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The Baker Plan

Progress, Shortcomings, and Future

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The basic strategy spelled out in the Baker Plan (1985-88) remains valid, but stronger policy efforts are needed, banks should provide multiyear new money packages, exit bonds should be guaranteed to allow voluntary debt reduction by banks, and net capital flows to the highly indebted countries should be raised \$15 billion a year. Successful emergence from the debt crisis, however, will depend primarily on sound economic policies in the debtor countries themselves.

The Baker Plan essentially made existing strategy on the debt problem more concrete. Like existing policy, it rejected a bankruptcy approach to the problem, judging that coerced forgiveness would "admit defeat" and cut borrowers off from capital markets for many years to come. It assumed that the principal debtor countries could grow their way out of the debt problem and could expand their exports enough over time to reduce their debt burden to normal levels. It called for structural reform (particularly trade liberalization, more liberal policies on direct foreign investment, and reform of the state enterprise sector). And it continued the adjustment efforts in the debtor country in return for financial support from foreign official and bank creditors.

The plan did shift emphasis, however: from short-term balance of payments stabilization to longer-term development objectives, and thus from the IMF to the World Bank as lead institution in debt management. It did not address the problem of the transition from "involuntary" lending of new money — in which all banks were pressured to lend new amounts proportionate to their exposure — back to voluntary capital flows. And it failed to integrate all public lending, remaining silent on the role of the IMF.

Except for the collapse of oil prices, global economic conditions were broadly favorable to debt management under the Baker Plan. Major Latin American debtors achieved important reductions in interest/export ratios. On the other hand, the banks provided one-third less new money than the Baker Plan target, and the

multilateral development banks raised net flows by only one-tenth of the targeted \$3 billion annually. If the IMF and bilateral export credit agencies are included, net capital flows from official sources to the highly indebted countries (HICs) actually fell, from \$9 billion annually in 1983-85 to \$5 billion annually in 1986-88.

Political fatigue is evident in major debtor countries but their recent stagnant growth has been caused primarily by internal economic distortions (high fiscal deficits and inflation), not the debt burden. Of the six large Latin American debtor countries, the three with the largest outward transfer of resources relative to GNP (Chile, Colombia, Venezuela) achieved the highest growth and the lowest inflation in 1986-88, indicating that external debt does not explain high inflation or low growth in Argentina, Brazil, and Mexico.

The basic international debt strategy remains valid, but intensified policy efforts are necessary. Banks should provide multiyear new money packages. Banks should also confer senior status on "exit bonds," and the World Bank should then guarantee these instruments — to make viable substantial voluntary debt reduction by interested banks. Bilateral and multilateral creditors should raise annual net capital flows to the highly indebted countries by \$10 billion annually, and the banks by \$5 billion, to cut the outward resource transfer in half over the next 3 years. The key to successful emergence from the debt crisis, however, will have to be sound economic policies in the debtor countries themselves.

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**by
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Origins

From the suspension of Mexican debt payments in August of 1982 through 1983, the debt problem was addressed on a basis of short-term crisis management. All four parties were expected to act: the banks, through rescheduling payments and providing new loans; the countries, by adopting adjustment programs; the international financial agencies (especially the IMF), by providing leadership to the banks and funding as well as policy guidance to the countries; and the industrial countries, through reschedulings of export credits in the Paris Club and bridge loans. The objective was twofold: to avoid a collapse of the international banking system and to permit adjustment and renewed development in the debtor countries.

Extremely high interest rates and severe global recession had played a major role in precipitating the debt crisis. Buoyant recovery by 1984 (with industrial country growth at 5 percent) and a reduction of interest rates (as LIBOR ebbed from 19 percent at its 1981 peak to 11 percent) led to considerable optimism in that year that the debt crisis was on its way to resolution. Indeed, key debtors ran large current account surpluses, and economic growth in Latin America again turned positive (3.7 percent, versus -1.2 percent in 1982 and -2.6 percent in 1983).

By 1985 the mood began to swing once again toward pessimism.

Latin American policy-makers were facing intensifying political pressure as the lagged effect of severe recession in 1983. Moreover, they were beginning to conclude that bank lending could be expected to remain frozen over the near term, despite adjustment progress. Governments had shifted from military to civilian rule in Argentina and Brazil, and in both countries there were initial breaks with the formula of IMF-led adjustment that had dominated the initial response to the debt crisis.

