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The Changing Legal Framework for Resolving the Debt Crisis: A European's Perspective**

Since its rise, the international debt crisis has proved to be a major problem for the world economy and has become an important issue not only for highly indebted countries, commercial banks, international institutions, and the governments of the creditor countries, but also for the international community as a whole. Apart from its economical and political dimensions, the debt crisis also reveals a legal dimension involving difficult questions of institutional and contractual law. This article concerns the changing legal framework on which the handling of the debt problem is based and its impact on steps towards a durable solution.[1]

What prompted this article is the fact that the management of the debt crisis seems to be entering a new phase since its rise almost seven years ago. After years of rescheduling accompanied by negotiations, confrontations, announcements of nonpayment, and continually increasing indebtedness, more sophisticated approaches to debt management are now being developed that will hopefully provide more satisfactory results for those involved. The main characteristic of this new phase is the trend away from legal structures in debt management that treat all creditors equally.[2] This policy originated in the nature of syndicated loans, whereas current lending policies are designed to create more

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1. The date of this article is as of January 1, 1989, unless otherwise indicated, and was written without benefit of the new U.S. "Brady" plan. Mr. Quale's article, elsewhere in this issue, addresses the "Brady" Plan.

2. SOVEREIGN LENDING: MANAGING LEGAL RISK (M. Gruson & R. Reisner eds. 1984).

market-induced incentives for economical adjustment and financing, including debt relief to the indebted countries.

I. First Phase of Debt Management

A. Extent, Structure and Origins of the Debt Problems

The emergence of the debt crisis is generally considered to have begun with Mexico's announcement in August 1982 that it could no longer service its external debt. Since then, various multilateral agreements have been concluded to reschedule the internal indebtedness of more than fifty countries, mostly newly industrialized countries and less developed countries facing comparable problems.[3] The external indebtedness of these countries amounted to 831 billion U.S. dollars in 1982 and has continued to increase. The indebtedness of the developing countries exceeded 1000 billion U.S. dollars in 1985, reached 1183 billion U.S. dollars in 1987, and is estimated to have risen to 1245 billion U.S. dollars at the end of 1988.[4]

The debtor countries are affected by the debt crisis in different ways. The ability to serve the indebtedness has to be analyzed for each country separately. By taking the distinctive features[5] of the absolute extent of indebtedness, its relation to the GNP, the ratio between debt service and export revenues, the nature of debt, the indebted country's concept of economic policy, its political system, its stage of development, and its resources, the debtor countries can be classified into three types.[6] These are the Latin American, the South-East Asian, and the Sub-Saharan African types. This regional distinction is not absolute, since the Philippines and Nigeria belong to the Latin American group and Colombia, until recently, had been grouped among the South-East Asian pattern.

The three countries with the highest level of indebtedness outstanding as of 1987 are Brazil with 114.5 billion U.S. dollars, Mexico with 105 billion U.S. dollars, and Argentina with 49.4 billion U.S. dollars.[7] All three belong to the Latin American group. The group with the second highest level of external indebtedness is the South-East Asian group. For both groups, floating rate indebtedness to commercial banks predominates. Up to now, the South-East Asian group has been able to service its external debt.

The Sub-Saharan African group reveals a completely different picture. Although the absolute external indebtedness is low in comparison with the other

3. 1 World Bank, 1987–88 World Debt Tables xxxvi (Tab. IV.3).

4. *See id.* at viii.

5. *See, e.g.*, Corti, *Tritt das Internationale Verschuldungsproblem in eine neue Phase?*, [1988] 2 Finanzmarkt und Portfolio-Management 23, 24; C.T. Ebenroth, Globale Herausforderungen durch die Verschuldungskrise 15 (1987).

6. Corti, *supra* note 5.

7. *See* 1 World Bank, *supra* note 3, at xiv (Tab. Box 1).

groups, its relation to the GNP is very high. These countries are mainly indebted to official creditors at fixed interest rates. For these reasons, debt problems of the Latin American pattern do not arise, although the situation in these countries is desperate because most of them are bankrupt in the proper sense of the word and there is no long-term prospect for recovery.[8] An examination of the three types of debtor nations shows that there is no homogeneous international debt problem. The situation among newly industrialized countries, for instance Mexico, is completely different from that of low-income countries in Africa. Each group and within these groups each country should be considered differently according to its individual debt situation.

The reasons for the emergence of debt problems, especially in the countries of the Latin American group, on which this article focuses, are well-known and have occurred simultaneously.[9] They are based equally on internal and external factors and can be traced back to mistakes in economic and development policies in the debtor countries, in the creditor countries, uncautious borrowing by the banking community, and an unexpected change in the conditions of world trade.

The problem became obvious overnight with the Mexican announcement in 1982. Subsequently, similar debt problems emerged in other major debtor countries. This sudden emergence of debt problems in major debtor countries threatened the stability of the international financial system. For a considerable number of commercial banks, especially U.S. banks, the amount of loans given to developing countries after the sudden loss of liquidity endangered their primary capital. An immediate write-down of these loans would have caused a considerable number of bank insolvencies. By setting off a chain reaction affecting other banks, it would have resulted in the collapse of the world financial system.

Based on the aforementioned situation, the stage was set for the first phase of debt management. International institutions such as the IMF, the World Bank, and the Bank for International Settlements, as well as central banks, commercial banks, and the debtor and creditor countries, forestalled the collapse of the international financial system by renegotiating and rescheduling the external debt of the debtor countries to private and official creditors.[10] Although the restructuring proceedings in the first phase of the debt crisis varied in many details, the steps debtor countries took to resolve their external debt problems were very

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8. *See* Abbott, *Debt Relief for the Poorer Developing Countries*, 19 CASE W. RES. J. INT'L L. 1, 2 (1987).

9. For a discussion, see, e.g., S. GRIFFITH-JONES & L. SUNKEL, DEBT AND DEVELOPMENT CRISIS IN LATIN AMERICA: THE END OF AN ILLUSION 96 (1986); J. Barth, M. Bradley & P. Panayotacos, *Understanding International Debt Crisis*, 19 CASE W. RES. J. INT'L L. 31 (1987); M. GARRITSEN DE VRIES, THE IMF IN CHANGING WORLD 1945–85, at 182–86 (1986), C.T. EBENROTH, CODE OF CONDUCT—ANSÄTZE ZUR VERTRAGLICHEN GESTALTUNG INTERNATIONALER INVESTITIONEN, RdNr. 99–123 (1987) [hereinafter CODE OF CONDUCT]; C.T. EBENROTH, *supra* note 5, at 7–8.

