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Managing the LDC Debt Crisis

THE DEBT CRISIS of the developing countries is now entering its fifth year. Since August 1982, when Mexico declared its inability to service its debts, more than forty developing countries have experienced crises in external finance.[1] Several earlier Brookings studies analyzing the debt crisis have focused on the origins of the crisis, the market responses to it, and the relationship of the industrialized nations' macroeconomic policies to the prospects of the debtor nations.[2] This paper has a different focus: the management of the debt crisis by the creditor governments, especially the United States.

Looking back at the past four years, one can discern a basic strategy on the part of the United States, Japan, and other creditor governments. For them, the debt crisis opened up the prospect of a major world financial crisis. With the world's largest commercial banks holding claims on the debtor countries that typically exceed 100 percent of bank capital,

1. The World Bank's study "Development and Debt Service: Dilemma of the 1980s," table 2, page xiv, in *World Debt Tables: External Debt of Developing Countries*, 1985–86 ed. (World Bank, 1986), lists thirty-eight countries that have engaged in multilateral debt renegotiations during 1982–85. Several more countries that have entered IMF standby arrangements because of debt-servicing difficulties have not engaged in multilateral debt renegotiations. The countries in the World Bank list are Argentina, Bolivia, Brazil, Central African Republic, Chile, Costa Rica, Dominican Republic, Ecuador, Equatorial Guinea, Guyana, Honduras, Ivory Coast, Jamaica, Liberia, Madagascar, Malawi, Mauritania, Mexico, Morocco, Mozambique, Nicaragua, Niger, Nigeria, Panama, Peru, Philippines, Romania, Senegal, Sierra Leone, Somalia, Sudan, Togo, Uganda, Uruguay, Venezuela, Yugoslavia, Zaire, Zambia.

2. See Carlos F. Diaz-Alejandro, "Some Aspects of the 1982–83 Brazilian Payments Crisis," *BPEA, 2:1983*, pp. 515–42; Diaz-Alejandro, "Latin American Debt: I Don't Think We Are in Kansas Anymore," *BPEA, 2:1984*, pp. 335–89; Jeffrey D. Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia," *BPEA, 2:1985*, pp. 523–64; and Rudiger Dornbusch, "Policy and Performance Links between LDC Debtors and Industrial Nations," *BPEA, 2:1985*, pp. 303–56.

any wholesale repudiation of debt by the leading debtor countries would threaten the solvency of these banks and push the world economy into treacherous and uncharted waters. The strategy of the creditor governments therefore coalesced around one principal goal: maintaining the servicing of commercial bank claims by the debtor governments.

Most foreign and economic policy initiatives on the debt by the creditor governments and the multilateral institutions have been designed with that objective at the core. The creditor governments have used their leverage to make sure that reschedulings of bank debts owed by foreign governments involve neither an interruption of interest payments to the banks nor a reduction in the present value of the debtor countries' future obligations to the banks. In effect, the creditor governments have endorsed debt reschedulings rather than debt relief, where relief signifies any arrangement, such as below-market interest rates, forgiveness of principal, or repurchase of debts by the debtor country at below par, that reduces the present value of contractual obligations of the debtor country. Although banks have written down the value of some sovereign loans on their own books, sometimes at the behest of regulators or auditors, they have not granted relief to the debtor governments.[3] Write-downs are an internal matter; relief is a matter between creditors and debtors.

The private banks have sometimes been encouraged by creditor governments to make new loans, but in amounts significantly less than the interest that they receive from the debtor countries. The new loans have almost always been conditioned on an agreement between the country and the International Monetary Fund on a high-conditionality standby loan, under which the debtor government declares its intent to pursue austerity measures. Finally, various official lenders have made new loans, some of which have also been conditioned on policy reforms in the debtor countries. The creditor governments have sometimes extended new loans to the major debtor countries (as with a "bridge" loan to Mexico in the fall of 1986) to enable them to service their bank debts.

3. In some cases, explicit relief has been granted to private borrowers in the debtor countries, usually when the loan involves a single bank and a single borrower. However, with respect to private-sector loans, the commercial banks have repeatedly pressed foreign governments to take over or at least guarantee the private-sector debts on an ex post basis, after which they are treated like sovereign debt.

The strategy has so far succeeded in keeping the foreign debts serviced, as is evident from data in table 1 on the net resource transfer to the debtor countries during the past five years. Since 1982, the net transfer—the net flow of new capital into the debtor countries minus the repayment of interest and profits on foreign investment—has been negative because the debtors have paid back much more than they have received in new loans. For Latin America, the negative net resource transfer since 1982 has totaled more than $95 billion. Yet the years under the debt crisis and IMF-style austerity programs have been ones of extreme economic hardship and declining living standards in most of the debtor countries. In some of the worst cases, the declines are shocking, with 1985 real wage levels down to 50 or 75 percent of 1975 values. Social and political dislocations have been profound.

Since the onset of the debt crisis, there have been several waves of optimism and pessimism in the creditor countries as to whether the fundamental debt strategy would succeed. Some of the economic indicators prompting these swings in mood are shown in table 2. After the jolt of Mexico's financial distress in mid-1982, the immediate concern was whether the debtor countries would simply renounce their obligations. Creditors were thus delighted with the events of 1983, when the major debtor countries chose to maintain debt servicing despite an extreme fiscal crisis and plummeting economic activity. Creditors applauded the sharp swings towards trade balance surplus and argued that the accompanying sharp fall in gross national product in those countries was unavoidable but temporary. As seen in the table, among the group of countries with debt servicing problems, real per capita GDP in 1983 fell by 4.8 percent, while the trade balance swung from a $6 billion deficit in 1982 to a $22 billion surplus in 1983. In the western hemisphere, the fall in real per capita GDP was more than 5 percent. Creditor optimism increased in 1984 when the world economic recovery, led by the United States, accelerated. The major debtor countries experienced per capita growth once again (though African per capita GDP continued to fall), albeit at a modest rate, and their terms of trade improved. Creditors talked as though the debt crisis were behind them, and they began reaching for long-term solutions through multiyear rescheduling agreements with the major debtor countries.

The optimism was shattered in 1985. The news from the countries of the Organization for Economic Cooperation and Development was

Table 1. Net Resource Transfers to Latin America, 1981–85
Billions of dollars

Year	*Net capital inflow*	–	*Interest repayments and foreign profits*	=	*Net resource transfer*
1981	49.1		27.8		21.3
1982	27.6		36.8		−9.2
1983	6.1		34.9		−28.8
1984	11.6		37.1		−25.5
1985[a]	4.1		36.7		−32.6

Source: Inter-American Development Bank, *Economic and Social Progress in Latin America, 1986 Report* (Washington, D.C.: IDB, 1986), table III-8, p. 35.
a. Preliminary.

Table 2. Economic Indicators of the Debtor Countries, 1981–86
Annual percent change unless otherwise indicated

Indicator	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*[a]
Countries with debt-servicing problems						
Per capita real GDP	−1.0	−2.5	−4.8	0.2	0.6	−0.5
Trade balance (billions of dollars)	−19.4	−6.0	22.0	34.6	35.4	24.2
Terms of trade[b]	−2.8	−4.8	−2.8	2.7	−2.5	−5.8
Export volume	−3.0	−4.2	5.4	7.0	1.4	0.6
Debt-export ratio (percent)	180.2	234.5	252.3	244.2	260.6	275.4
Western hemisphere						
Per capita real GDP	−1.2	−3.2	−5.3	0.8	1.7	−0.6
Trade balance (billions of dollars)	−3.2	7.2	28.7	37.0	33.6	26.9
Terms of trade[b]	−4.4	−5.8	−2.8	4.0	−3.0	−5.1
Export volume	6.1	−2.2	7.1	7.3	−1.2	−0.2
Debt-export ratio (percent)	208.8	267.2	287.5	273.3	295.0	311.1
Sub-Saharan Africa						
Per capita real GDP	−1.2	−2.8	−2.8	−1.4	0.9	2.4
Trade balance (billions of dollars)	−4.5	−3.9	−1.6	0.6	0.1	−0.7
Terms of trade[b]	−7.3	−6.5	1.2	5.0	−2.0	−1.9
Export volume	−2.6	4.4	0.4	4.9	0.7	9.1
Debt-export ratio (percent)	169.3	201.3	215.8	216.3	240.3	236.0

Source: International Monetary Fund, *World Economic Outlook* (IMF, April 1986).
a. Preliminary.
b. Terms of trade measure the price of exports relative to the price of imports.

adequate: continued industrial country growth, a fall in the U.S. dollar, and a drop in interest rates. Nevertheless, the debtor countries experienced a fall in their dollar export prices, a sharp deceleration in the growth of export volumes, and therefore a drop in dollar export earnings for the year. Coming against a backdrop of acceptable OECD economic performance, and after several years of debtor country austerity, that outcome was highly unsettling. Although, according to the table, per capita output in Latin America grew slightly, the aggregate figure is deceptive. Output in Brazil, the largest of the major debtor countries, grew rapidly, while real per capita GDP growth was negative on average for the other major debtors of Latin America.

For the first time since the onset of the crisis, the poor performance of the debtor countries in 1985 could not be blamed on either external conditions or internal profligacy. Commercial banks further restricted their exposure to the indebted countries of Latin America and Africa during the year, as can be seen in table 3 (from mid-1984 to March 1986, exposure for the nine major U.S. banks fell by $1.6 billion in Latin America). So far, 1986 has been even worse for most of the heavily indebted countries in Latin America and Africa. Real commodities prices have continued to fall, bank lending has been stagnant, and the forecast is for negative per capita growth for much of Latin America and Africa for 1986 and 1987.

In October 1985, in reaction to the unfavorable events of that year, U.S. Secretary of the Treasury James A. Baker III offered a plan that acknowledged that the debtor countries were not rebounding from the crisis of the early 1980s as had been forecast. But the methods of the Baker plan were merely an intensification of earlier procedures. Under the plan, the commercial banks were encouraged to make new loans to the heavily indebted countries, specifically $20 billion of increased exposure over three years, while the multilateral lending institutions were called upon to make $9 billion of new loans in return for policy adjustments in the debtor countries. The debtor countries were expected to continue to meet huge interest obligations on a timely basis. Latin American debtors, for example, have obligations projected at $94.6 billion for 1986–88.[4] The Baker plan was significant not as a new policy

4. The forecast is by Data Resources, Inc. (DRI), in the *Latin American Review* (Lexington, Mass.: DRI, Summer 1986), table 3, p. 6.