In US policy circles, economic leadership had shifted in an activist direction under new Treasury Secretary James Baker, as illustrated by his Plaza Agreement in September 1985 to reduce the value of the overly-strong dollar to avoid a protectionist outbreak. In debt, Mexico in particular provided reason for this Texan's concern, as that country experienced fiscal erosion, rising inflation, weakening oil prices, and a devastating earthquake. It was evident that Mexico would once again need to borrow from the banks as its large 1984 current account surplus evaporated with a partial recovery in imports and lower oil exports. Yet the banking community was in no mood to renew lending.

Design

Although Mexico was an important catalyst, the Baker team prepared a broader attack on the debt problem that amounted to a global indicative plan.

STRATEGY AND TARGETS -- The new initiative called for banks to extend new lending amounting to approximately \$7 billion annually (\$20 billion over three years), or 2-1/2 percent of existing

exposure each year, to 15 major developing countries with debt difficulties. The implication was that this target was conceived of as a net disbursements concept, above and beyond amortization of principal (but not net of interest payments). The announcement of this goal for bank lending served notice that the absence of major new money programs in 1984-85, which had been possible because of the greater than expected increases in trade surpluses of debtor countries, could not be expected to continue over the medium term.

The plan called for structural reform by the debtor countries. It stressed three areas: trade liberalization, the liberalization of policies toward direct foreign investment, and reform of the state enterprise sector, including through privatization.

Industrial countries were to provide more support through an increase in net loan disbursements of multilateral banks (MDBs) by \$3 billion annually (\$9 billion over three years). Secretary Baker indicated that successful implementation of the plan by all parties would serve as the condition for US support for a substantial increase in the capital of the World Bank, a measure which, however, US authorities were not yet prepared to endorse at the time. Added to the 1985 base of net disbursements by MDBs, the expansion meant total net capital flows (excluding interest) of approximately \$7 billion annually from these agencies, or almost the same three-year magnitude as the \$20 billion asked of the banks. Private bank/ public sector symmetry thus seemed present.

The Baker Plan essentially provided a more concrete

formulation of the existing strategy on the debt problem. It did not change the fundamental assumptions of that strategy. In particular, from the outset the debt strategy had rejected a bankruptcy approach in which major portions of existing debt would be forgiven on a coerced basis. The plan's architects judged that forced forgiveness would "admit defeat" and cut off borrowers from capital markets for many years to come.

Instead, the plan continued the policy premise that the principal debtor countries could grow their way out of the debt problem, and in a non-hostile world economy could expand their exports enough over time to reduce their relative debt burdens to sustainable levels compatible with a return to more normal credit market access. The new initiative also continued the principle of financial support by foreign official and bank creditors, matched by adjustment effort in the debtor countries.

STRENGTHS -- The plan did make an important shift in emphasis. It stressed that the official community recognized the debt problem was one that would take a long time to address, and that it was foremost a problem of economic development. This thrust of the plan was widely interpreted to signify a move away from short-term balance of payments stabilization, particularly through programs that could have contractionary effects, to longer-term development objectives. The implicit institutional shift was from the IMF to the World Bank as the lead institution in debt management. In view of the costly recessions of 1982-83, this new emphasis was timely.

The plan was also correctly oriented in its intent of

encouraging new bank lending. From the outset of the debt problem it had been apparent that the free rider problem, in which individual banks could seek to avoid new lending yet would benefit from the strengthening of the country's ability to ride through the crisis resulting from new loans by other banks, could cause bank lending to grind to a halt, and that orientation from a central force was necessary to deal with this externality. The IMF had provided this direction early in the crisis; the Baker Plan targets sought to do so over the medium term.

The initiative was also positive in its implicit confirmation that the industrial country governments recognized a responsibility to participate in the solution to the debt problem. Public sector action was to occur primarily through the MDBs. This commitment was important in an environment of the facile and popular political critique that the public sector should not bail out the banks.

The plan was even broadly correct in its selection of the priority structural reforms in debtor countries. Excessive protection and import-substituting industrialization carried to an inefficient extreme had played a large role in the vulnerability of Latin America to the debt problem, as this development strategy had left an export base much weaker than that developed in the East Asian NICs. Similarly, the fiscal fragility that had given rise to much of foreign borrowing owed much to chronic deficits of state enterprises. The emphasis on direct investment was also logical given the need to reverse the pendulum in its extreme swing in the 1970s from risk capital inflows to borrowing abroad.