10. M. GARRITSEN DE VRIES, *supra* note 9, at 186–87.

similar, and the parties involved soon developed a standardized practice for responding to the practical and legal issues raised by this process.[11]

B. Prephase of Rescheduling

After finding itself unable to obtain any regular financing to prevent insolvency, a debtor country in the prephase of rescheduling[12] usually seeks help from the IMF and its private and official creditors. In some cases, indebted countries have even chosen to announce a moratorium on interest or capital payments. This has proved to be an inadequate solution that leads to isolation from international capital markets. Sooner or later most indebted countries decide to renegotiate their debt in order to achieve an extension of the payment on its external debt due and, usually more important, to obtain fresh money to retain access to the world economy. Both the government and the central bank in the debtor country are in charge of leading the renegotiations. Private sector debtors are only indirectly involved in rescheduling, as the Central Bank has to coordinate all foreign exchange payments.

C. Role of the IMF

The IMF is the main coordinator in debt renegotiations, a role that goes beyond its traditional task of safeguarding international liquidity.[13] The IMF coordinates the separate negotiations with private creditors, official creditors and international institutions such as the World Bank and regional development banks which, like the IMF, have increased their loan facilities to debtor countries. In 1983 the IMF increased its financial aid by 10.6 billion SDR to a total 29.9 billion SDR.[14] This measure was financed by drawing from the IMF's reserves and from various credit facilities.

Financing by the IMF is characterized by conditionality and surveillance. The allocation of funds is determined by the debtor country's ability to comply with certain monetary and economic factors. These conditions consist of adjustment programs that the debtor countries must submit to in order to use the credit facility. The aim of these programs is to stimulate economic growth and achieve

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11. N. Horn, Rechtsfragen Internationaler Umschuldungen 713–21 (1984); M. Bothe, J. Brink, C. Kirchner, & A. Stockmayer, Rechtsfragen der Internationalen Verschuldungskrise 152–56 (1988) [hereinafter Bothe & Brink].

12. For the prephase, see, e.g., N. Horn, *Internationale Schuldenkrise und Ansätze ihrer Bewältigung*, in Handelsrecht und Wirtschaftsrecht in der Bankpraxis, Festschrift für Winfried Werner zum 65. Geburtstag am 17. Oktober 1984, at 357, 361 (W. Hadding, U. Immenga, H.J. Mertens, K. Pleyer & U.H. Schneider eds. 1984); IMF, External Debt in Perspective 27 (1983).

13. *See* Vázquez Pando, *The Mexican Debt Crisis in Perspective: Faulty Legal Structures and Aftershocks*, 23 Tex. Int'l L.J. 171, 193 (1988); M. Garritsen De Vries, *supra* note 9; Gold, *Relations Between Banks' Loan Agreements and IMF Stand-by Arrangements*, Int'l Fin. L. Rev. [IFL Rev.], Sept. 1983, at 28–35.

14. IMF, Restoring Market Access, New Directions in Bank Lending 7 (June 1987).

a balance of payments by expanding exports and replacing imports with the debtor country's own products. The IMF adjustment programs have been subject to much criticism[15] in respect to its targets, the economic concept, the extent of interference with the debtor countries' sovereignty, and insufficient flexibility, although some of the criticism is of a polemic nature and motivated by the internal political situations in the debtor countries.[16]

D. The Rescheduling of Debt to Private Creditors

1. *Process of Negotiation*

When a debtor country is not able to service its debt to private creditors such as commercial banks, this default usually affects several syndicated loans with a great number of creditors.[17] As no institutional framework exists for rescheduling this debt, and since a debtor country is unable to negotiate with such a great number of parties, the debtor country approaches, usually with the assistance of the IMF, the lead managers or agents for the respective syndicated loans. These banks then form a steering or advisory committee to ensure that the creditors act as one unit. The function of this committee is to draft a concept for rescheduling the affected debt in cooperation with representatives of the debtor country and the IMF.

The parties involved in rescheduling negotiations must first define the categories of debt subject to restructuring. Usually excluded from debt renegotiations are debts to international institutions, foreign bond holdings, and trade debts, as their rescheduling would cause a loss in credit-standing unacceptable to the debtor country.

During the first years of the debt crisis, the renegotiations included only external debt with maturities of one year, which made rescheduling necessary every year. Those involved, however, soon perceived that the debtor countries could not solve their debt problems in such a short time. As a result, it became common practice to include medium-term maturities in the rescheduling, depending on the debtor countries' response to IMF adjustment programs. This practice led to the so-called multiyear rescheduling agreements (MYRAs).[18]

The model case adopted in the rescheduling of other countries' debt was that of Mexico in 1985. Here the external debt of the public sector with maturities up to five years was rescheduled over a period of fourteen years. The aim of the

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15. *See, e.g.*, Vázquez Pando, *supra* note 13, at 193.

16. *See* Montagnon, *The IMF and Debt Policy*, Int'l Banking Rev. 153, 153 (Europe/Banker's ed. 1986).

17. For the process of negotiation, see Walker & Buchheit, *Legal Issues in the Restructuring of Commercial Bank Loans to Sovereign Borrowers*, in Sovereign Lending: Managing Legal Risk 139 (M. Gruson & R. Reisner eds. 1984); Bothe & Brink, *supra* note 11, at 152–56.

18. *See* Armaral, *The Foreign Debt from Liquidity Crisis to Growth Crisis*, 19 Case W. Res. J. Int'l L. 17, 21 (1987).

MYRAs is to allow the debtor country a medium-term grace period for adjustment, while also giving the banks the opportunity not to issue new involuntary loans to enable the indebted countries to serve their debt.

After a rescheduling proposal is completed by setting the conditions for the extension of existing debt and the granting of fresh money, the draft is presented to the banks by the steering or advisory committee. The proposal can be modified in subsequent negotiations among the creditors. A restructuring agreement can basically only be concluded by consensual agreement of all parties involved. Although no bank has a legal obligation to participate in a rescheduling,[19] economic considerations such as future market shares in other business branches are usually incentive enough for banks to join in.

2. *Legal Structures of Rescheduling Agreements*

The technique for documenting restructuring agreements originated in the structure of syndicated loan agreements.[20] One main characteristic of rescheduling agreements is the mechanisms that ensure equal treatment of all creditors involved. Such equal treatment is mainly achieved through sharing clauses, mandatory prepayment clauses, cross-default clauses, pari passu clauses, and negative pledge clauses.[21] Sharing clauses oblige creditors to share all funds that originate from nonrateable payments from the borrowers or set-offs of loans against deposits of the borrower or are otherwise realized on securities of the loans with the other creditors on an equal footing. Mandatory prepayment clauses bind a borrower to a rateable prepayment of each restructured loan in the event that any amount of restructured debt is prepaid earlier than contemplated by the rescheduling agreement.