Table 3. Exposure of Nine Major U.S. Banks in the Debtor Countries, Various Periods, 1982–1986[a]

Billions of dollars unless otherwise specified

Region	End-1982	Mid-1984	March 1986
Total Exposure			
All LDCs	83.4	84.0	75.6
Latin America	51.2	53.8	52.2
Africa	5.6	4.9	3.6
Exposure as percent of bank capital			
All LDCs	287.7	246.3	173.3
Latin America	176.5	157.8	119.6
Africa	19.3	14.3	8.1

Source: Federal Financial Institutions Examination Council, "Country Exposure Lending Survey." Mid-1984 data from statistical release of October 15, 1984; March 1986 data from release of August 1, 1986.

a. Exposures are total amounts owed to U.S. banks after adjustments for guarantees and external borrowing. Total exposures are calculated for all LDCs (OPEC, Nonoil Latin America, Nonoil Asia, Nonoil Africa); Latin America (Nonoil Latin America plus Ecuador and Venezuela); and Africa (Nonoil Africa plus Algeria, Gabon, Libya, and Nigeria).

departure, but rather as an admission by the United States that the debt strategy up to 1985 had not generated adequate economic growth in the debtor economies.

While the creditors have ridden waves of optimism and pessimism in the past five years, many observers and policymakers in the debtor countries have seen the story more simply as one of fairly continuous decline. With the exception of a mediocre year in 1984, they have had little to cheer about. Critics of the creditor governments' current approach argue that the failure of the debtor countries to prosper is not surprising in view of the collapse of investments there and in view of the political and economic uncertainties that result from the heavy external debt burden. They point out that among the countries that have been forced to reschedule their debts in the past decade, there are almost no success stories of countries that have pursued IMF austerity measures and World Bank structural adjustments to reestablish creditworthiness and restore economic growth. As table 4 shows, all but one of the countries that rescheduled their bank debts between 1978 and 1981, before the onset of the global debt crisis, have languished with slow growth and without access to the international capital markets. The only notable case of success is Turkey, whose turnaround after a debt crisis in the late 1970s was, as I argue later, materially assisted by an inflow of

Table 4. Debt Reschedulings and Economic Indicators, 1978–86

First rescheduling	*Percent change in per capita real GDP between first rescheduling and 1985*	*Later reschedulings*	*Access to capital markets in 1986*
1978			
Peru	−13.0	1980, 1983, 1984	No
Jamaica	−14.3	1981, 1984, 1985	No
1979			
Turkey	9.4	1981, 1982	Yes
1980			
Togo	−21.0[a]	1983	No
Zaire	−5.8[b]	1983, 1984, 1985	No
Bolivia	−28.2	1981	No
Nicaragua	−13.1	1981, 1982, 1984	No
1981			
Madagascar	n.a.	1982, 1983, 1984	No
Sudan	n.a.	1982, 1983, 1984, 1985	No

Sources: Per capita real GDP from IMF, *International Financial Statistics,* various issues, and unpublished IMF data. Rescheduling dates from Maxwell Watson and others, *International Capital Markets: Developments and Prospects,* Occasional Paper 43 (IMF, February 1986).
n.a. Not available.
a. Until 1983.
b. Until 1984.

some $5 billion in new official loans during 1978–82—far more than anything available today.[5]

Dissatisfaction among creditor nations with the current debt arrangements has grown sharply in the past year. Peru has made a break with the system by declaring unilaterally its intention to limit debt servicing to 10 percent of exports. Powerful opposition groups within Argentina, Bolivia, Brazil, Mexico, and many other countries are pressing for similar policy initiatives from their governments. In response, Senator Bill Bradley of New Jersey has broken new political ground by offering a plan for managing the debt crisis that is based on debt forgiveness by

5. Recently, Brazil, the black sheep of 1984, has been touted as the great success story of 1986, in view of its rapid economic growth for the past two years. But Brazil is an example of a country that has explicitly rejected participation in standard IMF programs. Its current growth is fueled by large budget deficits, a rapidly growing internal debt, a huge black market premium on the exchange rate, and price controls, as well as favorable external conditions, such as falling interest rates and a terms of trade improvement. Thus, the sustainability of Brazil's miniboom is open to doubt, and the "lessons" of Brazil for the current debt management strategy are hard to see.

the commercial banks rather than debt rescheduling and full interest servicing. The Bradley plan would maintain the current case-by-case approach, conditioning debt relief on economic policy reforms. The exact nature of relief would be subject to negotiation, but an example might be a yearly package of 3 percentage points of interest rate relief, 3 percent forgiveness of principal, and $3 billion in new loans from the multilateral lenders.[6]

In view of the problems attendant upon the current debt strategy, I propose six principles as part of a new approach to be put in its place:

—debt relief should play a role in a new comprehensive strategy of debt management;

—debt relief can and must be applied selectively, limiting relief to the countries most in need;

—selective debt relief would not threaten the international financial system, since the bank debt of most countries is far too small to pose any systemic risk, while many of the largest debtors, such as Brazil and South Korea, do not need, and probably would not seek, debt relief;

—even where debt relief is not a desirable option, other financial arrangements can and should be found to increase the net transfer of resources to the debtor countries;

—many of the current risks to the debtor countries should be shifted back to the world financial markets by encouraging multiyear rescheduling agreements, explicit interest capitalization, and contingency clauses linking capital flows to the terms of trade;

—as in the current arrangements, the financial restructurings should be carried out on a case-by-case basis, in conjunction with internationally supervised programs of policy reform in the debtor countries.

Debt relief is necessary as a safety valve for countries that are collapsing under the debt burden. It makes little sense to argue that relief is unwise because "on average" the debtor countries may be recovering or because the largest debtors might not need relief. There are dozens

6. Senator Bradley's proposal is notable both for shifting the political debate in the United States (Bradley is the first major U.S. politician to endorse a program of relief) and for linking debt negotiations with trade talks. There have been several earlier proposals for relief, following the pioneering proposal in 1983 of Professor Peter Kenen for a new public institution to repurchase LDC debt at a discount from the commercial banks. See Peter B. Kenen, "A Bailout Plan for the Banks," *New York Times*, March 6, 1983. For Senator Bradley's plan, see "A Proposal for Third World Debt Management," presented at the Congressional Summit on Exchange Rates, Zurich, Switzerland, June 29, 1986.

of countries struggling now under the debt burden, and some are not making it. Peru is a case in point. The Peruvian economy is in a deep depression, and its terms of trade, already falling, are projected to plummet 14 percent in 1986. Per capita gross domestic product has declined by about 15 percent since 1980, and real wages have declined by an estimated 40 percent. The social fabric is crumbling. Murder and terrorism are the daily fare of Lima. President Garcia's announcement last year of a unilateral suspension of debt repayments was a true cri du coeur. The response from the creditors has been to prove that he cannot get away with it.

For countries, such as Peru, that have suffered very large drops in living standards, out-and-out debt relief is now warranted. As a modification to Senator Bradley's proposal, which seems to make debt relief available to all debtors, I develop a proposal in which objective indicators, such as a country's decline in real per capita output over a period of several years, are used to trigger debt relief on a selective basis. Selectivity is important both to protect the financial system and to reduce the moral hazards that would be present with the unconditional availability of debt relief.

For countries that are performing poorly, but not so poorly as to require debt relief, the debt servicing burden should be eased by methods that compromise between rescheduling and forgiveness. One realistic possibility is to move away from the current system, in which only the existing creditors are called upon to make new loans, towards a system in which new lenders are also enabled to enter, by granting their claims seniority relative to the existing creditors. International agreements could be reached to provide that the new loans will be serviced in entirety before any of the existing debt is serviced. In some cases such agreements would require a rewriting of existing loan covenants. An attraction of such an approach is that it would promote a capital inflow into the country without necessitating a definitive decision on the need for debt forgiveness. The current bank creditors would be fully repaid only if the debtor country in fact grows fast enough to service both the new debt, which has priority, and the old. Otherwise, some part of the debts of the existing creditors will have to be forgiven at some point. Other mechanisms for promoting new investments should also be introduced. Both swaps of debt for equity and rescheduling arrangements that are contingent on the debtor country's terms of trade, as in the recent agreement with Mexico, are now being tentatively tried, but should be greatly expanded in coverage. As in most debt workouts, the ultimate solutions will surely be messy and filled with "ad hockery." It is clear, however, that bolder approaches are now needed.

Strategy in the Debt Crisis

Although it is sometimes asserted that official creditors and bank creditors have been treated equally in the management of the debt crisis, in the past five years the commercial banks have received large net transfers from the debtor countries, while the official creditors, including the creditor governments and the multilateral institutions, have made large net transfers to the debtor countries. Operationally, it can be argued that the official creditors are indeed "bailing out the banks."

As can be seen from table 5, large positive net transfers of resources from the private creditors (mostly banks) to the major borrowing countries came to a quick halt during 1982; the transfers turned negative during 1983, significantly negative during 1984. At the same time, resource transfers from the official creditors have continued to be positive, though not as large as the net transfers to the private creditors. Even in Sub-Saharan Africa in 1984, negative transfers to private creditors were larger than positive net transfers from official sources. While comprehensive World Bank data for 1985 are not yet available, there is little doubt that the diverging trend between private and official creditors widened substantially. One of the important reasons for the differing pattern of resource transfers is that the official creditors have rescheduled interest payments through the Paris Club, the international forum for rescheduling service on debt granted by official bilateral creditors, while of course the commercial banks have not.

Creditor government policies have further supported the commercial banks through their decisions in the area of bank supervision. The most important decision in this area has been that of the U.S. banking regulators to allow the commercial banks to hold almost all of their LDC debt on their books at face value, and to count each dollar of interest receipts as a dollar of income, despite the fact that a large part of the interest receipts is made possible through fresh, "involuntary" lending by the same banks (involuntary in the sense that each individual bank is forced to increase exposure on a pro rata basis).

Table 5. Net Resource Transfers to Debtor Countries, 1981–84
Billions of dollars

Category	*1981*	*1982*	*1983*	*1984*
Major debtor countries				
Official creditors	5.7	5.4	1.5	4.6
Private creditors	4.8	1.0	−1.8	−10.0
Latin America				
Official creditors	2.6	3.0	1.8	3.2
Private creditors	4.0	0.4	−3.5	−10.9
Sub-Saharan Africa				
Official creditors	3.3	3.2	3.3	2.0
Private creditors	1.7	2.6	1.8	−2.1

Source: World Bank, *World Debt Tables: External Debt of Developing Countries,* 1985–86 ed. (World Bank, 1986). For World Bank country classifications, see pp. xliii–xlv.