WEAKNESSES -- The Baker initiative did not address the difficult problem of the transition from "concerted" (or "involuntary") lending through "new money packages," in which all banks were pressured to lend additional amounts in proportion to their exposure at the outset of the debt crisis, back to voluntary capital flows. Indeed, the more pressure applied in pursuit of the bank lending targets, the more resentment there was likely to be and the longer the delay of voluntary lending. At the same time, the official sector lacked means other than moral suasion to ensure that the private sector met the lending targets in the indicative plan.

The initiative appears to have been somewhat misleading in its capital flow targets for the public sector by not taking an integrated approach to all official lending, and in particular by remaining silent on the role of the IMF. As discussed below, the shift of the IMF from an extremely active new lending role early in the debt crisis to a posture of minimal or negative new lending meant that the widely publicized targets for expansion of lending by multilateral development banks overstated the net capital contribution that could be expected from the international institutions as a whole. From the bureaucratic standpoint it was natural to argue that the IMF was not a "development agency" and thus could not be expected to continue indefinitely its initial high level of net lending; but from the standpoint of the broader development objectives of the Baker plan itself, a comprehensive view of public sector financing for the debt problem needed to be

taken. The same observation applied to bilateral export credit agencies, which had provided considerable financing before the debt crisis but cut back much like the private banks after its onset.

There was an awkwardness in the seeming interventionism of the industrial country governments into what could be considered the internal affairs of the debtor countries. While liberalized treatment of imports and foreign investment and slimming of the state sector were in practice desirable in many of the debtor countries, in principle adjustment and growth could have been carried out through other means of fiscal correction and improved efficiency at the choice of each country according to its political tradition. There were delays in the mobilization of new lending efforts in early 1986 as each major debtor waited for another to bear any taint that might be associated with being the first to sign up in the program, thus appearing to accept foreign conditions in areas more fundamental than the macroeconomic guidelines familiar in IMF programs.

There was also considerable doubt about the adequacy of the capital flow targets of the Baker Plan. From 1981 to 1985 the net transfer of resources (capital inflow less net payments of interest and profits abroad) to the highly indebted countries identified in the Baker Plan fell from \$18.3 billion to -\$26.5 billion,¹ a decline of almost \$45 billion. The 1981 flows had been seriously

¹ World Bank, World Debt Tables: External Debt of Developing Countries, 1988-89 Edition, Vol. I (Washington: World Bank, 1988), p. xvii. Hereafter referred to as World Bank Tables 1988.

exaggerated by excess demand in some key countries such as Mexico, and the 1985 flows had been artificially small because of transitory high current account balances in major debtor countries such as Mexico and Brazil that meant they were not asking for new money. Nonetheless, reversal of only one-fourth of the decline in resources transfers (through an increase of \$10 billion annually between the banks and the multilateral development banks, "MDBs") appeared to be too modest a policy goal, and many analysts argued that the objective should be at least twice as large. There was, of course, an inherent tension between the scale of new lending and the speed of reduction of the debt burden to more sustainable levels, which many critics of the Baker Plan who attacked both the lending target as too low and the debt buildup as too high failed to recognize.

Mid-term Evolution

Brazil's moratorium in early 1987 triggered widespread loan-loss provisions by US banks, and both events led to an erosion in market psychology that drove secondary market prices for the debt of major Latin American countries from the range of 60-80 cents on the dollar to the 40-60 cent level. An increasing number of banks, especially regional banks that had been involved in Latin American lending for a relatively brief period in the late 1970s, simply wanted to be rid of their portfolios of loans to debtor countries. Lengthy delay in mobilization of the \$7.7 billion new money package for Mexico in late 1986 had led many to question whether there could be any further new lending programs.

At the annual meetings of the IMF and World Bank in September of 1987, Secretary Baker suggested a further evolution of his initiative, which called for a "menu approach" to tailor the forms of bank participation in support of debtor countries to the varying interests of the individual banks. The approach included more attractive vehicles for new money (bonds to confer implicit seniority, rights to convert new loans into equity) as well as alternative options for banks desiring to exit from the new-money process ("exit bonds").² Secretary Baker backed the new approach more concretely when the US Treasury subsequently gave its blessing to Mexico's exit bond, designed with Morgan Guaranty, which used Mexican reserves to purchase zero-coupon US Treasury bonds as collateral for 20 year bonds paying LIBOR plus 1-5/8 percent. The Mexicans hoped banks would convert existing claims at close to the secondary market price of 50 cents on the dollar in return for this more secure instrument, and some did; but the total volume exchanged was limited (\$3 billion) and so was the discount (which turned out to be 30 percent rather than 50 percent), because the bonds had a guarantee only for distant maturity and none for ongoing interest payments. In addition, the banks credited the menu approach with the relative success in mobilizing a package of \$5.2 billion in new lending for Brazil in 1988, although when

² Several of these options as well as alternatives such as discounted debt buybacks were examined in my Mobilizing Bank Lending to Debtor Countries (Washington: Institute for International Economics, Policy Analyses in International Economics No. 18, June 1987).

