancial company under the following conditions: (1) the nonfinancial company must be in the process of being transferred from public to private ownership, (2) the company must be located in a heavily indebted developing country, (3) the shares are acquired through a debt-for-equity exchange, (4) the shares are held by the bank holding company or its subsidiaries and (5) the ownership interest must be divested within five years from the date of acquisition, unless the Board extends the time for good cause, but in no event may ownership continue longer than 10 years. *Id.* at 30,914.

For a critical response to the Board's action and a call for increased liberalization, see Letter from the New York Clearing House to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, app. at 1-11 (Sept. 30, 1987) (available from The Freedom of Information Office, Board of Governors of the Federal Reserve, Washington, D.C.) [hereinafter Clearing House Letter].

<sup>163</sup> Clearing House Letter, *supra* note 162; Ollard, *The Debt Swappers*, EUROMONEY, Aug. 1986, at 67. In addition, by involving third parties, banks can charge a broker's fee for setting up and structuring the debt-for-equity exchange. Several banks and brokers, in fact, have earned sizable profits through this process. Moreover, these fees can help banks to offset the discounting of their loans. See L. MALKIN, *supra* note 8, at 126; Berg, *supra* note 155.

<sup>164</sup> Due to this type of debt-for-equity exchange and other forms of debt trading, a thriving secondary market for debt has developed. See Kuczynski, *supra* note 1, at 131,

debtor's national currency<sup>165</sup> which they invest within the debtor nation.<sup>166</sup> Generally, this type of exchange involves a multinational corporation which has a subsidiary in the debtor nation or is interested in expanding into that nation. Instead of investing United States dollars directly in the subsidiary, the multinational is able, in effect, to purchase investment capital at a discount from creditor banks.<sup>167</sup>

### 3.2.2. *Benefits of Debt-for-Equity Exchanges*

Debt-for-equity transactions alleviate the burdens created by extensive debt in a number of ways. First, the debtor nation is able to retire substantial portions of its outstanding debt<sup>168</sup> and, thereby, reduce interest payments.<sup>169</sup> Second, debt-for-equity exchanges encourage and facilitate much needed foreign investment in debtor nations.<sup>170</sup> Multinationals are given a means to invest in or setup subsidiaries at a discounted rate, but more importantly, the debt can be converted into a form of capital that stimulates investment and encourages economic

<sup>165</sup> These exchanges are generally arranged by a bank, although not necessarily by the creditor bank. In many instances, the banks do not sell their own debt but rather broker debt-for-equity exchanges for corporate clients. Such was the case when the Bank of Boston facilitated an exchange involving a corporate client interested in buying equipment for its Argentine plant. *See infra* note 167. The fact that brokerage fees can be as much as \$1 million for every \$100 million of debt exchanged raises troubling possibilities. *See* L. MALKIN, *supra* note 8, at 126; *cf.* Miller, *When Swaps Unwind*, INSTITUTIONAL INVESTOR, Nov. 1986, at 165 (examining the risk involved in interest rate exchanges).

The price that the investor receives from the debtor nation is dependent upon the nature of the enterprises in which the investor intends to invest. *See* Clearing House Letter, *supra* note 162, app. at 2 nn.3-4; *see also infra* notes 198-200 and accompanying text.

<sup>166</sup> *See, e.g., Argentina Plans to Swap Part of Its Debt for Equity, supra* note 161; *President Reveals Plans for Bilateral Trade, Investments Talks with Mexico*, 3 Int'l Trade Rep. (BNA) No. 34, at 1061 (1986).

<sup>167</sup> Berg, *supra* note 155; L. MALKIN, *supra* note 8, at 124-25. Nissan Motors recently bought \$60 million in Mexican debt from 18 United States banks for approximately \$40 million. Nissan then sold the debt to the Mexican Central Bank for \$54 million in Mexican pesos which Nissan then invested in its Mexican subsidiary. In another instance, Bank of Boston arranged for an Argentine corporate client to buy Argentine Government debt and exchange it for Argentine currency which the client then used to purchase equipment for its Argentine plant. L. MALKIN, *supra* note 8, at 126; Ollard, *supra* note 163, at 69; Berg, *supra* note 155, at D5, col. 2.

<sup>168</sup> Berg, *supra* note 155; Meltzer, *supra* note 32.

<sup>169</sup> If debtor nations converted some of their loans to equity, they would require less foreign currency for servicing debt and could use their financial resources to increase productivity and exports. Meltzer, *supra* note 32, at 138, 143; *see also* Clearing House Letter, *supra* note 162, app. at 1-4; Debt-Equity Swaps, *supra* note 31, at 1. For a discussion of the beneficial effect of debt-for-equity exchanges on the debt-service ratio, *see* Clearing House Letter, *supra* note 162, app. at 6 & nn.6-7.