The creditor strategy has successfully avoided an international banking crisis. The commercial banks have not only continued to receive interest servicing from most of the debtor countries, but enjoyed large net resource transfers during 1984 and 1985. It appears that the banks have been able to reduce their absolute exposure levels in the debtor countries mainly by calling in their claims on private-sector debtors at a greater rate than they have made concerted loans to the governments. For example, between mid-1984 and March 1986, bank loans in Latin America to nonbank official entities rose by $4.5 billion, while loans to banks and private nonbank borrowers fell by $6.1 billion.[7]

One of the deep ironies of the current situation is that while the creditor strategy is applied to all debtor countries, the banking risks result from only a few countries and apply to only a few banks, as evidenced in table 6. While the nine major banks in the United States do have about 100 percent of capital locked up in Argentina, Brazil, Mexico,

7. The data are from the Federal Financial Institutions Examination Council, "Country Exposure Lending Survey: October 15, 1984, and August 1, 1986," table II, which divides the debtors by category: banks, public borrowers, and private nonbank borrowers. There are, unfortunately, several problems with interpreting the data on falling exposures and on the shifts between public- and private-sector debtors. First, a small and undisclosed part of the decline in exposure is due to write-offs of debt rather than amortizations of debt. Second, part of the shift to public-sector borrowers reflects not new concerted lending, but rather an ex post shift of existing debt from the private sector to the public sector through a variety of schemes in which private-sector debt has been absorbed by governments. The most important interpretation of the data, however, is probably the one offered in the text: concerted lending has covered public-sector debt only, so that the private sector has been forced to amortize loans without any way to obtain new lending.

and Venezuela, the exposure of other U.S. banks to these countries represents only 35 percent of capital. For Latin America as a whole, bank exposure is 120 percent of capital for major U.S. banks, but only 43 percent of capital for other banks. Indeed, *all* LDC debt is only 61 percent of bank capital for the others.

Table 6 puts to rest the myth that the U.S. banks could not afford to grant widespread debt relief. With just a modicum of selectivity, debt relief could be easily absorbed by the banks. Suppose, for example, that debt relief comes in the form of five years of zero interest payments, with the missed payments forgiven rather than capitalized. Assuming a market interest rate of 7 percent during the five-year interval, such relief has a present value of $0.31 per dollar of debt.[8] Suppose further that such relief is granted to all but the three largest debtors—Brazil, Mexico, and Venezuela—of the individual countries in crisis shown in table 6. The cost of such relief would be only 15 percent of bank capital for the major U.S. banks and 5 percent of bank capital for all other U.S. banks. If the relief were also extended to include Brazil, Mexico, and Venezuela, the cost would rise to 41 percent of bank capital for the major banks and 14 percent for the rest. Later in the paper I suggest a criterion for granting relief that further reduces the costs.

Why the Debtors Do Not Repudiate

The creditor strategy has so far been notably less successful for the debtor countries than it has been for the banks. Real living standards in the debtor countries have declined sharply since the early 1980s in many countries, and further declines are in prospect for 1986. Table 7 shows the declines in per capita real GDP for the debtor countries in Latin America since 1981. Unfortunately, as striking as these declines are, they have not contributed much towards the goal of improved creditworthiness, since, as shown in table 8, debt-export ratios throughout Latin America are, with the exception of Brazil, higher in 1985 than they were in 1982. The GDP declines, furthermore, understate the overall declines in living standards in most countries, since in addition to falling output per capita most of these economies have also suffered significant

8. Calculated as $0.07 + 0.07/(1.07) + 0.07/(1.07)^2 + 0.07/(1.07)^3 + 0.07/(1.07)^4 = 0.31$.

Table 6. Exposure of U.S. Banks to the Debtor Countries, March 1986[a]

	Nine major banks			*All other banks*		
Region and country	*Billions of dollars*	*Percent of capital*	*Percent of loans to LDCs*	*Billions of dollars*	*Percent of capital*	*Percent of loans to LDCs*
All LDCs	75.6	173.3	100.0	40.3	61.0	100.0
Latin America	52.2	119.6	69.0	28.4	43.0	70.5
Africa	3.6	8.1	4.8	1.0	1.7	2.5
Brazil	16.0	36.7	21.2	7.7	11.6	19.1
Mexico	13.8	31.6	18.3	10.4	15.8	25.8
Venezuela	6.9	15.8	9.1	2.8	4.2	8.4
Argentina	6.0	13.9	7.9	2.5	3.7	6.2
Chile	4.0	9.1	5.3	2.3	3.5	5.7
Philippines	3.6	8.3	4.8	1.4	2.1	3.5
Yugoslavia	1.3	3.0	1.7	0.7	1.1	1.7
Ecuador	1.2	2.8	1.6	0.8	1.1	2.0
Peru	0.8	1.8	1.1	0.6	0.9	1.5
Uruguay	0.7	1.6	0.9	0.2	0.3	0.5
Panama	0.7	1.6	0.9	0.3	0.5	0.7
Nigeria	0.6	1.5	0.8	0.2	0.3	0.5
Morocco	0.6	1.4	0.8	0.2	0.3	0.5
Ivory Coast	0.3	0.7	0.4	0.1	0.2	0.2
Dominican Republic	0.3	0.7	0.4	0.1	0.2	0.2
Costa Rica	0.2	0.5	0.3	0.2	0.3	0.5
Jamaica	0.1	0.3	0.1	0.0	0.0	0.0
Romania	0.1	0.3	0.1	0.0	0.1	0.0
Zambia	0.1	0.2	0.1	0.0	0.0	0.0
Honduras	0.1	0.1	0.1	0.0	0.1	0.0
Malawi	0.1	0.1	0.1	0.0	0.0	0.0
Liberia	0.1	0.1	0.1	0.0	0.0	0.0
Senegal	0.1	0.1	0.1	0.0	0.0	0.0
Nicaragua	0.0	0.1	0.1	0.0	0.1	0.0
Sudan	0.0	0.1	0.0	0.0	0.0	0.0
Zaire	0.0	0.0	0.0	0.0	0.0	0.0

Source: Federal Financial Institutions Examination Council, "Country Exposure Lending Survey: August 1, 1986."
a. Exposures are total amounts owed to U.S. banks after adjustments for guarantees and external borrowings. Total exposures are calculated for all LDCs (OPEC, Nonoil Latin America, Nonoil Asia, Nonoil Africa); Latin America (Nonoil Latin America plus Ecuador and Venezuela); and Africa (Nonoil Africa plus Algeria, Gabon, Libya, and Nigeria). The list of individual countries is not all-inclusive and therefore does not sum to the total for all LDCs. Figures are rounded.

declines in their terms of trade. In most of the debtor countries, real wages have plummeted. In Peru, for example, real wages in 1985 were 49 percent of their level a decade before; in Uruguay, 64 percent; and in Mexico, 74 percent.[9]

9. See United Nations, Economic Commission for Latin America and the Caribbean, "The Economic Crisis: Policies for Adjustment, Stabilization, and Growth" (Mexico City: April 1986), table 16, p. 108.

Table 7. Changes in Per Capita Real GDP, Latin America, 1981–85
Percent

Country	*Cumulative change*
Argentina	−18.5
Bolivia	−28.4
Brazil	−2.0
Chile	−8.7
Colombia	−0.1
Costa Rica	−11.2
Ecuador	−3.9
El Salvador	−24.0
Guatemala	−18.3
Jamaica	−2.2[a]
Mexico	−4.3
Panama	0.7
Peru	−14.8
Uruguay	−18.6
Venezuela	−21.6

Source: United Nations Economic Commission for Latin America and the Caribbean, "The Economic Crisis: Policies for Adjustment, Stabilization, and Growth" (Mexico City: April 1986).
a. To 1984.

Why, then, have the debtor countries continued to pay their debts? In the 1930s, in a similar economic situation, almost every Latin American government unilaterally suspended servicing on its external bond obligations. So far, only Peru has broken ranks and unilaterally reduced debt payments. Some other countries have fallen into deep arrears, but have continued to bargain with the commercial banks on the basis of a resumption of interest servicing. Most countries have in fact continued to make their interest payments.

The major difference between the 1930s and the 1980s appears to lie in the absence of a "hegemonic" power in the 1930s, a role that the United States fills in the 1980s. As Charles Kindleberger has amply documented, none of the creditor governments in the 1930s was willing or able to provide the public goods needed to preserve the economic order.[10] Without a lender of last resort and an enforcer of international contractual obligations, the debtor countries chose to default and generally faced only mild sanctions in response. Only in rare cases did

10. C .P. Kindleberger, *The World in Depression, 1929–39* (University of California Press, 1986).

Table 8. Debt-Export Ratios, Latin America, 1981–85
Percent

Country	*1981*	*1982*	*1983*	*1984*	*1985*
Argentina	333.4	447.3	458.6	489.7	509.0
Brazil	277.5	356.8	376.7	330.8	348.6
Chile	276.8	332.8	361.2	399.7	414.5
Colombia	150.1	183.0	243.1	248.2	245.9
Ecuador	198.2	232.7	259.5	243.4	254.1
Mexico	243.3	304.1	323.6	291.5	326.9
Peru	229.4	270.9	323.8	335.0	368.1
Venezuela	118.4	154.5	197.9	171.7	181.2

Source: Data Resources, Inc., *Latin American Review* (Lexington, Mass: DRI, Summer 1986).

creditor governments force debtor countries to continue to service their debts.

In the 1980s, the United States has managed the debt crisis with a view toward maintaining continued commercial bank debt servicing. Under the U.S. aegis, the other creditor governments and, through them, the multilateral institutions have supported that basic strategy. The ability of the banks to enforce their loan agreements has rested not only on their own bargaining power, but also, crucially, on the willingness of the U.S. government to back them up at critical junctures. With the creditor governments placing so much emphasis on continued servicing of bank debts, a decision by a country unilaterally to suspend its debt repayments is as much a foreign policy decision as a financial one.

Countries that might happily break with the commercial banks are loath to break with the rest of the international system. Retaliation by the banks would involve no more than a cutoff of new loans, a withdrawal of trade credits, and possible seizure of some assets of the debtor government held in the creditor countries. But breaking official ties with creditor governments would involve such crucial financial and nonfinancial areas as aid, trade policy, technology licensing, and arms deals. Moreover, as Carlos Diaz-Alejandro pointed out, defaults could let loose political passions that would threaten the debtor government itself: "For a while, the leader may bask in nationalist glory, but the forces unleashed by default, especially an active one, may threaten constitutional order and could reopen the gates to populist-nationalistic authoritarian generals—after all, the nation would be surrounded by enemies."[11]

11. Diaz-Alejandro, "The Latin American Debt Crisis," p. 381.

The creditor governments have also been reinforced by the international financial and development institutions. The IMF routinely requires that countries come to terms with their creditor banks as a condition for an IMF program. In most cases an agreement in principle between the debtor and the banks is a precondition for an IMF loan; in others the IMF program is approved on the basis of a likely agreement and may be suspended if agreement is not reached. While the IMF generally does not specify the terms that an agreement must follow, the commercial banks know that they can afford to hold out for full interest servicing, with a rescheduling of principal.