Cross-default, pari passu, and negative pledge clauses deal with the treatment of debt not subject to the restructuring. Cross-default clauses enable the creditors to terminate the restructuring agreement if the creditor defaults on any other specified debt to third parties. Pari passu clauses contain a representation by the borrower that the restructured debt ranks equally with the borrower's other external debts. Negative pledge clauses oblige the borrower not to grant security interests in its property or assets in favor of third parties. Therefore, negative pledge clauses complete the contractual mechanism securing the equal treatment of all creditors on a rateable basis.

A restructuring agreement not only regulates the contractual obligations between the debtor country and the creditors respective to relations between creditors, but also covers a number of legal issues with different structures. Often the debtor country is required to apply and to execute an adjustment program with the IMF. When the restructuring agreement also covers the restructuring of

19. *See* BOTHE & BRINK, *supra* note 11, at 155.
20. Clark & Yianni, *Are These Solutions to the Debt Problems?*, IFL REV., Sept. 1988, at 9.
21. *See* Walker & Buchheit, *supra* note 17, at 144; BOTHE & BRINK, *supra* note 11, at 212–17.

private sector debt, the debtor country usually enters the agreement as guarantor for this debt. Convenants, representations, and other provisions are also documented, notably the submission of the debtor to foreign law and jurisdiction, including the waiver of sovereignty.[22]

Despite their impact on the underlying syndicated loan agreements for extending existing debt, rescheduling agreements[23] do not combine the effected loan agreements into one single contract. On the contrary, in restructuring agreements the underlying syndicated loans are treated formally as separate loans that are merely rescheduled under identical conditions. Legally, not one single restructuring agreement is concluded, but as many parallel restructuring agreements as there are underlying syndicated loans. All of these agreements, however, are contained in a single document.

E. Rescheduling of Debt to Official Creditors

The Paris Club proceedings represent a means of institutionalizing the rescheduling of external debt to official creditors.[24] The Paris Club is an informal and intergovernmental association of member countries in the OECD, which acts as a legally nonbinding forum for the coordination of joint activities among the most important creditor countries. The rescheduling proceedings of the Paris Club have been developed in practice and underly the following rules.

The debtor country initiates the Paris Club proceedings by addressing the French Ministry of Finance, which traditionally convokes the Conference. Participants at the proceedings are the debtor countries and the main creditor countries with claims of more than 1 million SDR. The IMF, the World Bank, the U.N. Conference on Trade and Development, and the OECD have observer status.

After the debtor country has disclosed the amount of its external debt and its economic situation, the creditor countries hold consultations among themselves. In these consultations, the Paris Club drafts a proposal for rescheduling, which is then presented to the debtor country. These negotiations are usually held during a single, well-prepared session and are summarized in the so-called "agreed minutes."

The rescheduling of the debt by the Paris Club usually depends on the acceptance by the debtor country of an adjustment program with the IMF. Originally, the Paris Club proceedings were designed to conclude one-year

22. *See* Ebenroth & Tzeschlock, *Rechtswahlklauseln in Internationalen Finanzierungsverträgen nach New Yorker Recht*, 1988 Praxis des Internationalen Privat- und Verfahrensrecht 197; Ebenroth & Teitz, *Winning or Losing by Default—The Act of State Doctrine, Sovereign, Immunity and Comity in International Financial Transactions*, 19 Int'l Law. 225 (1985).

23. For the legal structures of rescheduling, see Walker & Buchheit, *supra* note 17; Bothe & Brink, *supra* note 11, at 212–17.

24. For the Paris Club proceedings, see Vázquez Pando, *supra* note 13, at 209; Bothe & Brink, *supra* note 11, at 132–39.

restructuring agreements, but now, as in private credit restructuring, the tendency is to conclude multiyear rescheduling agreements (MYRAs). The Paris Club proceedings come to an end when the participants agree to conclude bilateral rescheduling agreements. Although this agreement is a legally nonbinding "pactum de contrahendo," it must also be considered a soft law since it develops strong constraints for its adherence.

II. Entering a New Phase in Debt Management

A. Unsatisfactory Results of Debt Management

The management of the debt problem during the first five years of the debt crisis prevented collapse of the international financial system. The principal reason was that commercial banks were able to build up high loan loss reserves.[25] The development of a secondary market[26] in developing countries' debt with a high discount off face value allowed the diversification and reduction of the loan portfolios of commercial banks in these countries. As a result, most banks can now cope with the sudden insolvency of a main debtor even if they would have to write off their claims completely.[27] For the indebted countries, however, debt management has not led to any substantial improvements. As far as these countries are concerned, debt management is led by a "muddling through approach"[28] that has not provided a durable solution to the debt crisis.

Debt management could not reestablish an acceptable credit standing for these countries that would stimulate commercial banks to voluntary lending, nor could it regain them access to international capital markets. The annual debt growth rate has declined, but this decline is mainly due to the lack of willingness among commercial banks to provide fresh money. The economic adjustment programs the IMF supervised were only partly successful. In spite of adjustment programs, a strong deceleration of growth in debtor countries has taken place. The continuing debt crisis has also had some impact on the economies of the debtor countries. Decreasing imports and increasing exports among the debtor countries have had a considerable influence on the trade deficit in the United States. The restrictive economic policy in the debtor countries has also had a negative influence on the labor situation in the creditor countries.

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25. Glynn, *Taking the hit on LDC-debt*, INST. INVESTOR, July 1987, at 105.

26. *See* Chamberlain, Gruson & Weltcheck, *Sovereign Debt Exchanges*, ILL. L. REV. (1989) (forthcoming); Wulfken & Berger, *Juristische und oekonomische Grundlagen des internationalen Handels von Kreditforderungen*, 87 ZEITSCHRIFT FÜR VERGLEICHENDE RECHTSWISSENSCHAFT [ZVglRWiss] 335 (1987); Lancy, *The Secondary Market in Developing Country Debt: Some Observations and Policy Implications*, FEDERAL RESERVE BANKS OF DALLAS ECON. REV., July 1987, at 1.

27. Clark & Yianni, *supra* note 20, at 9.

28. Corti, *supra* note 5, at 23.

B. Theoretical Approaches Towards a Durable Solution

Since the beginning of the debt crisis, various proposals for a durable solution have been developed. Basically, there are three approaches to a solution of the debt crisis.[29] The first approach consists of an adjustment policy among debtor countries that brings indebtedness into line with the ability to service the debt. The second approach is to finance the debt service of these countries by extending existing loans and granting new loans. The third approach involves partial or total relief of the payment of principal or interest.