<sup>170</sup> *See infra* notes 195-201 and accompanying text.



growth.<sup>171</sup> Third, the banks are offered a manageable way to realize the losses occasioned by their previous extension of financially questionable, but nonetheless expedient,<sup>172</sup> loans to debtor nations.<sup>173</sup> Fourth, the losses are realized in a rational and incremental fashion, and some of the outstanding debt is either recovered or exchanged for equity.<sup>174</sup> Finally, where the exchange involves trading debt for a government holding, the process of privatization<sup>175</sup> is advanced.<sup>176</sup>

### 3.2.3. *Traditional Barriers and Novel Reform — The Mexican Model*

Early proponents of debt-for-equity exchanges were concerned that barriers erected by Latin American nations to limit foreign investment would curtail use of this type of transaction.<sup>177</sup> For example,

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<sup>171</sup> For a description of exchanges that generated additional capital in Mexico and Argentina, see *supra* note 167. For a general discussion of Latin America's need for such recapitalization, see Bogdanowicz-Bindert, *supra* note 16, at 267-73; Hormats, *supra* note 7, at 473-78; *Mexico Opens Several Key Industry Sectors to Direct Investment Participation by Foreign Capital*, 20 Int'l Trade Reporter's U.S. Export Weekly (BNA) No. 20, at 667 (1984) [hereinafter *Mexico Opens Key Sectors*]; Ollard, *supra* note 163, at 69-71.

Latin America will ultimately solve its economic difficulties only by attracting investment capital to fuel its economic growth. During past periods of high external borrowing, large amounts of capital left Latin America. Debt-for-equity exchanges represent a means of facilitating the return of this capital from abroad. Kuczynski, *supra* note 1, at 138-40, 143-44; see also Silk, *supra* note 8, at D2, col. 3 (discussing problems caused by the outflow of capital from developing countries).

<sup>172</sup> See *supra* notes 63-73 and accompanying text.

<sup>173</sup> Because the value of the loans is already impaired, the banks ultimately cannot avoid realizing losses; they can only seek to do so in the most palatable way. Partial repayment of the loans can minimize losses before further deterioration in value ensues. See D. DELAMAIDE, *supra* note 1, at 233; Meltzer, *supra* note 32, at 138, 143; see also Guenther, *supra* note 105, at 6, cols. 1-2 (discussing similar benefits offered by the Mexican debt-for-bond plan).

<sup>174</sup> See *supra* text accompanying note 156.

<sup>175</sup> Privatization is defined as the conversion of state-owned banks and businesses to private ownership. It is generally believed that privatization enhances competition and efficiency. Both the International Finance Corporation and the Reagan administration favor privatization. See Meltzer, *supra* note 6, at 7. Proposals to sell national holdings have met with political opposition in debtor nations. In Mexico, for instance, news of proposed privatization sparked heated debate. See Berg, *supra* note 155, at D5, col. 5; *Defusing the Debt Bomb the Less Painful Way*, *supra* note 154, at 1, col. 5; see also L. MALKIN, *supra* note 8, at 125-26 (likening the sale of national industries to "some surrealistic capitalist fantasy . . . whose . . . hero sells off arms, legs, and much else to stay alive").

<sup>176</sup> For example, Bankers Trust Company recently exchanged approximately \$40 million for a 40% interest in the Provida Pension Fund and a 97% interest in the life insurance company Consorcio Nacional de Seguros. Both companies were previously owned by the Chilean Government. *Bankers Trust Swapping Chile Debt for 2 Firms*, J. Com., Jan. 9, 1986, at A1, col. 2.

<sup>177</sup> See generally Fiszman, *Foreign Investment Law: Encouragement Versus Restriction*, Mexico, Cuba, and the Caribbean Basin Initiative, 8 HASTINGS INT'L & Published by Penn Law: Legal Scholars Repository, 2014

Mexico's 1973 Law to Promote Mexican Investment and Regulate Foreign Investment (Mexican Investment Law)<sup>178</sup> limits foreign investment<sup>179</sup> in most sectors of the economy to forty-nine percent ownership of any enterprise.<sup>180</sup> In addition, some investors remain concerned that Mexico's lack of specific legislative guidelines and statutory rules leaves them vulnerable to unanticipated policy changes.<sup>181</sup> Mexico, however, has demonstrated a willingness to encourage increased foreign investment.<sup>182</sup> A variety of Mexican regulations that once restricted foreign investment have been lifted.<sup>183</sup> Majority foreign ownership, although

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COMP. L. REV. 147, 150-59 (1985) (reviewing the history of Mexican foreign investment laws and various devices that have been adopted to control foreign investment); Maviglia, *supra* note 18, at 290-98 (discussing regulatory barriers encountered by foreign investors in Mexico).