Without an IMF program, the country typically cannot reschedule its debts with official export credit agencies of the creditor governments in the Paris Club. Failure to reschedule debts with foreign governments can trigger cutoffs of foreign aid and export credits from industrial country governments. Such credits are not only an important form of finance, but are often necessary for attracting foreign direct investment by foreign multinational firms.

Failure to reach an agreement with the Fund can also jeopardize new lending from the World Bank and the multilateral development banks. In some cases, such as with many World Bank structural adjustment loans, World Bank conditionality has de facto required that the country be in compliance with an IMF program. World Bank programs are also often delayed until countries come into compliance with the Fund. In any event, a country that rejects an IMF program does so at considerable risk to most of its other channels of official financial support.

What this analysis suggests is that the creditor governments could significantly alter the balance of power between the private banks and the debtor countries if they desired to do so. The most important change would be the easiest: the creditor governments and the multilateral institutions would simply have to declare that official policies, such as foreign aid and IMF programs, would not be conditioned on the success or failure of negotiations between the debtor country and the banks. Even without more explicit instruments of persuasion or a legal requirement on the banks, such a shift in policy would probably be sufficient to lead to considerably easier terms on bank debt servicing. A hands-off policy by the official creditors was precisely the U.S. government policy toward Latin American debtor governments that were in default on the outstanding international bond obligations during the 1940s. The policy was likely important in inducing the Foreign Bondholders Protective Council, which negotiated with the debtor governments, to reach post-war settlements involving, in many cases, a significant amount of relief.

Depending on the nature of debt relief that is sought by official creditors, such a laissez-faire policy might not be enough to impel the banks to go along. In that event, some combination of regulatory action or even legislation might be necessary to induce the banks to join official creditors in granting debt relief. In the end, though, the U.S., European, and Japanese governments would have several policy instruments at their disposal if they chose to deploy them. The power of the U.S. government to induce both U.S. and foreign banks to grant debt relief was evident in the case of the Chrysler Corporation bailout, when the government successfully pressured the banks to convert some of their debt instruments into Chrysler equity. As chroniclers of the negotiations among Chrysler, the banks, and the U.S. Treasury have observed, "Looming over the bickering and squabbling between the lenders was the indubitable presence of the U.S. government. Both the American and the foreign lenders conducted their business at the mercy of Congress, the Federal Reserve Board and other federal agencies. Every facet of banking—from electronic cash dispensers to new bank branches—was monitored, directly or indirectly, by the same politicians who had granted aid to Chrysler [and who were now pressing for relief from Chrysler's bank creditors]."[12]

The Economics of Crisis Adjustment

When economists consider the burden of the foreign debt, they usually think of the cost to the debtor country of making a transfer to the rest of the world. The debt burden is measured simply as the discounted flow of resources that the debtor country must provide to its creditors. But over and above the transfer burden is the enormous deadweight loss resulting from the way that the current debt overhang discourages investment in the debtor countries.

Were the debt burden limited to the direct costs of making transfers abroad, the debt crisis would be painful but not as debilitating as it has

12. Michael Moritz and Barret Seaman, *Going for Broke: The Chrysler Story* (Doubleday & Co., 1981), p. 310.

been for most debtor countries. For the typical Latin American debtor country, external debt as a percentage of GNP now averages about 60 percent. Suppose that in a normal period the country has a trend growth rate of 4 percent per annum and faces a real interest rate, including fees and spreads, of 8 percent. If the country must service enough debt each year to keep the debt-GNP ratio constant, it must make net transfers abroad equal to the debt-GNP ratio multiplied by the difference between the interest rate and the growth rate. In other words, the debt-GNP ratio would be stabilized with annual net international transfers equal to 0.60 (0.08 − 0.04), or 2.4 percent of GNP. An annual trade surplus of 2.4 percent of GNP seems a reasonably attainable goal. If the creditors are more restrictive and insist not that the debt-GNP ratio be stabilized but that the absolute value of the debt be stabilized, then the net transfers abroad would have to equal the annual interest burden, which is 4.8 percent of GNP, a much larger but also attainable goal.

How painful would it be for a country to generate a trade surplus of either 2.4 percent or 4.8 percent of GNP? On the eve of the debt crisis, most of the Latin American debtors were near to trade balance, although current accounts were in large deficit since net interest payments abroad were already significant. Thus, the trade surplus would have had to rise by, say, 2 to 5 percent of GNP. The ease of accomplishing that shift is determined in part by the ease with which domestic resources can be reoriented from domestic production to net exports or from nontradables sectors to tradables sectors.

Suppose as the simplest case that nontradables can be converted into tradables at a constant marginal rate of substitution that is equal to the ratio of prices of the two sectors at an initial base period. Measured in base period prices, each unit value reduction of nontradables output generates a unit value increase of tradables output. In this case, the requisite trade surpluses can be achieved by simply forgoing a couple of years of real consumption growth while the economy continues to grow along its initial growth path. For example, an economy begins with trade balance, with consumption, investment, exports, and imports all initially growing at 4 percent a year, with consumption constituting 75 percent of GDP. As consumption is cut back, all released resources move one for one into increased net exports, with all values measured at base period prices. After a year of unchanged consumption, the national saving rate would have grown by about 2.8 percentage points of GDP.

In about 1.7 years, the national saving rate would have grown by the requisite 4.8 percentage points. Of course, with population growth, unchanged aggregate consumption means falling per capita consumption. With 2 percent population growth, per capita consumption would fall by 2 percent for 1.7 years, rather than rising by 2 percent a year as would be typical along the stable growth path.

For some debtor countries, such as South Korea, the adjustment went almost this smoothly. Korea never lost the confidence of its international creditors, so it was not forced into an emergency rescheduling, although it did receive clear signals in the early 1980s to reduce its pace of debt accumulation. Korean total real consumption, both public and private, grew very slowly during 1979–82, only 2.2 percent per annum, compared with 12.5 percent per annum during 1975–79. The trade deficit was reduced by 4.5 percentage points of GNP from 1979 to 1983. Korea suffered only one year of negative growth, 1980, and was able to restore rapid growth by 1983. In 1986, the economy is expected to grow by 10 percent.

For most of the debtor countries, the adjustment has been far more painful. Indeed, per capita consumption has declined by far more than would theoretically be necessary, at the same time that growth has collapsed and debt-GNP and debt-export ratios have continued to rise. What is it that has prevented the smoother adjustments achieved by Korea? One difficulty is that the reduction in domestic spending has not been converted one for one into higher net exports, so that real GNP has declined as the nontraded goods sector has shrunk. Even to the extent that resources have remained fully employed, the cost of producing increasing amounts of tradables in terms of forgone production of nontradables has proved to be steeply increasing in most of the debtor countries, since highly protected inefficient industries in Latin America and Africa could not easily be reoriented into producing competitive exports. Also, as the nontraded goods sector has collapsed, there has been a massive increase in unemployed resources, which failed to find their way into tradables production. Furthermore, increases in volume of traditional commodity exports have been blunted by the continuing fall in commodities prices, so that commodity export earnings have been stagnant at best.

The failure of Latin America and Africa to increase export earnings should be regarded in part as the legacy of their inadequate trade policies in previous decades. A diversified export base was never established because of inward-looking, protectionist trade policies and overvalued exchange rates. Not only did these trade policies contribute to the onset of the crisis; they have made it harder to react flexibly in response.[13]

A second key difference between Korea's smooth adjustment and the experience of most of the debtor countries is that the drop in spending has fallen heavily on investment as well as consumption, with highly deleterious effects on growth in the medium run. One explanation is that the credit crunch hit the Latin American debtors directly in the public-sector budget. Whereas in Korea much of the debt was held directly by the private sector, it was held by the public sector in Latin America, as a result of high budget deficits in the years preceding the debt crisis. When the credit squeeze came in 1982, the Latin American countries responded by cutting public investment and, in many cases, increasing money financing of the budget, often with serious inflationary consequences. The sharp contraction in government spending sent the Latin American countries into a deep recession in 1983. During the next two years, the Latin American countries groped with decreasing real tax revenues (due both to inflation and to recession), rising inflation, and the need to cut spending even further. Most important, because of the large overhang of debt, the Latin American governments did not have the creditworthiness even to borrow in their own capital markets, so that budget deficits could not serve as an automatic stabilizer. The choice for these countries was therefore whether to reduce spending in the midst of recession or to print money. Most countries chose some combination of the two approaches.

The debt overhang now discourages investments by the public sector even beyond its direct budgetary burden. A fragile government riding the storm of a downward spiral of living standards cannot shift spending from current consumption to investment without justifying the shift politically on the grounds that the citizens in the country will soon be much better off by virtue of the investment. But the citizenry of the debtor countries now believes that a shift from consumption to invest-

13. Brazil is a partial exception in Latin America. For a discussion of Latin American trade policies and their implications for the debt crisis, see Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia."

ment will serve first, and perhaps only, to improve the capability of the country to service its debts. Unless an increase in investment spending is combined with substantial debt relief, the needed squeeze on consumption is seen as something that is done for Citibank rather than for the nation itself.

The overhang of the debt also encourages capital flight, which further depresses investment, the startling decline in which is shown in table 9. Since the private sector well understands that the public sector is starved for funds, no astute wealthholder now leaves any signs of wealth lying around to advertise a ready source of revenues for the fiscal authorities. Wealthholders hold their assets outside of the country to avoid taxation, with the result that new private savings simply spill over into capital flight, rather than into real investment. Capital flight is now a symptom of the debt overhang, and not a cause, as it was initially when it reflected the conversion of domestic financial assets into foreign financial assets in anticipation of devaluations of overvalued currencies.

Private investment has been impeded even in the export sectors, which depend on foreign demand rather than domestic demand and which have gained substantially in profitability because of real exchange rate depreciations since 1982. Private-sector entrepreneurs do not feel safe leaving their money in the country, even in a temporarily profitable sector, if it appears that the rest of the economy, and perhaps the government itself, is collapsing. The investments are vulnerable not only to tax increases, but also to the possibility that the government will, at some point, abandon debt servicing, repudiate the debt, and thereafter allow a sharp real appreciation of the exchange rate once again. When a stabilization effort seems to be failing, even investment in currently profitable sectors falls, since the risks of dramatic reversals in government policy are heightened. Private investment incentives are also reduced to the extent that private investments are complementary with public investments. The government must provide the roads, dams, ports, and railroads necessary to make new exports possible. All such public investments have declined sharply in recent years.