Within this framework, the proposals designed to solve the debt crisis have to be divided into global proposals and differentiated proposals. The global proposals, of which the best known is the Castro plan;[30] are radical solutions and have to be rejected. They require debt renunciations and the financing of the debt problem with fresh money. These proposals are not workable because they imply equal treatment of all debtor countries. This approach disregards the wholly different situation in each individual country. The proposals do not provide realistic alternatives to adjustment and finance and ultimately generate the moral hazard of declarations of insolvency by debtor countries in order to achieve better conditions in rearranging their debt situation.

Differentiating proposals proceed on a case-by-case basis.[31] Each debtor country has to be treated according to its particular situation. Accordingly, adjustment, financing, and debt relief are combined in different ways under the principle of burden-sharing among debtors, creditors, and international organizations. The best known of the differentiated proposals is that proposed by Mr. James E. Baker, then Secretary of the United States Treasury, at the joint annual meeting of IMF and World Bank in Seoul in October 1985.[32]

C. New Practical Strategies in Debt Management

International debt management has now entered a second phase.[33] Though no theoretical approach to a solution of the debt crisis has been fully implemented, the strategies of debt restructuring have nevertheless changed. This change is due to the influence of the differentiated approaches and the admitted insufficiency of some of the formerly practiced strategies. The new strategies are based on

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29. C.T. Ebenroth, *supra* note 5, at 15.

30. There's No Other Choice: the Cancellation of the Debt or the Political Death of the Democratic Processes in Latin America, Economic section of the interview with Fidel Castro granted to Representative Mervyn Dymally and Professor Elliot of the United States. Impreso en el palacio de la convenciones, La Habana, Cuba (March 29, 1985).

31. Clark & Yianni, *supra* note 20, at 9.

32. *See* C.T. Ebenroth, *supra* note 5, at 17–19; Code of Conduct, *supra* note 9, at RdNr. 90–94; Conway, *Baker Plan and International Indebtedness*, 10 World Econ. 193 (1987).

33. *See* Griffith-Jones & Nicols, *New Directions in Debt Management*, 19 Case W. Res. J. Int'l L. 53 (1987); Corti, *supra* note 5, at 23–24; Clark & Yianni, *supra* note 20, at 9–14.

established practices, but avoid the policy of equal treatment of all creditors in order to enable more efficient measures of adjustment, financing, and debt relief.[34] The new strategies in debt management follow the case-by-case philosophy.

While a substantial amount of Sub-Saharan African debt has been waived by its official creditors,[35] the strategy for the Latin American type pursues a combination of adjustment and financing measures that increasingly include partial debt relief under market conditions.[36] This latter strategy is commonly referred to as the menu approach because of its combination of different measures governed by the individual situation in the respective country. The assumption is that countries of the Latin American type have to contribute the principal share to the solution of their debt problems by more efficient usage of the resources, by increasing exports, and by acquiring sufficient internal savings. In order to gain the time necessary to make this adjustment process socially bearable, adjustment measures must be combined with financing measures.

The aim is to create legal and economical incentives for both adjustment and financing, including debt relief under market conditions. To achieve this aim, a variety of measures have to be grouped and implemented under the principle of burden-sharing in both restructuring agreements and national legislation of the debtor country. Adjustment processes can be supported by promoting direct foreign investment and repatriation of flight capital. Financing, however, has to be backed by preferential treatment for the granting of new loans or debt relief.

To create such incentives, especially for commercial creditors, the menu approach has to avoid equal treatment of all creditors by modifying the respective clauses in the restructuring agreements in order to make an individual strategy feasible for each creditor according to its specific business policy.[37] The menu approach also relies on measures for the adjustment of existing loans and innovations in granting fresh loans. Some of the measures in the first group are the conversion of syndicated loans in bonds (securitization), the buy-back of discounted loans on the secondary market by the debtor countries or the conversion of external debts into equity investments in the debtor countries (debt equity swaps). In the second category heterogeneous measures are available such as re- and on-lending schemes, currency and interest rate swaps, the introduction of interest caps, the creation of innovative bonds, and co-financing schemes between commercial creditors and the World Bank.

34. Griffith-Jones & Nicols, *supra* note 33, at 67.
35. Abbott, *supra* note 8, at 13.
36. Clark & Yianni, *supra* note 20, at 9–14.
37. *Id.*

III. Adjustment Measures

A. Trade-Oriented Adjustment

In the long run, the debt crisis can only be solved by restoring the ability of the indebted countries to service their external debt by export revenues. Trade-oriented adjustment is one of the most important of the steps that have to be taken. But these processes must take place in the United States, Europe, and Japan, as well as in the debtor countries.[38]

In order to finance the debt service by trade revenues, the indebted countries have to achieve a balance of trade surplus. This surplus can be defined as the difference between domestic production and its absorption by domestic demand. A balance of trade surplus can therefore only be achieved by increasing productivity or by reducing the domestic share in the GNP. If growth is intense enough, the need for reduction or absorption is not very strong. All indebted countries want to gain higher trade surpluses by increasing production, but this goal is very difficult to achieve.

Absorption can be reduced by different means. One main measure is to reduce the absorption of the official sector by reducing existing budget deficits. Private sector absorption, on the other hand, can be reduced by increased taxation on consumption. Limiting the growth of the money supply can reduce endogenous mechanisms, for example, inflation. The demand for imported goods can be reduced by devaluing local currency as an incentive for expanding exports and for import substitution.

The IMF has already pursued such a menu approach in its adjustment programs.[39] Since the poorest classes bear the brunt of the burden resulting from the reduction of absorption in developing countries, this approach is obviously limited to social and political acceptance in the debtor country.

B. Importance of Foreign Direct Investment

In the 1970s a shift took place from direct foreign investment to financing.[40] Figures show that foreign financing has become smaller since the rise of the debt crisis. Nevertheless, less developed countries (LDCs) need direct investment for their economic reconstruction. As they have insufficient local capital for direct investment, they need foreign capital.[41]

38. C.T. Ebenroth, *supra* note 5, at 20–22.

39. M. Garritsen De Vries, *supra* note 9, at 188; Montagnon, *supra* note 16, at 153–55.

40. *See* Code of Conduct, *supra* note 9, at RdNr. 100.