<sup>178</sup> Diario Oficial [D.O.], Mar. 9, 1973 [hereinafter Mexican Investment Law], reprinted in *English in 1 DOING BUSINESS IN MEXICO*, app. I2 (S. Lefler ed. 1987). This law's purpose was "to promote Mexican investment in order to stimulate a just and balanced development and consolidate the country's economic independence." *Id.* art. 1. This legislation was part of a broader policy aimed at minimizing the role of foreign capital in Mexico. Implementation of this policy, along with the devaluation of the Mexican peso in 1976, led to a decline in confidence in Mexico's economic health and ultimately to near default. Fiszman, *supra* note 177, at 152.

<sup>179</sup> According to Mexican law "foreign investment shall be considered that undertaken by: I. Foreign corporate bodies; II. Foreign physical persons; III. Foreign economic entities without legal personality; and IV. Mexican business enterprises with majority foreign capital or in which foreigners are empowered . . . to determine the management of the business enterprise." Mexican Investment Law, art. 2. *See also* Fiszman, *supra* note 177, at 153-54.

<sup>180</sup> Mexican Investment Law, art. 5. The National Commission on Foreign Investment [hereinafter Commission] has authority to approve investment in excess of the 49% limit. *Id.* The Commission was established by the Mexican Foreign Investment Law as a cabinet-level group with wide authority to regulate foreign investment. *Id.* arts. 11-17. There are, however, some areas of investment that are reserved exclusively for state ownership. These include oil, gas and basic petrochemicals, nuclear energy, electricity, railways, radio and telegraphic communications, and certain areas of mining. *Id.* art. 4; *see also* Fiszman, *supra* note 177, at 154-55 & n.35, 162; Maviglia, *supra* note 18, at 290-94.

<sup>181</sup> Maviglia, *supra* note 18, at 299. Mexico's investment policy is based upon administrative guidelines rather than upon legislative measures. The Mexican President has authority to promulgate regulations which explain and provide detailed precepts for the application of specific laws. MEX. CONST. art. 89, § 1. No regulations per se address foreign investment in Mexico. Rather, the Commission has the authority to issue General Resolutions setting forth standards and requirements for applying the law. Mexican Investment Law, arts. 12-13; *see* Fiszman, *supra* note 177, at 158-59; Maviglia, *supra* note 18, at 292; Treviño, *Mexico: The Present Status of Legislation and Governmental Policies on Direct Foreign Investments*, 18 INT'L LAW. 297, 305 (1984). For example, the Commission has authority to rule on debt conversion matters or to promulgate guidelines to govern debt conversion policy. *See Operating Manual*, *supra* note 158, at V-4.

<sup>182</sup> *See, e.g., Mexico Opens Key Sectors*, *supra* note 171, at 667.

<sup>183</sup> *See* Fiszman, *supra* note 177, at 155-56. *But see* Ollard, *supra* note 163, at 73 (noting that Mexican pesos generated by these types of investments cannot be converted back to United States dollars to pay for imported machinery and plant improvements).

not always encouraged, is now more readily permitted in targeted industries.<sup>184</sup> Although the Mexican attitude towards foreign investment is not uniformly hospitable,<sup>185</sup> vast improvements have been made during the past several years.<sup>186</sup>

In particular, Mexico's 1984 Guidelines for Foreign Investment and Objectives for Its Promulgation (Guidelines)<sup>187</sup> allow increased investment of foreign capital within Mexico and, contrary to conventional Latin American practice, tolerate a loss of domestic control where substantial economic benefits are expected.<sup>188</sup> The Guidelines stress the attainment of stability and growth through the balancing of foreign exchange, the production of competitive imports and the further integration of Mexico into the international economic community.<sup>189</sup> Furthermore, the Guidelines acknowledge Mexico's past failure to establish a consistent policy towards direct foreign investment.<sup>190</sup>

With respect to debt-for-equity exchanges, Mexico, in accordance with the August 1985 Public Sector Debt Restructuring Agreement,<sup>191</sup>

<sup>184</sup> For example, guidelines promulgated by the Commission now specify priority activities which may receive up to 100% direct foreign investment. Guidelines for Foreign Investment and Objectives for Its Promulgation, D.O., Aug. 30, 1984, at 5-6 [hereinafter Guidelines]. These activities include: "production of nonelectric equipment and machinery, electric machinery and appliances, electronic equipment and devices, and equipment and material for transportation; metal mechanics; the chemical industry; other manufacturing industries; advanced technology services; and the hotel industry." Maviglia, *supra* note 18, at 296 (footnotes omitted).

<sup>185</sup> For example, disputes involving investment in Mexico must be decided by a domestic forum. Fiszman, *supra* note 177, at 157-58.

<sup>186</sup> See Maviglia, *supra* note 18, at 294-98. Moreover, it is generally assumed that businesses incorporated under the Guidelines could retain majority foreign ownership even if Mexico returned to a 49% foreign investment limit. See *id.* at 299 & n.130 (reporting on interviews with foreign investment attorneys).