There are several more subtle ways in which the debt overhang discourages investment. Now that the ability of the debtor governments to continue to service their debts is in doubt, external private creditors have started a "grab race" to get their assets out of the country.

Table 9. Ratios of Gross Investment to GDP, Debtor Nations, Various Years, 1980–85
Percent

Category	*1980*	*1983*	*1984*	*1985*
Countries with debt servicing problems	25.4	19.1	18.0	18.0
Countries without debt servicing problems	28.1	26.5	26.4	26.6
Western hemisphere	23.4	17.4	17.2	17.9
Sub-Saharan Africa	19.9	17.7	16.5	17.2

Source: IMF, *World Economic Outlook* (April 1986), table A7, p. 186.

Individually, these creditors have an incentive to call in their claims against the overextended debtor countries, even if doing so injures the economic performance of the debtor so much that the creditors suffer collectively. Preventing such a destructive race to liquidate assets is one of the major purposes of a bankruptcy code, which restricts the ability of individual creditors to act against the group interest. Unfortunately, countries cannot file for Chapter 11 protection. It has been argued that the concerted lending packages have overcome the problem, but in fact the commercial banks have been able to reduce their absolute exposures in Latin America and Africa despite the strategy of concerted lending. It appears that while exposure to debtor governments has gone up, exposure to the private sectors of these countries, which are not protected by concerted lending, has declined even more.

At present, new external lenders will not make new loans to a debtor government even for investments whose returns easily exceed the market cost of capital, since those lenders rightly fear that their claims will simply become part of the enormous pool of uncollectible claims against the debtor. Even a debtor government with a good investment project will generally not be able to attract new creditors, unless it can somehow assure them that their claims will be granted seniority relative to the existing creditors. Such assurances are not easy to structure, and they may even violate "negative pledge" clauses in the original loan agreements.

Investment rates will thus continue to be insufficient for many of the debtor countries, not because of a shortage of good investment opportunities, but rather because of the wrong financial incentives resulting from the debt overhang. Prospects for long-term growth are therefore bleak unless the incentives to make new investments can be changed.

New Strategies for Restoring Debtor Country Growth

In the early days of the debt crisis it made sense for the creditor governments to focus their energies on protecting the commercial banks. Nobody knew in mid-1982 whether the debtor governments would in fact be able or willing to service their debts or whether the large banks might succumb to a banking run. Also, it was clear that much of the debt problem was the result of policies in the debtor countries that were in obvious need of reform. A tough approach based on continued debt servicing, concerted lending, and conditionality made sense. That case is much harder to make today. The commercial banks are clearly much stronger and would be able to absorb partial debt forgiveness. The debtors, on the other side, have now lived through several years of austerity, with little evident improvement in their creditworthiness or growth prospects.

It is not easy to predict the prospects for most of the debtor countries. On the one hand, with low investment rates and declining terms of trade, their prospects appear rather bleak. On the other hand, with declining world interest rates and a depreciating dollar that should eventually push up the dollar prices of developing country exports, the situation could brighten, even substantially. In these circumstances it is hard to be categorical, but surely the present strategy of muddling through does not protect the debtor countries against the obvious risks that they now face. At the very least, many of the risks should now be shifted from the debtor countries back to the international capital markets where they belong.

The problem of deciding what to do now about the debt crisis is that no agreed-upon standards apply. In domestic debt crises, the participants may rely on bankruptcy law to provide a framework for action. In the international context, such a framework does not exist. A simple view would hold that policymakers should therefore enforce whatever contracts have been written between the debtors and the creditor banks, regardless of the resulting duress or economic inefficiencies. But such a view flies in the face of common sense and runs counter to the basic theory of contracts itself, which has long held that contracts should sometimes not be enforced and should sometimes even be rewritten by judges. Legal theorists such as Richard Posner and Andrew Rosenfield argue that since contracts are expensive to write and therefore cannot generally include contingencies for low-probability events, it is sometimes the duty of a judge or an adjudicating party "to reduce the costs of contract negotiation by supplying contract terms that the parties would probably have adopted explicitly had they negotiated over them."[14]

This principle is applied in practice when courts impose restructurings of long-term commodity supply agreements. After a sharp rise in energy prices in the early 1970s, for example, the Aluminum Company of America (ALCOA) sought relief from a long-term contract under which it was a supplier to Essex Group, Inc. The contract had become extremely unprofitable to ALCOA and extremely favorable for the Essex Group. The court gave relief to ALCOA by imposing a "reasonable" reformation of the contract on the two parties, after they had failed to renegotiate the terms on their own. The court described its role as follows:

> The Court's role here is limited to framing a remedy for a problem [the parties] did not foresee and provide for. And while the Court willingly concedes that the managements of ALCOA and Essex are better able to conduct their business than is the Court, *in this dispute the Court has information and hindsight far superior to that which the parties had when they made their contract.* The parties may both be better served by an informed judicial decision based upon the known circumstances than by a decision wrenched from words of the contract which were not chosen with a prevision of today's circumstances. The Court gladly concedes that the parties might today evolve a better working arrangement by negotiation than the Court can impose. But they have not done so, and a rule that the Court may not act would have the perverse effect of discouraging the parties from resolving this dispute or future disputes on their own. Only a rule which permits judicial action . . . will provoke a desirable practical incentive for businessmen to negotiate their own resolution to problems which arise in the life of long term contracts.[15]

In the case of the debt crisis, the question is whether to enforce a contract in which the contracting parties "did not foresee and provide for" such extremely low-probability events as all-time low commodity prices, all-time high interest rates, or the collapse of the debtor's economy.

14. Richard A. Posner and Andrew M. Rosenfield, "Impossibility and Related Doctrines in Contract Law: An Economic Analysis," *Journal of Legal Studies*, vol. 6 (January 1977), p. 88.

15. Richard E. Speidel, "Court-Imposed Price Adjustments Under Long-Term Supply Contracts," *Northwestern University Law Review*, vol. 76 (October 1981), p. 380. The emphasis is added.

By the standard of "contract completion," debt contracts should be forgiven in at least two circumstances: when a debtor country has suffered such a large loss of income that continued servicing of the debt poses enormous risks of economic duress or political and social instability, or when enforcement of the contract would result in such a large decline in the debtor's capacity to repay that both the creditors and debtor would be better off with a partial forgiveness of the debt. The first case is a plausible standard since the debtor would presumably have chosen to insure against repayments in such a situation. In the second case, it would be in the interests of the parties to renegotiate the contract voluntarily, unless one of the parties believes that instead of renegotiation it can entice a third party, such as a creditor government, to bail it out.

Twenty or thirty years ago, few people would have needed convincing that it is sometimes appropriate to excuse part or all of the obligations of a debtor country. One lesson of the 1930s was that it is possible to push countries past the breaking point in attempting to collect on debts. Three major policy mistakes of the 1930s demonstrated that lesson. The first mistake was the U.S. insistence on repayments of the inter-allied war debts. The debts proved to be uncollectible in the end, but the United States pushed hard to collect them and severely weakened its allies in the process. Following a one-year repayment moratorium, President Hoover pressured France to make payments in 1932, in the depths of the Great Depression, and thereby caused the fall of the Herriot government. By 1933, U.S. pressures for repayment and the repayments themselves finally ceased, under the realities of the depression.

The second and more notorious mistake was to press for collection of the German reparations payments, even after Germany had lost access to international capital markets in the late 1920s and even after the German economy sank into deep depression. As Kindleberger puts it, "Deflation produced by the cutoff in American lending was enhanced by the brutal policies, beginning in March 1930, of Heinrich Brüning, German Prime Minister, who was determined to show the Allies that it was impossible for Germany to pay, even if he had to destroy the economy and the political system to do so."[16] He succeeded all too well, though many observers failed to recognize what was happening. Just

16. Charles P. Kindleberger, *A Financial History of Western Europe* (London: George Allen & Unwin, Inc., 1984), p. 306.

before Germany's utter collapse came its largest trade surplus, which, as Harold Moulton and Leo Pasvolsky noted in a 1932 Brookings study, "was proclaimed by many unanalytical writers as conclusive evidence of Germany's steady progress . . . [when] it was in fact little more than a depression phenomenon."[17]

The third misadventure in enforcing debt repayments was the case of Argentina, one of the few countries in Latin America that continued full debt servicing in the 1930s. The British were able to keep the Federal Government of Argentina on track with respect to debt servicing and were able to extract significant trade concessions as well. According to arguments heard today, one might expect that Argentina was well served later on by a favorable international reputation based on its "good behavior." The truth is precisely the opposite. The subsequent Argentine revulsion against foreign influence contributed to the rise to power of Juan Peron, a nationalist demagogue who did much to destroy both the Argentine economy and its international reputation over the succeeding decades.[18]

By 1943, the lessons were clear to the young analyst Henry Wallich. Writing about the overhang of defaulted Latin American bonds, Wallich had little doubt that these countries should be forgiven much of their debt burdens. Rather than arguing that debt forgiveness would debilitate the private capital markets, Wallich argued the opposite, that "a satisfactory settlement of the defaults would greatly improve the prospects of private foreign lending after the war."[19] He applauded the fact that the U.S. government did not apply pressures to get full servicing of the debt and noted approvingly that "apparently no attempt has been made to tie up the liberal [U.S. government] loans which began to be made in 1940 with demands for resumption of service to the defaulted bonds."[20]

17. See Harold G. Moulton and Leo Pasvolsky, *War Debts and World Prosperity* (D. Appleton-Century Company, Inc., for the Brookings Institution, 1932), p. 306.

18. The role of Argentina's foreign economic policy in Peron's ascension to power has been noted by several observers. Diaz-Alejandro put it this way: "The nationalist-populist coup of June 1943 . . . was able to revive memories of wounded national pride with notable domestic political success and with disturbing consequences for the international system" ("Latin American Debt," p. 389). See also Richard D. Mallon, in collaboration with Juan V. J. Sourrouille, *Economic Policymaking in a Conflict Society: The Argentine Case* (Harvard University Press, 1975), for a similar view.

19. See H. C. Wallich, "The Future of Latin American Bonds," *American Economic Review*, vol. 33 (June 1943), p. 321.

20. Ibid., p. 335.

From the 1940s to the 1970s, the major creditor countries continued to pursue the logic of debt relief rather than debt rescheduling when appropriate circumstances arose. An instructive case is that of Indonesia, whose turnaround in the mid-1960s is one of the greatest in the past twenty-five years. All of the right things happened in Indonesia: a hyperinflation was ended, a trade liberalization occurred, and economic growth and creditworthiness were restored. And the financial basis of the success was a generous and concessionary treatment of Indonesia's foreign debt.