41. On the importance of direct foreign investment see IMF, Foreign Private Investment in Developing Countries 9, 28, 41 (1985); P. Juhl, Direktinvestitionen in Entwicklungsländern unter dem Einfluss Politischer Risiken 15 (1983); S. Lall & P. Streeten, Foreign Investment, Transnationals and Developing Countries 16, 81, 130 (1977); Becker-Boost, *Direct Foreign Investment as an Issue in the North-South Dialogue*, in Kapitalinvestitionen im Ausland—Chancen und Risiken 63 (K. Esser & K. Meessen eds. 1984); Code of Conduct, *supra* note 9, at RdNr. 122;

Foreign direct investment has further advantages. If the foreign investor pursues entrepreneurial aims, his investment will usually be combined with additional know-how. This transfer of technology leads to spillover and growth-pool effects.[42] A constant stream of direct foreign investment can lower a debtor country's net resource transfer and in the long run its access to capital markets. A precondition is, of course, an interesting climate for foreign investment. The new Brazilian constitution, on the contrary, establishes policies favoring local companies and seems to institutionalize unfair competition.[43]

Direct foreign investments by transnational enterprises also lead to a further access of international markets.[44] These junctions enable transnational enterprise to circumvent protectionism because production can be easily adjusted to national regulations. Protectionism among developed countries, however, has to be overcome.[45] A debtor country cannot be blamed for not servicing its debt if it is not allowed to earn foreign currency. Thus, a developed country which has an income in payments caused by a debtor country's debt service cannot have an additional trade surplus to this debtor country. Developed countries must take a negative trade balance against LDCs into account.

C. Privatization and Development of Capital Markets

The massive participation of a government in its own economy normally leads to an initial period of growth.[46] Stimulated by government spending, the budget grows as a function of the inefficiency of the enterprise. The last stage involves the distortion of the national markets caused by privileges granted to state-owned enterprises, corrupt management, and disadvantages for the remaining private enterprises. In such a case a country utilizes its resources inefficiently.

The reverse of this situation is privatization. In LDCs beginning on privatization, however, private enterprises normally do not have enough capital in their private portfolios to finance takeovers. Thus the same situation applies as in direct foreign investments.

A. Herrhausen, *Internationale Investitionsfinanzierung in der Zukunft: Eine Herausforderung*, 10 Zeitschrift für Betriebswirtschaft 966 (1987); Riedel, Büttner & Ernst, *External Debt Alleviation Through Foreign Direct Investment: A Real Issue for Third World Countries?*, in Tokyo Club Paper No. 1, at 68 (1988).

42. *See* J. Karl, Die Potentialorientierung beim Internationalen Ressourcentransfer 73, 175 (1987); L. Ngo-Huy, Auslandische Privatinvestitionen auf den Philippinen 136 (1982); Agarwal, *Ausländische Direktinvestitionen und industrielle Entwicklung in der Dritten Welt*, in 1987 Die Weltwirtschaft 146.

43. *See* Stuber, *New Constitution and Foreign Capital*, IFL Rev., Jan. 1989, at 43.

44. *See* Code of Conduct, *supra* note 9; Donges, *Rendite darf kein Reizwort sein*, Frankfurter Allgemeine Zeitung, Aug. 20, 1988, at 13; S. Lall & P. Streeten, *supra* note 41, at 123.

45. On the accusation of protectionism, see Rouey & Carli, *A Route Map*, Economist, June 18, 1988, at 17; Eggerstedt, Hentschel & Nok, *Quantitative Trade Restrictions Against Developing Countries*, Asian Econs., Sept. 1987, at 5.

46. *See* P. Cook & C. Kirkpatrick, Privatization in Less Developed Countries (1988).

Most of the LDCs suffer from underdeveloped capital markets.[47] A capital market has two preconditions. The first involves volume in trade, otherwise fixing prices is impossible. The second involves a system of control that facilitates portfolio investment since a portfolio investor does not typically exercise corporate control.

The IFC offers two services for promoting the development of capital markets in LDCs.[48] One of the IFC programs aims at fostering the institutional framework of capital markets. It contains the advice, software, and know-how necessary for trading securities.

A new approach involves investment funds.[49] The IFC organizes an open-ended fund together with another investment bank, which invests in one or more LDCs. The shares of the so-called emerging market funds are normally registered on at least one international stock exchange where the investments are made. This attracts foreign capital, giving local enterprises an incentive to register.

A working capital market, moreover, can make debt equity swap programs more attractive, even if portfolio investments are not eligible for financing by conversion of debt. A capital market facility is based on the acquisition and, more importantly, on the liquidation of an investment. As most of the existing debt equity swap programs only allow the repatriation of investments to be made in *tranches*,[50] the liquidating investor would have to look for a new holder for every *tranche* if he is unable to use the stock exchange.

IV. Financing

Economic adjustment cannot overcome the indebtedness of Latin American type LDCs. Additional financing is necessary, although international banks have become more and more reluctant to issue new loans. Supranational financing entities like the World Bank or the IMF, however, cannot take on the burden of additional financing. Even the planned augmentation of the World Bank's nominal capital would not enable it to carry this burden alone. The World Bank would risk losing its standing, which in turn would seriously damage the international banking community.

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47. Gill, *The Emerging Global Equity Market—Dimensions and Issues*, 4 B.U. INT'L L.J. 39, 46 (1986). W. Hankel has made an interesting comment in this respect, alleging that one important factor for the development of the debt crisis was the so-called underbanked status of these countries. As a result, a lock of private banks led to an inefficient allocation of the foreign loans. *See* Hankel, *Hintergründe der internationalen Schuldenkrise*, AUS POLITIK UND ZEITGESCHICHTE, BEILAGE ZUR WOCHENZEITUNG DAS PARLAMENT, Aug. 12, 1988, at 13.

48. INT'L FINANCE CORP., RESTORING MARKET ACCESS, NEW DIRECTIONS IN BANK LENDING 16 (1987) [hereinafter RESTORING MARKET ACCESS]; INT'L FINANCE CORP., IFC ACTIVITIES IN PROMOTING PORTFOLIO INVESTMENT AND DEBT CONVERSION THROUGH INVESTMENT TRUSTS (1986) [hereinafter IFC ACTIVITIES].

49. RESTORING MARKET ACCESS, *supra* note 48; IFC ACTIVITIES, *supra* note 48; *Love Thy Country Fund*, ECONOMIST, July 18, 1987, at 81.

50. *See* S. RUBIN, GUIDE TO DEBT EQUITY SWAPS (1987).