<sup>187</sup> Guidelines, *supra* note 184.

<sup>188</sup> *Id.* at 4-5; see Maviglia, *supra* note 18, at 294-95. But see Fiszman, *supra* note 177, at 162 (commenting that "this relaxed attitude does not imply an unguarded door").

<sup>189</sup> Guidelines, *supra* note 184, at 4-5; see Maviglia, *supra* note 18, at 295.

<sup>190</sup> Guidelines, *supra* note 184, at 5; see Maviglia, *supra* note 18, at 295.

<sup>191</sup> New Restructure Agreements Among Mexican Public Sector Obligors, the United Mexican States, Banco de Mexico and Bank Signatories, Aug. 29, 1985. The August 1985 Agreement was one of a series of periodic restructuring agreements. See *supra* notes 47-73 and accompanying text. In contrast to previous restructuring agreements, the 1985 Agreement explicitly adopted an official debt-to-equity program. Its operative provision is art. 5, cl. 5.11, reprinted in *Operating Manual*, *supra* note 158, at V-22. See also Recent Development, *supra* note 160.

As noted in the *Operating Manual*:

Clause 5.11 of the Public Debt Restructuring Agreement of August 29, 1985 establishes the possibility of using the collecting rights of this debt to convert them into equity of public or private companies. Such rights belong to the domestic and international banks that signed the restructuring contracts with the entities and companies of the Mexican public

established a formal system of government supervision. The National Commission on Foreign Investment (Commission)<sup>192</sup> has been given the responsibility for establishing the criteria upon which debt-for-equity exchanges will be approved and for supervising the administration of those exchanges.<sup>193</sup>

By adopting and adhering to explicit criteria for approving debt-for-equity exchanges, Mexico has created a vital debt-for-equity program.<sup>194</sup> Mexico has shown a willingness to tolerate a loss of domestic control over Mexican business when foreign investment is expected to provide the benefits of increased employment, investment and new technology.<sup>195</sup> To achieve these goals, the Commission has adopted a hierarchical structure for determining which applications will be approved.<sup>196</sup> The Commission considers the export performance of potential recipients of debt conversion capital and gives preference to those companies showing a surplus in balance of payments.<sup>197</sup> Priority is also granted to projects which promote desirable technological development.<sup>198</sup> In addition, the Commission prefers companies which already have majority foreign participation.<sup>199</sup> Above all, the Commission

Said Clause permits foreign investors to acquire those rights in the markets and to exchange them for equity of public or private companies; to complement the investment, to begin a company, or to pay their debt in pesos.

*Operating Manual, supra* note 158, at V-7.

<sup>192</sup> The Commission's establishment and its powers are described *supra* note 180.

<sup>193</sup> The Commission established that "[i]n case the concerned acquisition is to be carried out through debt capitalization or profit reinvestment, the previous authorization of the National Commission on Foreign Investment is required." Foreign Investment Commission, General Resolution No. 5, *reprinted in Operating Manual, supra* note 158, at V-4. For a complete description of the Commission's administrative procedures, see *Operating Manual, supra* note 158, at V-9 to -12. For a discussion of the criteria relied on in evaluating potential exchanges, see *id.* at V-4 to -7.

<sup>194</sup> See Debt-Equity Swaps, *supra* note 31, at 1; Kuczynski, *supra* note 1, at 144-45.

<sup>195</sup> Kuczynski, *supra* note 1, at 155; see *Operating Manual, supra* note 158, at V-4 to -7; *Mexico Opens Key Sectors, supra* note 171, at 667.

<sup>196</sup> *Operating Manual, supra* note 158, at V-5. This hierarchy involves many of the economic criteria that an investor would use in deciding what amount to pay for the debt.

<sup>197</sup> "The Commission considers in first place, those companies showing a surplus in the balance of payments, in second place, those with an even balance, and in third place those with a deficit." *Id.*

<sup>198</sup> "The Commission grants priority to projects with peak technology, second place to those with median technology, and third place to those with old technology." *Id.*

<sup>199</sup> "The Commission grants preference for debt capitalization to those companies that, at the moment of application, have 100% foreign capital; then to companies with a majority of foreign capital, and last, to those that due to debt capitalization will pass from a (foreign) minority or nil participation to majority or minority participation respectively." *Id.*

stresses expansion into new areas, economic development and the creation of jobs.<sup>200</sup>

The current program, however, prudently limits exchanges to "exclusively productive, not speculative, investments."<sup>201</sup> Moreover, the Commission thus far has restricted dividend remittances and capital repatriation during the first few years after investment.<sup>202</sup> Both these policies demonstrate a judicious willingness to permit increased foreign investments where the risks of attendant abuses are reduced. Mexico, by adhering to these sound principles of investment and by maintaining careful supervision over its program has thus far been able to avoid the risks of foreign<sup>203</sup> and domestic<sup>204</sup> financial domination. As a result, Mexico has begun not only to retire some portion of its international debt, but also to increase its inflows of foreign investment capital.<sup>205</sup> In the two-year period prior to September 11, 1986, Mexico engaged in twenty-three exchanges and repaid over \$300 million in debt.<sup>206</sup> Additionally, an estimated \$500 million in debt was exchanged for equity in 1986.<sup>207</sup> Thus, Mexico presents an ideal model of a debtor nation's use of debt-for-equity exchanges to alleviate its debt problems and to en-

<sup>200</sup> The Commission is guided by the principles set forth in the Mexican Investment Law and the 1984 Guidelines. *Id.* at V-3; see *supra* notes 178-93 and accompanying text.