When President Sukarno left the Indonesian government it was on the verge of bankruptcy and a hyperinflation that topped 1000 percent in 1966. After a civil war, a new military regime under President Suharto began to bring economic order to the country. The Suharto regime first received debt relief from the official creditors (in those simpler days the commercial banks were not involved) as of late 1966, when three years of grace on all principal and interest payments were granted. Moreover, the interest was not compounded, so that the postponement reflected substantial relief in present value terms. In 1970, a standing committee of creditor governments, known as the Intergovernmental Group on Indonesia, was constituted to negotiate new terms with the Indonesian government. The specific nature of the agreement was as follows. The debt was consolidated, with principal to be repaid in thirty equal annual installments and interest, fixed at 3 percent, below market rates, to be repaid in fifteen installments, to begin after fifteen years (in 1986) and to run through the year 2000. The arrangement also permitted Indonesia to postpone up to three annual payments in the event of a shortfall in export earnings, following a precedent set in the 1946 Anglo-American loan agreement. The package, in all, represented substantial debt relief in present value terms and offered great flexibility for the country.

The Indonesian operation was enormously successful. The hyperinflation ended in the late 1960s, and since that time, with the exception of debt problems of the state oil company in 1975, Indonesia's macroeconomic performance has been among the best in the developing world, combining high economic growth and low inflation rates.[21]

The settlement of Turkish debt at the end of the 1970s is another

21. Sachs, "External Debt and Macroeconomic Performance in Latin America and East Asia."

example of how generous terms for repayment of debt can contribute to economic recovery. Like Indonesia, Turkey represents a vital foreign policy interest of the NATO countries, an interest that was underscored in 1979 by the fall of the Shah of Iran. Between 1980 and 1983, Turkey therefore received a large package of support from the IMF, the World Bank, individual OECD governments (including $1.5 billion of concessional balance of payments support), and the Saudi Arabian Monetary Authority. That financial cushion obviated the need for Turkey to make large outward transfers to its creditors. Under its protective financial umbrella, Turkey has followed through on an ambitious program of trade liberalization and policy reform, which is now paying dividends in the form of strong export growth. Its experience contrasts starkly with that of Mexico, for example, which was required to make very large net resource transfers to the rest of the world after 1981. The trade balance of the two countries, in billions of dollars, is shown below:

	1980	*1981*	*1982*	*1983*	*1984*
Turkey	−4.6	−3.9	−2.7	−3.0	−3.0
Mexico	−2.8	−4.1	6.8	13.8	12.8

A Strategy for Granting Debt Relief

The key to granting debt relief is to make it selective, so that not every debtor country feels the urge to suspend its international payments and so that the contractual basis for future international lending is not fundamentally undermined. For these purposes, I would propose simply that relief be granted according to a formula that both gives relief to the countries that, having experienced the largest declines in income, need relief the most, and minimizes the moral hazard that future borrowers will undertake policies with the goal of achieving debt relief. These criteria are the sort that creditors and debtors would select as contingencies that would modify the terms of the contract if they were negotiating with a clean slate. In order to minimize moral hazard problems, the relief should be granted only as part of an internationally supervised program of stabilization and reform. The case-by-case approach of the IMF and World Bank should be continued, but with financial arrangements that are much more attractive to the debtor countries than those now offered.

Conditioning relief on income is problematic, since it does not distinguish between income declines that arise from exogenous factors, such as the terms of trade, and those arising from bad policies. However, in practice it would be difficult to make a more refined rule. For one thing, existing models are generally not good enough to track with precision the sources of a particular shortfall in income. Moreover, in a world of despotic regimes, in which the citizens of a country often have little control over the bad policies of the government, it is a good idea to put the lenders on notice that relief will be granted to the country if GNP falls, even if that decline is policy induced. In that way, the lenders are forced to monitor the actions of the despots in a way that the country's own citizens cannot. (Why should we endeavor to protect, after all, the sanctity of contracts between the banks and corrupt, unaccountable regimes like those of Videla of Argentina, or Marcos, or Bokassa, who, with the knowledge of the bankers, all used the loans for private gain?)

A workable basis might be to grant relief, on a progressive scale, to countries whose per capita incomes have dropped 15 percent or more relative to previous peaks. The relief to be granted would be a suspension of interest payments for a given period, without capitalization of the missed payments. The suspension should apply to all debts currently subject to rescheduling by the commercial banks and by the official creditors in the Paris Club. As a rough example, countries whose living standards, as measured by real per capita national income, have declined by 15–25 percent since 1980 would be permitted to forgo all interest payments for five years. Countries with a decline of more than 25 percent in living standards would forgo interest payments for ten years. (In reality the scales would have to be smoothed so that countries would not have the incentive to reduce incomes to earn more relief. Different degrees of relief on debts of differing vintages would have to be worked out. Moreover, considerations of the country's size, level of living standard, size of external versus internal shocks, and extent of hidden income through capital flight might be part of the formula.) In addition to the interest relief, I presume that all principal payments would be fully rescheduled for a period of several years.

Table 10 shows how this simple example would work for the Latin American economies through the end of 1985 based on an interest rate of 7 percent. The amount of bank relief shown is the present value of the skipped interest payments. Overall relief by U.S. banks in this example would total $6.6 billion; relief by all commercial banks, $19.1 billion.

Table 10. Progressive Debt Relief Based on Decline in GDP, Latin America, 1980–85[a]
Billions of dollars unless otherwise indicated

	Bank exposure		Debt relief		
Per capita real GDP decline	*U.S. banks*	*Bank for International Settlements banks*	*U.S. banks*	*Bank for International Settlements banks*	*U.S. bank relief as percent of U.S. bank capital*
15–25 percent					
Argentina	8.7	27.8	2.7	8.6	2.6
Peru	1.5	5.2	0.5	1.6	0.5
Uruguay	0.9	2.1	0.3	0.7	0.3
Venezuela	9.8	25.8	3.0	8.0	2.8
25 percent or more					
Bolivia	0.1	0.6	0.1	0.2	0.1
Total	21.0	61.5	6.6	19.1	6.2

Source: Author's calculations as described in text. Bank exposure data are for end of December 1985. U.S. data are from "Country Exposure Lending Survey." BIS data are from Organization for Economic Cooperation and Development/Bank for International Settlements, "Statistics on External Indebtedness: Bank and Trade-Related Non-Bank External Claims on Individual Borrowing Countries and Territories at End-December 1985" (OECD/BIS: Paris and Basle, July 1986).

a. Debt relief consists of a suspension of interest payments without capitalization of the missed payments. Countries whose per capita real GDP declined 15–25 percent from 1980 to 1985 would be permitted to forgo interest payments for five years.Countries whose per capita GDP declined by more than 25 percent would be permitted to forgo ten years of interest payments. The amount of debt relief shown is the net present value of the skipped interest payments. Calculations are based on an interest rate of 7 percent. Figures are rounded.

The forgiveness by U.S. banks would represent approximately 6.2 percent of U.S. bank capital. Presumably, regulators would allow the banks to amortize the write-off of the debt over several years to smooth the effects on the banks' earnings. For instance, income could be reduced simply as the interest payments are missed. For the African countries, the total U.S. bank exposure is approximately $4.7 billion. If interest is forgiven for an average of five years for all of the African countries, the cost to the U.S. banks would be on the order of $1.4 billion, or a little more than 1 percent of U.S. bank capital.

The following simple illustration shows the benefits of interest relief. For a country with a public debt–GNP ratio of 60 percent, facing a 7 percent interest rate, the annual interest burden is 4.2 percent of GDP. With investment-GDP ratios in Latin America on the order of 14 percent, interest payments represent about 30 percent of gross domestic investment.[22] Investment rates could rise by about one-third if the savings

22. The investment rates for Argentina, Peru, and Venezuela in 1985 were, respectively, 11.7, 14.2, and 18.3 percent of GDP, according to data from DRI, *Latin American Economic Review* (DRI, Summer 1986).

from debt relief were channeled towards higher investments. The easing of the budget burden would be on the order of 20–25 percent of central government revenues.

Given the significant benefits to be achieved by relief, would countries actually pursue poor economic growth in order to merit reduced debt payments? Almost surely, the answer is no. The countries in question have had historical per capita growth rates of 2 percent or more per annum. Thus, for per capita GDP to fall by 15 percent between 1980 and 1985, the decline relative to trend is on the order of 25 percent. The cumulative decline in output relative to trend is of course greater than 25 percent, since one must add together the shortfalls in output in each of the years between 1980 and 1985. Assuming that output falls smoothly by 3 percent per year during the interval, the cumulative output loss relative to trend is on the order of 75 percent of trend GNP.[23] There would also be further loss in the future as output recovers. These total losses must be compared with the gains to relief. Assuming a debt-GNP ratio of 60 percent and five years of interest relief, the present value savings are on the order of 18.6 percent of GNP.[24] The savings are obviously a small fraction of the GNP losses.

For countries that have already suffered a significant, but less than 15 percent, decline in per capita income, it might pay to depress the economy for an additional short period to qualify for relief. There are two ways to ameliorate the problem. First, the extent of relief could be phased in gradually, rather than in one step. Second, when a government appeals for relief, its policies in the year preceding the relief could be scrutinized, as happens in bankruptcy proceedings, in order to disqualify countries that intentionally and flagrantly pursue bad policies for the sake of gaining relief.

Strategies for Increased Capital Flows

About half of the debtor countries in Latin America, including the two biggest, Brazil and Mexico, would not qualify for relief under the standards illustrated above. What should be done for countries that

23. The deviation from previous trend would be 5 percent in 1981, 10 percent in 1982, 15 percent in 1983, 20 percent in 1984, and 25 percent in 1985, for a cumulative decline of 75 percent.

24. See footnote 8, which showed relief to equal 0.31 of the face value of the debt. Thus, relief relative to GDP is $0.31 \times 0.6 = 0.186$, or 18.6 percent.

might not be eligible for relief but that are nevertheless suffering seriously from the effects of the debt crisis? An effective strategy would be to encourage higher investment rates, based on greater foreign financial support, in order to spur recovery. Moreover, the predictability of that foreign support should be enhanced; otherwise, the banks and private wealthholders will continue to withdraw their assets from the debtor countries.