Brazil launched its new anti-inflation program in January of 1989 its negotiators informed the banks that some of the attractive features ("relending" and debt-equity conversion) would have to be suspended or scaled back temporarily.

Results of the Strategy

By the end of the three-year time horizon of the original Baker Plan, its results as the core international strategy for dealing with the debt problem were mixed, but considerably more positive than the widespread image of failure conveyed by some of the media, some entities representing developing countries, and some academic, legislative, and business figures (including Senator Bill Bradley and the President of American Express, James Robinson). An evaluation of the results of the strategy requires special care in attributing a causal role to external debt, and within debt, a causal role to the Baker Plan. With this cautionary note in mind, the results of the Baker initiative may be reviewed according to several criteria.

ECONOMIC GROWTH -- The bottom line of the Baker Plan was supposed to be a restoration of economic growth in the debtor countries. Ironically, their growth rates were higher in the two years immediately before the plan than during its duration. Thus, Latin America as a whole achieved growth of 3.7 percent in 1984 and 3.6 percent in 1985. While the rate was approximately the same at 3.9 percent in 1986, the region's real GNP growth decelerated to 2.5

percent in 1987 and only 0.7 percent in 1988.³ However, the argument is developed below that the primary source of this decline was not the external debt problem, but the adverse growth effects of high domestic inflation. As discussed below, those countries that did achieve favorable performance on domestic adjustment were able to obtain relatively high growth in the Baker Plan period (1986-88).

INTERNATIONAL ENVIRONMENT -- An assumption of the Baker Plan was that the international economy would not collapse and make it impossible for the debtor countries to increase their exports and "grow their way out" of the debt problem. The industrial countries more than fulfilled this prerequisite. Thus, average growth in industrial countries in 1986-88 stood at 3.3 percent, comfortably above the range of 3 percent (or, after LIBOR subsided to single digits, 2-1/2 percent or lower) that had been considered necessary for progress on debt.⁴

International interest rates also remained in a range compatible with emergence from the debt problem. For 1986-88 as a whole, LIBOR averaged 7.3 percent, less than half the level of 1981-82. Although the rate rose by 200 basis points from the fourth quarter of 1987 to the fourth quarter of 1988 (when it stood

³ Economic Commission for Latin America, Balance Preliminar de la Economía Latinoamericana: 1988 (Santiago: ECLA, December 1988). Hereafter referred to as ECLA 1988.

⁴ IMF, World Economic Outlook, October 1988, p. 59; William R. Cline, "International Debt: Analysis, Experience and Prospects," Journal of Development Planning, No. 16, 1985, pp. 25-56.

at 8.9 percent), in part because of attempts to stabilize the dollar, US inflation was also up (from -3 percent in 1986 and +2.6 percent in 1987 to 4.1 percent in 1988, wholesale price index) so that real international interest rates were not much changed at the end of 1988 (and were lower than in 1986).

International prices of commodities and especially oil were the principal area in which the world economic environment caused serious difficulty during the Baker plan period. As figure 1 shows, the dollar price of oil fell by half in 1986, and after a modest recovery in 1987, in 1988 was not much higher than the weak level of 1986. Several debtors among the 15 countries identified in the indicative Baker Plan depend heavily on oil, especially Mexico, Venezuela, Nigeria, and Ecuador. Because oil is a smaller share of imports for such oil-importing debtors as Brazil than it is of exports for the oil-exporting countries, it is fair to say that the collapse of oil prices during the Baker Plan period was the most severe blow to the strategy from the international economy.