<sup>201</sup> *Operating Manual*, *supra* note 158, at V-10.

<sup>202</sup> Debt-Equity Swaps, *supra* note 31, at 3; see also Fiszman, *supra* note 177, at 158 (discussing incentives created by allowing control capital to be removed through remittances and foreign repatriation); Kuczynski, *supra* note 1, at 144 (discussing need for repatriation of capital within Mexico).

<sup>203</sup> Debtor nations fear that allowing foreign capital unregulated access to their economies will effectively deprive their people of control over their own economic destiny. Foreigners may choose to invest only in the most lucrative areas of the economy and transfer the resulting profits abroad. See Maviglia, *supra* note 18, at 283 & nn.13-14, 286-87; see also L. MALKIN, *supra* note 8, at 125-26; Clearing House Letter, *supra* note 162, app. at 4-5.

<sup>204</sup> The exercise of absolute national sovereignty over the legal rights of foreigners diminishes the security of foreign investors. Where foreign investors lack control over allocation of capital, repatriation of capital and maintenance of satisfactory returns, they hesitate to participate in even the most attractive opportunities. See Fiszman, *supra* note 177, at 157-58.

<sup>205</sup> Debt-Equity Swaps, *supra* note 31, at 3.

<sup>206</sup> Berg, *supra* note 155, at D1, col. 3. The Commission presents a higher estimate, claiming that during 1983-1985 it achieved "favorable resolution for debt capitalization [of] 769.1 million dollars." *Operating Manual*, *supra* note 158, at V-3. It is expected that Mexico will retire over \$10 billion of its debt over the next decade. Chile has also been extremely successful in its use of debt-for-equity swaps. In 26 deals over a two-year period, Chile has retired \$280 million in debt. Berg, *supra* note 155, at D1, col. 3.

<sup>207</sup> Debt-Equity Swaps, *supra* note 31, at 1. As of August 1987, The New York Clearing House estimates that Mexico has approved 178 debt-for-equity exchanges with a total value of \$1.5 billion since inaugurating its formal program in 1986. Clearing House Letter, *supra* note 162, app. at 5.

courage foreign investment.

### 3.2.4. *Obstacles Arising from United States Accounting Practices*

Despite the success of the Mexican program, debt-for-equity remains a buyers' market at this time.<sup>208</sup> From the standpoint of United States creditors, Generally Accepted Accounting Principles (GAAP), which are promulgated by the Financial Accounting Standards Board (FASB) and define accepted accounting practices, make employment of debt-for-equity exchanges a costly practice.<sup>209</sup> The GAAP rules suggest that loans must be marked to market whenever they are bought or sold.<sup>210</sup>

Regardless of the actual worth of an outstanding loan prior to its sale or exchange, the loan is listed on the bank's books at the face value of the original principal plus interest. However, once a market price can be fixed by sale or exchange, accounting standards require that the entire loan be adjusted to reflect the rate of that sale.<sup>211</sup> Thus, if bank

<sup>208</sup> Cf. Fiszman, *supra* note 177, at 163 (commenting that Mexican foreign investment is "a buyer in buyer's markets").

<sup>209</sup> See generally Debt-Equity Swaps, *supra* note 31, at 4-9 (discussing the uncertain accounting and tax ramifications of debt-for-equity swaps). In addition, various governmental restrictions prevent financial institutions from fully utilizing debt-for-equity swaps for their own benefit. See *supra* note 162 (discussing Regulation K of the Federal Reserve Board). As a result most United States banks limit their participation in debt-for-equity exchanges to brokering rather than exchanging their own debt. For instance, although Citicorp is regarded as one of the leaders in the emerging debt-for-equity market, Citicorp has actually exchanged little of its own debt. Current rules of accounting also deter United States banks from exchanging their own debt. See Ollard, *supra* note 163, at 74; Berg, *supra* note 155, at D5, col. 1.