For this reason, it is necessary for banks to provide additional financing. Banks from different countries, however, are affected differently by the debt crisis. The different national tax laws and regulatory statutes for banks have led to different degrees of vulnerability. For example, while German banks could deduct their tax write-offs and are not hindered by German regulations from liquidating their portfolios through investments, American and Japanese banks are faced with broader legal restraints on write-offs and investments. This would make international standards for bank regulation and taxation unrealistic, however, and it would not be necessary. In some cases, changes have been made. For example, the Federal Regulatory Board has changed its Regulation K,[51] enabling American banks to liquidate their portfolios through their own investments.[52] Although further changes are possible, it will not lead to equal standards for all banks. Only a menu of options for banks can lead to further voluntary lending. Each bank should be able to choose its own optimal financing facilities tailored to fit its tax and regulatory laws.

Financing in this sense means also certain forms of portfolio liquidation. On the one hand, some banks are unable to issue more loans, whereas on the other hand the debtor country can profit from some forms of portfolio liquidation.

Up to now, equal treatment for all creditors was the usual method for rescheduling loans. Mandatory prepayment, sharing, and negative pledge clauses are the most significant regulations. Common exemptions today are debt equity swap clauses, which allow the debtor country to pay the investor without triggering mandatory prepayment or the sharing clause.[53] Debt equity clauses differ from other types of exemptions because they leave the participants with different degrees of freedom. In some cases, for example the Mexican Bond offer,[54] the parties even went beyond this, which required an enormous documentation.[55] Once the equal treatment clauses are modified or cancelled, the participants have a broader scope of action. This facilitates the return to market mechanisms in international lending and imposes higher duties on banks in order to check credibility.

A. New Money Commitments

One solution to the debt crisis would be a return to market mechanisms in direct financing, that is, a commitment to new loans. Here several alternatives are

51. 12 C.F.R. § 211 (1981).

52. *See* Rowntree, *Broadening the Scope of Regulation K*, IFL Rev., July 1988, at 31; Spencer, *Regulation K Allows 100 Percent Ownership*, IFL Rev., Oct. 1987, at 13, 14.

53. Usually any restructuring agreement allows debt equity swaps.

54. *See* Ebenroth & Cremer, *Mexikos Umschuldungsangebot—ein Ansatz zur Lösung der Schuldenkrise?*, 1988 Die Bank 488.

55. *See id.* at 491.

possible: preferential servicing of debt, collateralization, securitization, confinancing, on-lending, and other facilities.

Some of these alternatives have already been implemented to some extent; for example, trade facilities are often excluded debts, meaning they are excluded from rescheduling. This affords exemptions from sharing clauses.

New loans in the form of bonds are also a part of a financing menu. If bonds are assignable without the debtor's consent, it would be very difficult to reschedule them. By exempting them from the sharing clause, it would be possible to make them even more attractive.

Collateralization is a difficult technique. Although full collateralization would be too expensive for the debtor, partial collateralization is an affordable alternative. The Mexico bonds[56] offered to the banks in the beginning of 1988 were collateralized with U.S. Treasury Zero Bonds for the principal. The bonds were obtained in exchange for debt in an auction, where Mexico offered a limited amount of bonds for those creditors who offered the biggest discount. Although the Mexicans have tended to view the auction of these bonds as disappointing, the results could have been foreseen. The estimated discount by Mexico of 50 percent was unrealistic because of the uncollateralized interest payments. A better strategy would have been for a bank to sell its loan on the secondary market and invest in U.S. Treasury Bonds afterwards. As a result, the market would establish an average discount rate of about 30 percent for the bond offering. One precondition for the Mexican offer was a waiver issued by the majority of the banks for the negative pledge and the pari passu clause. This waiver is still in force and could be used by Mexico for a second offering.

Since the Mexico bonds bore a significantly better interest rate and were freely assignable outside the U.S.A., the next logical step would be to trade in re-packaged bonds. A bank, in other words, could offer a Mexican bond with its own guarantee on interest payment for a certain time and sell it for a better price.

Cofinancing, or re- and on-lending[57] in combination with the projects of the World Bank or other investors can also be an attractive alternative if the conditions in addition to the normal restructuring ones are not too restrictive. If confinancing is also excepted from sharing clauses, banks will have an additional incentive for stricter control of the project. In this way market mechanisms can eliminate unattractive projects, although either a broader spread over LIBOR or other preferences are conceivable as a means of compensating for the eventually higher risks, particularly when there are no government guarantees.

Better debt equity swap conditions can also be a means of attracting new creditors. For example, the new money facilities in the latest Brazilian financing package offered creditors the option of debt equity swaps at face value while

56. See *id.* at 488.

57. *See, e.g.*, Cardenas, *On-lending Capitalization*, IFL REV., Nov. 1988, at 45.

restructured loans were made available only in the auction.[58] This meant an average advantage of 25 percent for the new creditors, which enabled them either to liquidate their portfolio without taking a loss or to make larger profits by arranging debt equity swap financed investments for nonbanking entrepreneurs. The documentation of this technique was quite easy. And as the regulation of debt equity swaps has been left to the debtor countries up to now, Brazil only had to waive its usual auction system. Consent by other banks was not necessary.

B. Portfolio Liquidation

Portfolio liquidation measures also represent an effective means of reducing LDCs' indebtedness. Here two different approaches are available for portfolio liquidation, one involving all forms of swaps schemes, the other based on debt relief. Elements of both approaches, however, can be combined.

1. *Swaps*

Debt equity swaps have become a very common technique for financing foreign investment and repatriation of flight capital. Their main advantage is the price reduction they offer an investor that is not a bank. This price reduction helps a debtor country attract foreign capital and shift entrepreneurial risk to the investor.[59]

If the banks themselves act as investors, they can use the price advantage of the investment to compensate for specific disadvantages, that is, the discount between face value and market value.[60] The debt equity swap program in the Philippines even facilitates debt equity swaps by banks by waiving the usual fee. This waiver allows creditor banks to participate in Philippine banks at the face value of the converted debt less 500 U.S. dollars.[61]

Although the vulnerability of U.S. banks is higher than European banks due to U.S. tax legislation, American bank regulatory law partly prevents them from taking advantage of these options. Although the main regulation for commercial

58. Parallel New Money Facility para. I–7, 8 reads:

> (3) (a) Loans held by Eligible Lenders (as defined below) may be used to make equity investments in Brazilian enterprises of either. . .
>
> (b) An "Eligible Lender" shall be any Lender whose commitment was consistent with the Commercial Bank Portion of The Brazil Financing Plan and . . .
>
> (c) . . .
>
> Loans under the Parallel New Money Facility shall be eligible (at the option of each Lender) for *conversion* into equity under Resolution 1460.

Loans under the Parallel New Money Facility, Deposits under the New Money Trade Deposit Facility (after the initial deposit period of one year), and New Money Bonds are eligible for the *auction system* of Resolution 1460.