At present, new funds come entirely from existing bank creditors, who are already locked into a financial bind with the debtor country, and from the official creditors. The arrangement poses the continuing paradox that it is precisely those banks whose portfolios are filled with bad loans that are called upon to increase their exposures the most when the situation deteriorates in one of the debtor countries. Since the banks have become increasingly reluctant to play this game, official creditors have more and more begun to bail out the banks, in the sense of providing net transfers into the country while the banks make net transfers out.

If the existing bank loans are indeed viable over the longer term and therefore should not be forgiven at this juncture, they will remain viable if the country borrows externally in order to spur investments, as long as those incremental investments have a rate of return above the incremental cost of borrowing and as long as the borrowing government raises internal revenues sufficiently to service the debts. For this reason, existing creditors should be willing, and indeed favorably disposed, to see new creditors enter the scene on a senior basis, if they can be guaranteed that the incremental funds will be utilized for profitable investment projects. Emphatically, the new lenders would not have to be banks. Senior lending could be made on the basis of marketable securities purchased by asset funds, multinational corporations, or private wealthholders, in addition to banks.

My proposal would be to increase and stabilize the inflow of capital into the debtor countries by an arrangement that reschedules the existing debt while allowing new creditors to enter on the basis of seniority. The multilateral institutions would be in charge of monitoring the investment programs of the debtor countries to verify that incremental capital flows from abroad indeed increase national investment rates on the margin, a task that would necessarily involve conditionality on both the level of the macroeconomy and the public-sector investment budget. They would also be charged with defending the seniority interests of the new creditors by monitoring the arrangement that new debts get serviced before old debts. If the debtor countries resume their economic growth, as the commercial banks keep predicting that they will, then both the existing creditors and the new creditors will be repaid. If, on the other hand, the debtor countries continue to stagnate, then the existing creditors will find that their claims are even further reduced in value, so that the assets would have to be forgiven at some point. The approach has the virtue of not forcing a decision on the issue of forgiveness today, but rather allowing creditors and debtors to see whether an economic recovery materializes.

As in the case of debt relief, an approach such as this should be guided by clear and objective rules. For example, eligibility might be limited to countries that have suffered an absolute decline in per capita GDP during 1980–85. On such a standard, all of the major Latin American debtors would be eligible, with the exception of Colombia. The overall package would involve rescheduling of the existing debt, some new concerted lending by the existing creditors, and senior lending by new creditors in amounts that would be tied to the availability of worthwhile investment projects in the country. The concerted lending of the existing creditors should also be put on a more automatic basis. For example, the creditors might be required to put in 2.5 percent of existing exposure each year during the life of such an arrangement. They would then receive two-thirds of a 7.5 percent interest repayment, and relend one third. New lenders could be allowed to enter on a senior basis up to a yearly maximum of 5 percent of existing exposure, or more if the country has unusually attractive investment prospects. Finally, a country's participation in such a package should be conditioned on compliance with an internationally supervised adjustment program.

Conditionality and the Debt Crisis

I have so far said little about how to tie a debt package to performance by the debtor countries. For one reason, my emphasis has been on the need to provide more financial support to the debtor countries; for another, I have less to quarrel with regarding conditionality than I do regarding financial support. Debt relief and debt reschedulings should continue to be tied to adjustment programs on a case-by-case basis as they are now. Policy reform is clearly needed to enable most of the debtor countries to resume economic growth and regain creditworthiness, and the provision of new lending or debt relief can be effectively and properly conditioned on such reforms being undertaken.

The major weaknesses of the current conditionality programs are two: they are underfunded and so ask too much for too little in return, and they demand unrealistically rapid reform. The same lack of realism is evident in the conditionality in the Baker plan, which emphasizes issues of microeconomic efficiency: opening up of foreign trade, privatization of state enterprise, and encouragement of foreign direct investment. Naturally, such liberalization efforts should be a part of a long-term economic adjustment program, but they must be expected to happen gradually, over a span of decades rather than a couple of years.

Indeed, the simple and sad truth about most attempts at rapid liberalization is that they do not succeed. Success tends to require a healthy macroeconomic environment, so that slower growth in sectors where protection is removed is balanced by higher growth in other parts of the economy. Also, in a growing economy, the "declining" sectors can decline in relative terms without having to decline brutally in absolute terms. Reductions in labor can then be accomplished through attrition rather than through layoffs. In the celebrated study by Anne Krueger of twenty-three liberalization attempts from the 1950s through the early 1970s, only four actually succeeded in the long run.[25] And in all four cases, the initial macroeconomic conditions were vastly superior to the conditions now facing the major debtor countries.[26] The study also confirmed that liberalizations that do take hold are instituted gradually. The most celebrated instance of liberalization in the past thirty years is probably that of South Korea, which began to liberalize in the early 1960s. And yet after more than two decades of steady trade liberalization, nobody today would call Korea an example of a truly open economy. Its foreign trade regime is characterized by a rational tariff structure, a declining number of quantitative restrictions, and a unified and competitive exchange rate. But free trade it is not.

25. Anne O. Krueger, *Foreign Trade Regimes and Economic Development: Liberalization Attempts and Consequences,* A Special Conference Series on Foreign Trade Regimes and Economic Development, vol. 10 (New York: National Bureau of Economic Research, 1978). By the "long run," I mean up to the time of publication of the study.

26. See Sachs, "Conditionality and the Debt Crisis: Some Thoughts for the World Bank" (Harvard University, January 1986).

Perhaps the most troubling aspect of the recent emphasis on structural reform is the virtual neglect of issues of equity and fairness in the debtor countries. Income distribution in Latin America has widened significantly in the past ten years, as the wealthy have protected themselves through capital flight and low tax payments, while the poor have suffered the burdens of high inflation and economic austerity. Many of the basic problems of the Latin American societies are ones of fairness in the first instance. The creditor governments, and especially the United States, should insist that the debtor governments come up with fair and equitable burden sharing within their countries as part of the adjustment effort. How to do that, however, is best part of a long and separate discussion.

Comments and Discussion

John Williamson: In my opinion the gloom in Sachs's assessment of where the debt crisis has got to is somewhat overdone. At least two countries that came close to having to reschedule, Colombia and Korea, have recovered impressively. Turkey is not the only country that rescheduled and has resumed voluntary borrowing: both Hungary and Yugoslavia also fall into that category. If Brazil can make the Cruzado Plan stick, it will almost certainly be judged sufficiently creditworthy to resume limited voluntary borrowing next year. (Unfortunately it seems rather unlikely that the Cruzado Plan will succeed: José Sarney shares Ronald Reagan's spinelessness when faced with the need for a tax increase, and lacks the latitude that circumstances are giving the latter to procrastinate.) One should also recall that more than 60 percent of the population of the Third World lives in countries, including India, that never did succumb to the debt crisis.

Similarly, Sachs measures the severity of the debt burden by the debt-export ratio in table 8. But the ratio of debt service to exports, at least as relevant a measure, has behaved much less discouragingly as a result of declining interest rates and long-term rescheduling. For example, the ratios for Argentina, Brazil, and Mexico have declined from 53 percent, 52 percent, and 36 percent, respectively, in 1982 to respectively 48 percent, 36 percent, and 30 percent in 1985. One can even find a few isolated cases that look hopeful in Sub-Saharan Africa, such as Botswana, Cameroon, Ghana, and Ivory Coast. And in Bolivia, while circumstances are indeed bad, they are certainly not as bad as is suggested by the official figure of a 28 percent decline in per capita GNP, which measures how much of the economy was forced underground, rather than how much of the economy was forced out of existence. So I think the gloom is overdone.

Nevertheless, it remains true that there is more than enough room for pessimism about the situation in many debtor countries. Two things have turned out worse than anticipated in earlier projections, such as those of William Cline.[1] One is the fall in commodity prices. The drop in the price of oil has posed a major problem for some of the debtors, although it has brought relief to others: overall it has probably made the debt problem worse rather than better. The other is the cutback in commercial bank lending. In 1983 the IMF's *World Economic Outlook* was forecasting a 1986 current account deficit in the nonoil developing countries of $93 billion, which presumably implied a belief that it would be possible to finance a deficit of that size. But the forecast in the October 1986 issue was $27 billion. The drop is clearly the result of the foreign exchange constraint, caused primarily by the unwillingness of the banks to resume lending.

It is therefore hardly surprising that discussion is turning to the question of debt relief. The banks have brought the prospect on themselves by their failure to act collectively to maintain an adequate flow of new lending. Even though his argument is not supported by much detail, I am convinced that Sachs is correct in claiming that under some circumstances both parties could gain from debt relief: the debt overhang is creating a set of incentives in the debtor countries that make it impossible to envisage new investment or, therefore, an expansion of nontraditional exports.

Does endorsement of the principle of debt relief imply endorsement of the Bradley plan? As I see it, there are three features in that plan. The first is an increase of $40 billion to $50 billion in foreign aid over three years, financed by a tax on the banks. I have no problem with that part. The second element is essentially World Bank conditionality. On that my reactions are very similar to Sachs's, namely that the principles are right but that the time limit is too short and inflexible with too much pressure to liberalize trade in the short run rather than do it as and when balance of payments developments permit liberalization without income compression. The third feature of the Bradley plan is that it would provide something like 30 percent of the total relief to Brazil. Now Brazil is a country whose welfare would probably be jeopardized rather than promoted by gaining debt relief, because the benefit of the relief would

1. William R. Cline, *International Debt and the Stability of the World Economy* (Washington, D.C.: Institute for International Economics, September 1983).

be outweighed in present value terms by the loss in creditworthiness that would come about through accepting debt relief. On the other hand, the Bradley plan offers almost no relief to Sub-Saharan Africa, because Sub-Saharan Africa is not a major debtor to the commercial banks. Only $17 billion out of its over $100 billion total debt is owed to the commercial banks. For these reasons, I believe that Sachs is right to argue in favor of selective rather than general debt relief.

The Sachs plan has two elements. The first is temporary interest suspension for countries that have suffered major declines in real per capita income. How long the interest suspension would last would depend upon the depth of the preceding decline in income. An interesting historical precedent for interest suspension under adverse circumstances, besides the Indonesian case that Sachs cites, is the postwar loan granted by the United States to the United Kingdom in 1946. The loan's bisque clause, which allowed for interest suspension, was invoked a number of times.

The second element of the Sachs plan is the subordination of existing debt for all countries that have had any fall in real per capita income over a five-year period. The same proposal was advanced in the very early stages of the debt crisis by Jack Guttentag and Richard Herring.[2] Unfortunately it got little attention, perhaps because it was coupled with a number of other proposals, notably for the securitization of bank credit, that most of us did not feel were terribly necessary or helpful at that time. In any event, the more important proposal for subordination of existing debt did not get the discussion that it deserved. It should receive such attention now.