<sup>210</sup> ACCOUNTING BY DEBTORS AND CREDITORS FOR TROUBLED DEBT RESTRUCTURINGS, Statement of Financial Accounting Standards No. 15, ¶¶ 27-39, 79-82, 90-97 (Fin. Accounting Standards Bd. 1979); see M. MILLER, GAAP GUIDE: A COMPREHENSIVE RESTATEMENT OF ALL CURRENTLY PROMULGATED GENERALLY ACCEPTED ACCOUNTING PRINCIPLES § 40.01-.07 (1986) [hereinafter GAAP GUIDE] (commenting on Standard No. 15). For additional discussion of the effects of the market-to-market rule, see Ollard, *supra* note 163, at 74; Berg, *Banks Cool to Brazil Debt-for-Bond Plan*, N.Y. Times, Sept. 28, 1987, at D4, col. 3 [hereinafter Berg, *Banks Cool to Brazil Debt-for-Bond Plan*]; Lissakers, *supra* note 24, at A31, col. 1; Berg, *supra* note 155, at D1, col. 1.

<sup>211</sup> The GAAP GUIDE states:

Receipt of assets or equity: When the creditor receives either assets or equity as full settlement of a receivable, he should account for these at their fair value at the time of the restructuring. The fair value of the receivable satisfied can be used if it is more clearly determinable than the fair value of the asset or equity acquired. In partial debt payments the creditor *must* use the fair value of the asset or equity received.

Combination of types: The creditor shall reduce his recorded investment by the *fair value* of assets received.

GAAP GUIDE, *supra* note 210, § 40.06-.07 (emphasis added).

Brazil's proposal to exchange debt for bonds encountered this type of problem.

A has a \$10 million loan outstanding to country Y, the bank lists that loan as a \$10 million asset plus interest to be earned. In reality, the loan may be worth substantially less, because the full \$10 million will never be recovered.<sup>212</sup> However, if the bank were to sell any portion of that debt at a discounted rate (as would generally occur in a debt-for-equity exchange),<sup>213</sup> the portion of the loan exchanged, and perhaps the entire loan,<sup>214</sup> would have to be marked down to reflect GAAP's views of market value. Under one of the most disadvantageous scenarios, if bank A sold \$2 million of the debt at a twenty percent discount rate, i.e., the debt were purchased for \$1.6 million, the entire remaining debt would have to be discounted by twenty percent. The bank would value its remaining asset at only \$6.4 million. Although it could be argued that the bank is merely being forced to recognize the real value of its asset, there would be little incentive for a bank to engage in such a costly recognition.<sup>215</sup> Perhaps most importantly, those banks which have the largest loan problems, and which face the greatest financial risk, would be unlikely to avail themselves of debt-for-equity relief because such relief would result in recognition of an across the board loss.<sup>216</sup> This type of problem could be remedied through a regulatory adjustment or explicit ruling on the part of the FASB.<sup>217</sup>

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The proposed scheme would have exchanged the debt for bonds, presumably with lower interest rates, which the creditor banks would have been free to sell. Creditors expressed concern about the actual value and practical effects of the bond scheme. The partner in charge of technical accounting issues at the international accounting firm of Ernst & Whinney stated that, if accountants concluded that an exchange had taken place, "the new bonds would have to be valued at their fair market value, and the banks would have to recognize a loss." Berg, *Banks Cool to Brazil Debt-for-Bond Plan*, *supra* note 210, at D4, col. 4. Because the bonds were expected to have a value of approximately 60% of the face amount of the debt exchanged, the banks would have been forced to write-off 40% of the debt's value. *Id.*

The mark-to-market rule also arose as an obstacle to the Mexican debt-for-bond scheme discussed *supra* note 105. The United States Securities and Exchange Commission [hereinafter SEC] announced that in its view any bank offering to exchange part of its loan portfolio would have to mark the value of that part down to the price offered. See *Some Big Banks Plan to Shun Mexican Plan*, *supra* note 72, at 2, col. 1; Ricks & Truell, *SEC Tells Banks How to Handle Mexico Debt Swap*, Wall St. J., Jan. 5, 1988, at 7, col. 2; Truell & Murray, *supra* note 5, at 4, col. 3. The SEC believed that the mere act of bidding on the Mexican bonds would require a write-down whether or not an actual exchange had occurred. See *Some Big Banks Plan to Shun Mexican Plan*, *supra* note 72, at 2, col. 1.

<sup>212</sup> See *supra* note 159 and accompanying text.

<sup>213</sup> See *supra* text accompanying notes 159, 164-67.

<sup>214</sup> See *supra* notes 210-11 and accompanying text.

<sup>215</sup> See Ollard, *supra* note 163, at 74; Berg, *supra* note 155, at D5, col. 1.

<sup>216</sup> Ollard, *supra* note 163, at 74; see also *Some Big Banks Plan to Shun Mexican Plan*, *supra* note 72, at 2, col. 1; Berg, *supra* note 155, at D5, col. 1 (discussing fact that most United States banks do not exchange their loans for equity).