Other commodity prices were weak but less dramatically so. Figure 1 shows an index of nominal dollar prices for six commodities weighted by their shares in Latin America's exports.⁵ The prices of these raw materials had shown promising recovery from

⁵ Coffee (32.6 percent), soybeans (25.8 percent), copper (22.8 percent), corn (9.1 percent), sugar (5.9 percent), and beef (3.9 percent). Price series are from International Financial Statistics; trade shares calculated from Inter-American Development Bank, Economic and Social Progress in Latin America: 1987 Report (Washington: IDB, 1987), pp. 474-5.

the initial debt crisis year of 1982 to 1984, as they rose by 9.1 percent. But from 1984 to 1987 these commodity prices fell by 15.8 percent, dominated by excess supply in world grains trade and coffee. Dollar commodity prices had been expected by many economists to rise once the dollar fell, and signs of this process began with higher copper prices by 1987. By 1988 there was a much broader commodity price increase, as the index for the six raw materials rose by 30 percent from 1987 and stood 10 percent above the 1984 level. US drought spurred grains prices, and a world boom in production and trade added more generalized upward pressures.

DEBT INDICATORS -- In a world economic environment that was generally hospitable, with the most notable exception of oil prices, by 1988 the debt indicators for the major debtor countries were showing significant improvement. Figure 2 shows the most important single indicator of the debt burden, the ratio of interest payments to exports of goods and services, for the six largest Latin American debtor countries, which account for 69 percent of external debt of the Baker-15 countries. By 1988 the interest/exports ratio was lower than its highest past year in all six countries. From their peak levels for the 1980s, the interest/export ratios had declined from 57.1 percent to 29.7 percent in Brazil, 47.3 percent to 29.1 percent in Mexico (despite the collapse of oil prices), 58.4 percent to 40.4 percent in Argentina, 31.1 percent to 26.4 percent in Venezuela, 49.5 percent to 22.6 percent in Chile, and 26.7 percent to 20.8 percent in

Colombia. By 1988 the interest/export ratio was not only lower than in the debt crisis year of 1982 but also either lower than or equal to the ratio in the pre-crisis year of 1981 for Brazil, Mexico, Chile, and Colombia. For Latin America as a whole, the ratio stood at the same level in 1988 (28 percent) as in 1981, and well below the peak 1982 level of 41 percent.⁶

Even the absolute level of debt, and the ratio of debt to exports and goods and services (which fails to take account of the sharp decrease in the price of debt, the interest rate) showed moderating trends by 1988. As indicated in figure 3, in 1988 the dollar value of total external debt for Latin America as a whole fell (from \$410 billion to \$401 billion) as the consequence of debt-equity conversions and substantial discounted debt buybacks in the private sector. In real terms (deflating by US wholesale prices), by 1988 debt for the six countries stood only 13.5 percent above the 1982 level, for average annual growth of only 2.1 percent. And the ratio of debt to exports of goods and services declined from its 1986 peak for the six countries at 424 percent to only 339 percent, a level moderately lower than in 1982 (354 percent) and not far removed from the pre-crisis 1981 level (331 percent).

In view of these absolute and relative trends, the summary view presented in the World Bank's 1988 debt report was misleading:

.. most of the indebted countries are still no better off than in 1982 -- when the debt crisis erupted. Debt disbursed and outstanding has doubled, and debt service

⁶ ECLA 1988, table 17.

payments on a cash basis are one-third higher.⁷

By aggregating debt for all developing countries, the statement seriously obscured the progress in the major Latin American debtor countries that had been and remain the central core of the debt crisis as a systemic problem. Thus, it may be seen in table 1 that the increase in debt in the 17 Highly Indebted Countries (HICs), or the original Baker 15 plus Costa Rica and Jamaica, was far smaller than in other developing countries (34.8 percent versus 63.2 percent). Moreover, of the large volume debt increases in other developing countries, the bulk occurred in countries well capable of carrying debt; indeed, had they not been, the debt would not have increased as it did. The largest absolute and percentage increase in debt occurred in China. Other large absolute increases occurred in Greece, Hungary, India, Indonesia, Malaysia, Thailand, and Turkey, all countries that have remained outside the locus of the debt crisis (and indeed, Turkey overcame its earlier crisis to achieve new access to credit).⁸

In short, for the major Latin American debtors at the center of the debt crisis, there has been much more improvement in the key debt indicators than is generally recognized. Large increases in debt of such countries as China, India, Greece and Portugal

⁷ World Bank Tables 1988, Vol. I, p. xi.