59. *See* S. Rubin, *supra* note 50.

60. Gruson, *Investment in Foreign Equity Securities and Debt-Equity Conversion by Banks, Bank Holding Companies and Foreign Bank Holding Companies*, 1 Colum. Bus. L. Rev. 441 (1988).

61. Central Bank of the Philippines, Circ. No. 1111, Program for the Conversion of Philippine External Debt into Equity Investments sched. 4 (1987).

banks that want to participate in nonbanking enterprises abroad has been amended in order to facilitate portfolio liquidation for U.S. banks,[62] American banks are still handicapped. Thus, U.S. banks that were allowed under strict regulations to participate in foreign entities through debt equity swaps are obliged to sell their interest in the foreign enterprise if this enterprise engages in nonbanking business in the United States.[63]

Although this regulation is logical in terms of the American banking system, LDCs view it as protectionism. American banks that invested under this regulation can run into a dilemma if the enterprise they participate in engages in business in the United States and the bank does not hold a majority stake that would enable it to bar foreign enterprise from U.S. business.[64]

On the other hand, every investor using a debt equity swap is obliged to maintain its interests in the foreign company for a minimum period of time. This is a key element of every conversion program, otherwise round-tripping would lead to an LDC's loss of foreign currency reserves. The Federal Reserve Board does not plan to deal with this situation in the foreseeable future.

Another criticism of the amended Regulation K is its sole application to public debt. Public debt, of course, plays the leading role in debt equity swap practice, but this involves some risk. As a strict separation between governmental fiscal policy and central bank policy on money supply does not exist, LDCs can easily finance debt equity swaps with public sector debt by printing money, though at the risk of inflation.[65] If the debtor country's central bank does not intervene, debt equity swaps with private sector debt have no influence on inflation, although they involve bargaining with a private debtor about prepayment. The amended Regulation K, however, is not applicable to debt equity swaps with private sector debt. So the only possibility for American banks to convert debt into equity without inflation is through privatization programs in combination with debt equity swaps where there is no flow of currency into the debtor country.[66]

Debt equity conversion funds are another option for banks seeking portfolio liquidation.[67] The main advantage here in comparison to direct investment, is the portfolio approach. While several banks assign parts of their loans to funds as opposed to directly participating in them, the fund manager undertakes the placement of the investment by debt equity swap. Thus, a single bank makes a portfolio investment when it participates indirectly in several foreign enterprises.

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62. *See* Spencer, *supra* note 52; *see also* Rowntree, *supra* note 52.

63. 12 C.F.R. § 211.5(f)(4)(iii); 211.5(b)(1)(C)(ii)(3) (1988).

64. An interest above 40% is only eligible when bought from a privatization program, 12 C.F.R. § 211.5(f).

65. *See* M. Baxter & Roldos, *Monetary Reform in Latin America: Prospects for Success*, [1987] 1 FINANZMARKT UND PORTFOLIO-MANAGEMENT, at 24.

66. *See* Roth, Bankenfonds für Debt Equity Swaps 57–58 (1989) (dissertation, University of Konstanz).

67. *See* Ebenroth & Roth, *Konversionsfonds für die Philippinen*, 87 ZVglRWiss 393 (1988).

The bank lowers its risk by diversification and only needs to control the fund manager. The fund itself undertakes direct investments.

Conversion funds constructed with their principal place of business outside the debtor country they want to invest in face some legal restraints. This problem is especially true for American banks. The application of the amended Regulation K is still not clear.[68]

Two existing funds for the Philippines initiated at the beginning of 1988 had to rely on the BHCA to make the participation of American banks possible.[69] The BHCA, however, leaves only a very small scope for the fund manager. The BHCA limits the maximum participation of the foreign company to only 5 percent of the voting shares. This small stake could be regarded by the debtor country as a portfolio investment that would be ineligible for debt conversion.

Another risk has to be avoided if the fund operates outside the debtor country. The fund manager will need about two years to undertake the conversion of all the fund's claims. In the meantime, the fund is prone to changes in investment laws or even cancellation of the debtor country's debt equity swap program. In the case of the above-mentioned funds for the Philippines, the managers arranged to convert the fund's claims into central bank bills that are peso denominated and interest bearing.[70]

This conversion can be considered appropriate because the Philippine restructuring agreement's debt equity swap clause provides a very broad scope. It applies to prepayment and Philippine currency and leaves the regulations of the proceeds to the Philippines.[71] In the case of the funds, the exchange of the central bank's bills for shares has to be approved by the central bank, which will check the investment by application of the debt equity swap program's eligibility conditions for investments.

Debtor countries with more specified debt equity swap clauses cannot offer this hedging technique. But another alternative is available in the case of Brazil,

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68. *See* Roth, *supra* note 66, at 130.

69. 12 U.S.C. § 1843(c)(7) (1982 & Supp. IV 1988); *see* Roth, *supra* note 66, at 132.

70. *See* Ebenroth & Roth, *supra* note 67, at 403.

71. Restructuring Agreement dated January 10, 1986, Amendment dated July 17, 1987: *Inapplicability to Payments Under Sections 5.11 and 5.12.* The provisions of this Section 5.03 do not apply to any payment made in Philippine currency pursuant to Section 5.11 or to any repayment of Eligible Relending Credits pursuant to Section 5.12.

. . .

Section 5.03 (1)

SECTION 5.11 *Optional Repayment in Philippine Currency.* With the prior consent of the Obligor and the Guarantor (which consent the Obligor and the Guarantor may, in their discretion, grant or refrain from granting), a Bank may agree with the Obligor th at all or any portion of any Credit payable by the Obligor to such Bank may be repaid by the Obligor's paying to such Bank the Philippine currency equivalent, determined on the date of such payment, of such Credit or portion thereof. In the event of any such repayment, the Obligor and such Bank shall submit a Correction Notice in accordance with Section 2.02 (d) reflecting such repayment.

which could be applied to other countries. Brazilian laws permit special foreign capital funds with their principal place of business inside Brazil and subject to the laws of Brazil.[72]

The participation of the bank or any other investor is regarded as an investment eligible for debt conversion while the fund's investment policy has to take into account the debt equity swap program pro rata to the participation in the fund paid by conversion. The blend of hard currency and converted debt provides a broader scope for the manager's investment policy. Hedging is not necessary because participation and conversion are made at the same time and each foreign bank is able to choose a stake in the fund that fits its banking regulations. This type of fund does not need to take different banking laws into consideration since this would reduce the scope for management to the lowest common denominator.