<sup>217</sup> Because the Financial Accounting Standards Board [hereinafter FASB] has not yet formulated rules addressing these issues, accounting in this area is based on estimates.  
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Bankers Trust Company, one of the leading practitioners in the debt-for-equity field, has devised an instructive way to avoid the dilemma.<sup>218</sup> This bank does not accept the market price as the true market value of the paper it is exchanging.<sup>219</sup> Bankers Trust regards the fair value of the debt as the debtor's cost of raising new money, taking into account factors such as rescheduling and trade finance. In calculating the value, Bankers Trust compares those figures with the current loan yield, ultimately achieving what it deems to be the true market value of the loan.<sup>220</sup>

Another possible valuation model would require the debt exchanged to be valued at the ultimate value of the equity purchased from the debtor.<sup>221</sup> In such situations, the real market value of the loan would not be the price paid by the third party to the bank for purchase of the loan, rather the market value would be recognized as the loan's ultimate value in the debtor nation. For instance, when bank A sells \$2 million of its interest in country Y's debt to a multinational corporation, the market value of the debt should be based on what it would cost the debtor to raise a similar amount of capital. Thus, if the corporation exchanged the debt for \$1.9 million in Mexican pesos, then bank A would discount its remaining asset by only five percent.

Although these proposals tend to inflate the value of the exchanged debt, the FASB should recognize that, where Third World debt is being accounted for, general standards do not apply.<sup>222</sup> The FASB is primarily concerned with ensuring that the bank's valuation of its assets comports with what those assets are truly worth on the open market. Yet, in the case of Third World debt, it is simply wrong to assume that the presale or postsale value is an accurate reflection of the debt's true worth.<sup>223</sup> Although the debt is undoubtedly overvalued on its face, it enjoys a certain degree of support by creditor governments and supra-national finance organizations.<sup>224</sup> Because that backing reflects a need to balance the financial requirements of the debtor nations with the risk of default faced by the creditors, it makes no sense for the FASB to upset that balance, especially where to do so would obstruct the conver-

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tion of the proper method. The problem of uncertain standards is currently being considered by the FASB's Emerging Issues Task Force. Debt-Equity Swaps, *supra* note 31, at 4.

<sup>218</sup> See Ollard, *supra* note 163, at 74.

<sup>219</sup> *Id.*

<sup>220</sup> *Id.*

<sup>221</sup> See *supra* notes 158-159 and accompanying text.

<sup>222</sup> See *supra* note 159 and accompanying text.

<sup>223</sup> See D. DELAMAIDE, *supra* note 1, at 233.

<sup>224</sup> *Id.* at 226-27; see also L. MALKIN, *supra* note 8, at 77; Bogdanowicz-Bindert,



sion of impaired debt into useful capital.<sup>225</sup>

### 3.2.5. Debt-for-Equity Caveats

Uncontrolled growth of the debt-for-equity market could lead to certain inherent pitfalls. First, the very nature of a debt-for-equity exchange is inflationary; the mechanism requires the creation of new money in a nation's economy.<sup>226</sup> However, proponents argue that the threat is overstated and is no different from the effect of any new inflow of foreign exchange into a country.<sup>227</sup> Second, debt-for-equity exchanges create an incentive for debtor nations to auction off national holdings.<sup>228</sup> Prevention of both these ills lies within the power of governments in the debtor nations. Vigorous enforcement of well-drafted regulatory guidelines would enable these nations to enjoy the benefits of debt-for-equity exchanges without suffering their drawbacks.<sup>229</sup> Finally, by focusing too closely on their own pecuniary self-interest, financial practitioners are allowing exchanges to develop as merely an expedient trading mechanism.<sup>230</sup> For instance, a recent article concentrated almost exclusively on the profit potential for practitioners in this burgeoning new market,<sup>231</sup> without fully exploring the overall effect of debt-for-equity exchanges on creditors and debtors. Although the potential to make a great deal of money through brokering debt does exist,<sup>232</sup> the value of exchanges as a tool for relieving the debt crisis will be lost if

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<sup>225</sup> The FASB could exempt certain Third World debt from the mark-to-market standard based on frequency of rescheduling. For example, if a loan were subject to annual or more frequent rescheduling, portions of it could be exchanged without marking the remaining debt to market. As one commentator has stated, "[a]ccounting rules could be adjusted so that the banks could sell large chunks of troubled portfolios at discounts without having to reflect these discounts in valuing similar loans they retain . . . ." Lissakers, *supra* note 24, at A31, col. 3.

<sup>226</sup> See *supra* note 160; see also Clearing House Letter, *supra* note 162, app. at 4.

<sup>227</sup> Clearing House Letter, *supra* note 162, app. at 4.

<sup>228</sup> See *supra* notes 175-76 and accompanying text (discussing privatization of Latin American industry).