⁸ The World Bank data, which only extend through 1987, do not capture the reduction in Latin American debt that occurred in 1988, as discussed above. Note also that the World Bank data show larger 1987 debt than does the Economic Commission for Latin America (table 1).

should be construed as a continued functioning of the capital market for developing countries despite the Latin American problem, rather than as evidence that the world debt problem has grown worse.

CAPITAL FLOWS -- A widespread view is that the private banks fell far short of their lending targets under the Baker Plan. In fact, the banks did lend less than the plan called for, but the shortfall was limited to about one-third. A much less recognized pattern is that on a consolidated basis, capital flows from the public sector to the Baker countries actually fell by approximately \$4 billion annually, rather than rising by \$3 billion annually as implied by the Plan. The main reason for the public sector shortfall was that decreases in IMF and bilateral (mainly export credit agency) lending were not offset by increases in lending by multilateral development banks.

Table 2 reports capital flows (net disbursements) to the Baker countries during the Plan years, 1986-88. For the private banks, the figures refer to the actual disbursements under the agreed "new money packages." Because outstanding principal was typically rolled over in this period, net disbursements are approximately the same as gross disbursements.⁹ For the IMF, net flows are

⁹ The major exception is for Venezuela, where there were repayments of principal of about \$1 billion annually. However, the Venezuelan government chose to repay principal rather than enter an IMF adjustment program, the condition the banks insisted on for complete rescheduling and new money. In any event, overstatement of the effort made by the banks from the standpoint of not deducting Venezuelan repayments is approximately offset by understatement from the standpoint of commitments undertaken by the banks but not disbursed because of changes in circumstances.

calculated by multiplying the change in the number of SDRs in outstanding "use of Fund credit" at the end of each year by the average dollar/SDR exchange rate for the year.

The table shows that the banks achieved capital flows of approximately \$14 billion over the Baker Plan period, or about two-thirds of the target \$20 billion for these countries. It is clear, however, that the flows were concentrated in the major countries. The smaller countries typically were unable to mobilize new money packages. This pattern reflected the greater importance of the large debtors to the banks, and implicitly the greater bargaining power that these countries had in new money negotiations.

Table 2 also shows that the multilateral development banks achieved average net disbursements of \$4.2 billion annually during the Baker Plan period. This outcome represented a massive shortfall from the target set under the Plan, according to which annual net disbursements were to rise by \$3 billion. Considering that the annual average for 1983-85 stood at \$3.86 billion (table 3), the actual increase achieved amounted to only about \$300 million annually, one-tenth of the target.¹⁰

The outcome was worse in IMF lending. For the 1986-88 period,

Thus, the banks pledged up to \$7.7 billion to Mexico in the 1986-87 new money package, but because oil prices recovered the full amount was not activated.

¹⁰ The World Bank made net disbursements to Latin America amounting to \$1.8 billion in its fiscal 1988. This rate was below the institution's average of \$2.4 billion annually in FY84-88. For its part, the Interamerican Development Bank faced paralysis in net lending as the result of an impasse with the United States over US veto power.

the IMF was a net taker of funds from the Baker countries, for a total of \$2.7 billion. The largest net repayments were from Brazil and Yugoslavia, but of the 17 countries in question, 11 had negative capital flows from the IMF over the period.

Table 3 summarizes the capital flows under the Baker Plan and before. The disbursements from banks averaged \$4.6 billion annually in 1986-88, modestly lower than in 1985 but less than half the rate of the early debt crisis years of 1983-84 (\$12 billion annually) and even further below the more than \$20 billion annually in 1981-82. Nonetheless, as noted the banks met approximately two-thirds of their new lending target under the Baker Plan.

For the public sector, capital flows to the Baker countries averaged \$5.2 billion annually in 1986-88, sharply lower than the average of \$9.3 billion during 1983-85. The main reason for the decline was the reduction in IMF flows (from \$6.5 billion in 1983 to -\$1.1 billion in 1988, a swing of \$7.6 billion). Flows from the bilateral credit agencies averaged \$1.9 billion annually in 1986-88, and thus showed a significant recovery from the lowpoint of less than \$700 million in 1987 (although the 1986-88 average still remained below the \$2.5 billion annual rate in 1981-83). Overall, the failure of multilateral bank lending to rise by the target amount, and the only limited recovery of bilateral lending, meant that the large decline in net IMF lending placed the consolidated official sector lending in the Baker Plan period sharply below the average levels of the preceding three years.

There were of course good reasons for part of this decline.