Debt commodity swap-schemes have already been undertaken in the case of Peru.[73] They can provide an indebted country with a price advantage and thus compensate for a lack of competitiveness on international markets. The arrangement for Peru represents a means of generating foreign currency by sharing the earned income between Peru and the organizing creditor bank.[74] This scheme, however, can only be applied to other countries when there is a similarly flexible debt equity swap clause or when payment in kind is explicitly allowed and exempted from the sharing clause. A debt equity swap clause that applies for payments in the debtor country's currency would allow the same approach.

The best known example of debt for bond[75] exchanges was Mexico's offer organized with Morgan Guaranty. It was not, however, the first debt for bond scheme. Argentina had already offered its creditors the so-called alternative participation instrument bonds.[76] These bonds were conceived of as exit options for banks that preferred to leave the credit syndicate without taking a loss in international business relations. Their conditions were significantly worse than those of the rescheduled loan and the new money facility, but explicitly excluded from new money calls. The necessary documentation was done within the 1987 financing package so that Argentina did not need any additional consent or waiver.

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72. *See* Stuber, *Setting up a Foreign Capital Investment Fund in Brazil,* IFL REV., Sept. 1988, at 18.

73. *Brazil Wants to Swap $3 Billion of Export for Debt,* 1988 INT'L FINANCING REV. 2116; *see* Jones, *Fishmeal? That'll do Nicely,* EUROMONEY, June 1988, at 149; Zuckerman, *Midland's Debt for Goods Deal,* IFL REV., Nov. 1987, at 23.

74. *See* Zuckerman, *supra* note 73, at 23.

75. Bonds are today's common financing measure. *See, e.g.,* the Listing of Value Impaired Debt Price Indications, FIN. TIMES EUROMARKET LETTER & REPS., Nov. 28, 1988, at 11.

76. *See* Republic of Argentina, Documentation to Implement, 1987 Financing Plan, July 31, 1987, part III-9 (unpublished); *cf.* Yianni & Oakley, *Using Negotiable Securities in Sovereign Debt Restructurings,* IFL REV., Dec. 1987, at 37; Buchheit, *The Changing Tactics of Sovereign Debt Restructuring,* IFL REV., Nov. 1987, at 35-37.

The Mexican bonds, on the other hand, had significantly better conditions than the loan, but were only available in an auction system in exchange for debt at a discount.[77] The exchange system itself did not need any additional consent as the offer was made to all creditors. And since the newly issued bonds were collateralized with the U.S. Treasury, the issue needed a waiver from the negative pledge clause, which was given by the necessary majority of banks.

2. *Debt Relief*

Up to now, debt relief seems to have been only a topic for public creditors.[78] Although sovereign lenders practiced debt relief on a case-by-case basis in differing amounts depending on the creditor's status and the status of the debtor country, bankers only dared to discuss this topic publicly at the annual meeting of the World Bank and IMF in Berlin in 1988.[79] In some cases, debt relief has been combined with antidrug measures aimed at debtor countries. Environmental protection offers a broad field for forgiveness schemes as well.[80] Such "debt for nature" swaps can be organized as a forgiveness scheme in order to preserve such features as tropical rain forests because the banks' loans used to finance the protection measures had been paid by official or semiofficial sources at secondary market price.

Although bankers still seem to avoid the expression "debt relief," it has nevertheless been put into practice in veiled forms. Debt buy-back schemes with private loans have already been negotiated.[81] If the price for the buy-back[82] is below face value, then the buy-back is in economic terms a debt relief because the creditor waives a part of his former contractual claim. This example shows that debt relief does not need to contain a loss for banks. Every buy-back above secondary market price can be a gain depending on a bank's loan loss reserves. The Mexican bond offer contained such an element of debt relief because of the issuance by auction where demands from creditors had to offer a discount. The result of the auction demonstrates that debt relief can be desirable for banks if they are offered an advantage from today's perspective.

Therefore, debt relief does not necessarily mean a plain loss for banks but can be used to offer a menu of options to debtors and creditors. Debt relief, for example, can be used in rescheduling schemes as an option instead of new money commitments. A bank that prefers to liquidate its portfolio for a particular country could choose to forgive an equal portion of its outstanding loan in order

77. *See* Ebenroth & Cremer, *supra* note 59, at 488.

78. *See* Abbott, *supra* note 8, at 12.

79. *Banks Firmly Oppose Debt Forgiveness*, 1988 INT'L FINANCING REV. 3168; *see* Rowley, *Backlash in Berlin*, FAR E. ECON. REV., Oct. 13, 1988, at 97; (1981).

80. *See* Burton, *Back to Nature—The Financial Way*, THE BANKER, Dec. 1988, at 22.

81. *See Third World Debt Crisis Over?*, 1989 INT'L FINANCING REV. 14, 15.

82. *See* M. DOOLEY, BUY-BACKS AND MARKET VALUATION OF EXTERNAL DEBT 215 (International Monetary Fund Staff Papers No. 2, 1988).

to avoid a loss of internationl business relations and additionally be given an incentive for reduction by granting better conditions to an equal portion of the old loan. The initial step in this direction has already been taken.

As mentioned above, future lending needs to have advantages beyond those of plain rescheduling. The 1988 Brazilian financing package contains such an element. Only credits from the new money facilities are eligible for debt equity swaps at face value while old loans are only eligible for the auction system. This incentive for new money commitments could also be used for debt relief when a forgiving bank has the option to use an equal portion of its old loan for debt conversion at face value.

V. Conclusion

Common management among all of the participants has overcome the debt crisis. Measures such as a formal standard for rescheduling and a main material standard for the equal treatment of all creditors have succeeded in making the international financial system less prone to debt crisis type shocks. Up to now, most of the debtor countries were unable to solve the debt problem through domestic economic growth. Conditionality, in combination with credits, has simply not been as effective as originally estimated. Even additional commitments tied to externalities like the Mexican oil price index facility do not provide enough incentive for economic adjustment in debtor countries. For these reasons, the case-by-case approach should be pursued as a means of developing incentives for economic adjustment. Trade barriers of developing countries should also be eliminated. Most important for the further development of LDCs, however, is direct or indirect financing, despite the growing reluctance of banks to become involved in such activities. Banks, too, need additional incentives for further loans.

This article has tried to show that this situation does not involve an inherent contradiction. Already some mechanisms are available that could provide advantages for both sides. What all of these new approaches have in common is the move from equal treatment to market mechanisms. The result is not the survival of only the fittest bank, but the possibility of offering all banks—despite different regulatory and tax laws—a menu of options to choose from. This menu should contain preferential treatment for new disbursements, but it should also include incentives for that kind of portfolio liquidation that a debtor country can also profit from.