<sup>229</sup> For a discussion of safeguards against the loss of national holdings provided by Mexico's debt conversion program, see *supra* notes 201-04 and accompanying text. With regard to the inflationary effects of debt-for-equity exchanges, one commentator has noted that "[t]he central bank can in effect sterilize any money created through debt-equity swaps by reducing its loans to domestic entities or reducing its purchases of domestic assets, such as government securities." Clearing House Letter, *supra* note 162, app. at 4.

<sup>230</sup> For example, Ollard presents debt-for-equity swaps as the latest "hot market" and loses sight of the international implications of the debt crisis. Ollard, *supra* note 163; see also L. MALKIN, *supra* note 8, at 62 (criticizing "the latest banking fashions").

<sup>231</sup> Ollard, *supra* note 163.

<sup>232</sup> It has been estimated that \$1 million is made for every \$100 million swapped.

debt exchanges come to be regarded solely as a new speculative market. It would be tragic and economically devastating if thoughtless exchanges of, and speculation in, debt became so prevalent as to undo the progress achieved in Latin America by past nationalization and development.<sup>233</sup>

#### 4. CONCLUSION

The Latin American debt crisis is not insuperable. Although widespread rescheduling has created conflict between the objectives of development and debt service, it has also staved off financial collapse.<sup>234</sup> Rescheduling, however, is not a permanent solution. The financial restrictions and trading disincentives that accompany rescheduling hinder the recovery of Latin American economies.<sup>235</sup> In addition, the negative economic effects of rescheduling quickly spread beyond debtor nations.<sup>236</sup>

Latin America can achieve economic health only if strategies are devised that both alleviate the economic restrictions caused by the long-term debt burden and, at the same time, create a favorable environment for foreign investment and repatriation of flight capital.<sup>237</sup> Although international countertrade arose out of necessity, it does offer a means by which a debtor nation's immediate economic needs can be satisfied without loss of vital foreign currency reserves.<sup>238</sup> Countertrade, therefore, offers a limited means through which a favorable economic environment can be fostered. Although United States policy makers may have some ideological and practical objections to countertrade,<sup>239</sup> an appropriate legislative response can minimize these reservations.<sup>240</sup>

Debt-for-equity exchanges represent an additional means of encouraging foreign investment in debtor nations and offer the debtor a means to counter financial restrictions.<sup>241</sup> Although debt-for-equity exchanges are not completely devoid of problems,<sup>242</sup> Mexico has demonstrated a willingness and ability to come to terms with these impediments.<sup>243</sup> Similarly, the obstacles on the creditors' side of the debt-

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<sup>233</sup> See Fiszman, *supra* note 177, at 150-53 (reviewing the history of Mexico's foreign investment policy).

<sup>234</sup> See *supra* notes 74-76 and accompanying text.

<sup>235</sup> See *supra* notes 81-89 and accompanying text.

<sup>236</sup> See *supra* notes 90-103 and accompanying text.

<sup>237</sup> See *supra* notes 104-10 and accompanying text.

<sup>238</sup> See *supra* notes 111-25 and accompanying text.

<sup>239</sup> See *supra*, notes 127-30 and accompanying text.

<sup>240</sup> See *supra* notes 141-50 and accompanying text.

<sup>241</sup> See *supra* notes 151-76 and accompanying text.

<sup>242</sup> See *supra* notes 177-82, 208-17 and accompanying text.

<sup>243</sup> See *supra* notes 182-207 and accompanying text.

equity equation, particularly in the United States, could be solved through more responsive accounting practices.<sup>244</sup>

Solution of the world debt crisis will require a coordinated effort to apply the various techniques for alleviating debt problems<sup>245</sup> in an orderly and effective manner.<sup>246</sup> Currently, both debt-for-equity exchanges and countertrade remain unfocused and underutilized devices. Regrettably, while rescheduling becomes fully accepted as an institutionalized, supranational event,<sup>247</sup> these newer mechanisms go largely ignored.

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<sup>244</sup> See *supra* notes 217-25 and accompanying text. As one commentator has written, "[s]urely a marketplace that invents a new financial instrument every five seconds can come up with a plan suitable to American banks. . . . [O]ur banking laws and regulations are not written in stone. Neither banks nor regulators hesitate to challenge or bend them when it suits their purposes." Lissakers, *supra* note 24, at A31, col. 2; see also L. MALKIN, *supra* note 8, at 64.

<sup>245</sup> See Alpern & Emerson, *supra* note 21, at A27, cols. 2-5 (listing various new proposals to deal with the Latin American debt crisis).

<sup>246</sup> See Kuczynski, *supra* note 1, at 148-49 (discussing precepts upon which international agreement is needed); Roett, *supra* note 3, at 716 (calling for a United States initiative to devise an orderly rescheduling process).

<sup>247</sup> See, e.g., Bolin & Del Canto, *supra* note 10, at 1100 (noting that one result of the recent debt crisis has been to produce effective cooperation among banks, borrowing countries and the IMF in rescheduling).