One major question that is not addressed by Sachs is whether official bilateral creditors and multilateral development banks should be treated the same as commercial banks. There are serious arguments against doing so, particularly in the case of the multilateral development banks. On the other hand, one has to recognize that if one does not extend the treatment to those forms of debt as well, then the benefits to most of Sub-Saharan Africa are going to be minor. Their problems simply will not be addressed, because most of their debt is to the official sector rather than to the commercial banks.

How does the Sachs plan rate on the standard list of objections to

2. Jack M. Guttentag and Richard J. Herring, *The Current Crisis in International Banking* (Brookings, 1985).

debt relief? The first objection is that debt relief could risk a financial crisis. The argument here is typically that if enough relief is offered to address the problems of countries like Zambia and Bolivia, and this is then generalized to all debtor countries, that this will jeopardize the continued solvency of the major commercial banks. The answer is to make relief convincingly selective, to restrict it to the countries that really need it. If only interest suspension and not subordination would damage the financial position of the banks, as Sachs believes, then the Sachs plan is safe on this score. If, on the other hand, subordination of existing debt would have an adverse impact on the value of existing debt, the matter is not clear. If Sachs is right in arguing that new money will go voluntarily after subordination and that the new money will improve the possibility of countries developing new export sectors, then countries will actually be in a better position to repay the original debt than they otherwise would have been. Thus it could be that Brazil's existing debt will go up from, say, 75 percent to 80 percent on the free market when the existing debt is subordinated. I am not at all sure that would happen, so there are some risks, though I think they are probably acceptable.

A second objection is that debt relief means a loss of access to future credit. The critical question here is the sign of the partial derivative of future credit availability with respect to current debt relief. The historical record is surely not as clear on this issue as Sachs claims. Indeed, I would have thought this is something that is going to differ from one country to another. I cannot, for example, believe that Brazil is going to improve its access to future credit by struggling to get relief at this stage. On the other hand, neither can I believe that Bolivia would not benefit in terms of its medium-term borrowing capability by having the slate wiped clean.

A third objection concerns moral hazard. Sachs's intention in choosing a fall in per capita income as the criterion for debt relief is to avoid countries taking deliberate steps to worsen their economies in order to qualify for relief. There is nevertheless some danger in a literal implementation of the Sachs plan, since by showing a 25 percent loss of per capita income instead of 24 percent a country would be entitled to ten years' interest suspension instead of five. Of course a country would be unlikely to create a recession to gain relief, but it would surely fiddle its statistics. To minimize the problem one would need to smooth the schedule.

Fourth, there is the equity question. Restriction of the benefits to countries that have had a fall in per capita income attempts to address that issue, but there nevertheless remain two problems. One involves the moral obligation to compensate those countries that did not borrow. Some countries never borrowed anything except International Development Association money because they knew they were not capable of servicing anything else: Rwanda is an example. The second problem is that Sachs's criterion—a fall in per capita income—could provide relief to some countries whose claims, taking into account the bounty of their natural endowment, the value of their citizens' external assets, and the level of per capita income, are strictly marginal. Both Argentina and Venezuela would qualify for relief under his criterion.

A fifth possible problem is that wiping the slate clean reduces the incentive to adopt reform measures. However, as Sachs notes, one could avoid making this a once-for-all action, but rather impose conditionality over a series of years.

Finally, there is the legal problem. Can the commercial banks be persuaded to abandon their claims, or will it be necessary to write new laws in all of the creditor countries to enable some authority to direct the banks to reduce their claims? I agree with Sachs in his argument that too much has been made of this objection. There is, incidentally, one way in which the official sector could sanction debt relief and leave the commercial banks little choice but to acquiesce. It could exploit the IMF's authority to approve exchange controls. The Fund could, if it so wished, agree to a member debtor country imposing exchange controls that prohibited residents, including the public sector, from making interest payments to banks abroad. The controls would give legal authority for the suspension of interest payments to banks located in the creditor countries, except Switzerland. It would not, however, prevent the banks treating the unpaid interest as arrears; that would require legal action.

Last December I advanced a proposal for selective debt relief that was intended to enable the countries in the most desperate situation to get substantial relief, without thereby opening the floodgates so that Brazil and Mexico also qualified.[3] My proposal was to create an inter-

3. John Williamson, "On the Question of Debt Relief," appendix to the *Statement of The Roundtable on Money and Finance* (Islamabad: North South Roundtable, December 1985).

national tribunal that would be empowered to restructure debt, with the possibility of granting substantial relief where there existed a conjunction of circumstances. I suggested that perhaps five out of the following eight circumstances would be needed to qualify a country for relief:

—the occurrence of exogenous shocks that had led to a substantial unexpected increase in the burden of debt service;

—low per capita income;

—the lack of a threat to international financial stability;

—little prospect of the country being able to resume debt service without an unacceptable welfare cost;

—poor use made of the proceeds of the loan (this and the following criterion are intended to improve the incentives confronting the lenders, to ensure that in the future they undertake proper monitoring);

—irresponsible lending, in the sense of failing to make a serious assessment of the probability that the borrower will be in a position to service its debts;

—doubtful legitimacy of the government that contracted the loan;

—refusal of the lenders to extend further loans in support of an internationally agreed adjustment program.

Sachs's paper inspires me to add two further criteria:

—a decline in per capita income;

—a presumption that economic recovery is being impeded by the debt overhang.

Sachs also persuades me that any debt relief tribunal should usually include the subordination of old debt in its debt restructuring award.

I am not convinced that Sachs's criterion of a fall in per capita income succeeds in doing what I argued explicitly no single one of my criteria could hope to accomplish—namely, provide a remotely satisfactory basis for discriminating between cases that do and do not merit debt relief. For that, one needs a series of criteria and a tribunal capable of combining them on a case-by-case basis. The only reason I can see for preferring Sachs's approach is the institutional and legal complexities of launching an international tribunal empowered to impose modifications in the terms of loan contracts on the lenders. I recognize that that reason may in the event prove decisive, since the need for selective debt relief is urgent. In any event, I am pleased that discussion is beginning to focus on the design of criteria and mechanisms for selective debt relief and escape from the dead end of advocating or criticizing generalized debt relief. Sachs has made a notable contribution to this crucial debate.

General Discussion

Several participants agreed with Sachs that some form of debt relief is appropriate. Stanley Fischer noted that the American banks continued to make large loans to the Latin American countries in 1980 and 1981, after it had become clear that repayment might be difficult. In his assessment, the banks' role in creating the debt crisis means that they should bear part of the costs of resolving it. Charles Holt suggested that Fischer's characterization of the banks' role may be somewhat too simple; in Holt's view, the governments of the industrialized countries, unwilling to offer direct assistance to the developing countries hurt by the 1979 OPEC price increases, put pressure on the banks to make loans. Holt speculated that avoiding future debt crises may require the creation of some mechanism for worldwide fiscal policy coordination. Matthew Shapiro suggested that debt relief would help not only the debtor countries but also the United States, in that relief would likely enable the Latin American countries to increase their imports of U.S. capital goods.

William Cline argued that the debt situation was not as dismal as Sachs depicted it. Falling interest rates have reduced interest payments on the debt in most countries. For example, Brazil's interest-to-export ratio has fallen from a peak of 52 percent to 31 percent. The aggregate interest-to-export ratio has not improved only because falling oil prices have hurt Mexico and, to a lesser extent, Venezuela. Moreover, experience suggests that nominal dollar commodity prices should eventually rise as a consequence of the recent fall in the real value of the dollar. Such a rise should help several of the debtor countries.

Cline also suggested that Sachs's argument for debt relief does not adequately come to grips with the negative impact that relief would have on access to credit markets for the countries accepting it. Cline attributed Mexico's and Brazil's strenuous efforts to avoid repudiating their debt to their concern about future creditworthiness. Peter Kenen countered that Mexico and Brazil were probably more concerned about possible retaliation, in the form of either trade sanctions or other nonfinancial sanctions. He also questioned whether the LDC government officials' actions reflect any rational calculus regarding their countries' interests. In Kenen's view, many of these officials acted out of a personal sense of partnership with their industrialized-country counterparts in a mutual effort to preserve the stability of the world financial system.

On Sachs's specific relief proposal, Robert Hall argued strongly against following a formula in granting debt relief. One reason not to use a formula is that the national income accounts kept by many of the debtor countries are simply not believable. A more fundamental objection, Hall continued, is that use of a formula would create incentives for poor economic performance. Hall preferred a strategy of tough talk, with relief to be negotiated as necessary on a case-by-case basis. Fischer suggested that, in fact, the United States is currently doing exactly what Hall recommends. He saw the recent Mexican plan as a good example of a fairly generous and imaginative package. Sachs questioned whether such an approach is really feasible over the long haul; tough talk would lose its credibility because any negotiated relief would become public knowledge.

Kenen suggested that it might be less costly to help Mexico and Brazil today, rather than waiting a year or two and taking the risk that current restrictive policies imposed by the lenders will lead to large cumulative declines in GNP that require more substantial relief. Kenen also suggested graduating the amount of relief according to the severity of each country's problems, but spreading all relief over a uniformly long time period. Sachs's plan would grant some countries relief over a very short period. Spreading all relief over, say, ten years would provide leverage for assuring that the debtor countries followed through on whatever actions they undertook as a condition for receiving relief.

Kenen went on to question the wisdom of making new loans to the debtor countries at the same time that relief is being granted on old loans. Making new loans to tide these countries over a bad patch made sense when the problem appeared to be a short-term one. It makes less sense now that it is clear that a lengthy adjustment lies ahead. Hall felt that some new debt might be a good idea, though he proposed a requirement that all new lending be to private companies rather than to governments. But Sachs pointed out that public spending on roads, dams, power plants, health care, and so on, is complementary to private investment.

Kenen noted that subordination of old debt to new would be difficult both because the banks would be unwilling to agree to any scheme that subordinated their claims and because the involvement of parties from many countries would greatly complicate any negotiations concerning debt subordination. He also questioned whether such a scheme would actually lead to significantly increased loan inflows.

Cline contended that both the Bradley plan and the Sachs plan expected too much from the banks. Because the banks are highly leveraged, any relief would have a large adverse effect on bank capital. He concluded that any debt relief plan must involve public money as well as bank money.

Benjamin Friedman argued that any plan for dealing with the debt problem should also provide for bank write-downs of outstanding LDC debt. Such an approach might well force some banks to raise new capital at prices they found unattractive, but it would be preferable to the present policy that implicitly ignores the reduced value of bank portfolios and thus risks bigger problems in the future.