Countries such as Brazil that chose not to enter an IMF program faced large repayments of earlier IMF credits. And in the very design of the Baker Plan, the IMF was regarded as a "revolving credit" agency rather than an aid institution, and international officials did not necessarily regard the reflows to the IMF as inappropriate. The broader problem, however, was that the original design of the Baker Plan failed to treat the official sector on a consolidated basis. The increase of lending targeted for the multilateral banks should have taken account of any expected reflows to the IMF and any decline anticipated in bilateral lending. Expression of the official sector contribution to the Baker Plan as limited to multilateral development banks sent a misleading signal. Unfortunately, not even that target was achieved.

The central implication of the record on capital flows to the Baker countries in 1986-88 is that both the private and public sectors fell short of their goals. The public sector shortfall was considerably greater than that of the banks, especially if the IMF and bilateral institutions are included. This record suggests that calls for increased official sector financing to deal with the debt problem are not inappropriate.

STRUCTURAL REFORM -- There has been a significant amount of structural reform under the Baker Plan, although presumably less than its authors envisioned. The most far-reaching reforms have come in Mexico, probably because that country faced one of the largest fiscal and external shocks (from the collapse in oil

prices) and has a political regime with relatively high control from the top. In 1986 Mexico broke with long tradition and became a member of the GATT. By the end of 1988, it had cut its maximum tariffs to 20 percent (and average tariffs to 10 percent) and reduced the share of imported products under quantitative restrictions from virtually 100 percent in 1982 to only 23 percent. In the state enterprise sector, the Mexican government reduced the number of state firms from nearly 1,200 in 1982 to fewer than 500 by 1988. Although many of the privatizations or closures involved small entities, by late 1988 the government had privatized such large enterprises as the airline Aerovias de Mexico and the copper firm Mexicana de Cobre. There was also progress toward trade liberalization and privatization in Argentina (where by late 1988 the government planned to sell 40 percent of the state telephone company to a Spanish telephone entity and 40 percent of Aerolinas Argentinas to Skandinavian Airline Systems). Even in Brazil, where import protection had remained relatively unchanged and there was a tradition of strong state enterprises, in late 1988 the government announced the freeing of half of some 2,500 import categories under import prohibition, and in early 1989 the government's new anti-inflation plan included a pledge to cut back government employment by tens of thousands.¹¹

¹¹ William R. Cline and Riordan Roett, Latin American Economic Outlook, No. 88-3, December 31, 1988. Note that the close timing of Mexico's acceleration of privatizations in late 1988 and the October announcement by US authorities of a \$3.5 billion credit line to Mexico suggested that linkage of financial support to structural reform under the Baker Plan had concrete content. Similarly, there have been large World Bank loans to Argentina and

BANK VULNERABILITY -- From the onset of the debt crisis in 1982, a major policy goal was to avoid a severe disturbance to the world economy from a crisis in international banking. By the time of the advent of the Baker Plan, the locus of the debt problem had already shifted away from bank vulnerability toward the need to restore sustainable growth in debtor countries. By the end of 1988, the international banking system had become even less vulnerable to the debt problem. European banks had generally set aside large provisions on Latin American debt. US banks had continued to build capital and, after Brazil declared its moratorium in early 1987, had set aside sizeable loan loss reserves. By late 1988, US banks had reduced the ratio of their exposure to the 15 Baker countries to primary capital from 136 percent in 1982 to 58 percent. For the nine money-center banks, the ratio of total developing country loans to primary capital fell from 191 percent in 1982 to 85 percent in 1987. Bank regulators testifying before Congress in early 1988 indicated that third world debt was no longer a proximate threat to the banking system.¹²

POLITICAL FATIGUE -- By the end of its initial three-year horizon, the Baker plan had failed to dispell the political perception in key debtor countries that the debt problem was

Mexico for trade sector reform.

¹² Thus, the Comptroller of the Currency testified that "the vulnerability of the US banking system to LDC debt performance has lessened significantly," while the Chairman of the Federal Deposit Insurance Corporation stated that "at this time we cannot foresee any bank failures resulting from LDC exposure alone." Washington Post, January 6, 1989; New York Times, January 6, 1989.

condemning their economies to stagnation. Elections were to be held in 1989 in both Argentina and Brazil. The front-runner in Argentina, Peronist Carlos Menem, spoke of a five-year moratorium on debt payments (sometimes using the qualification "negotiated"). Two leading presidential candidates in Brazil, leftists Leonel Brizola and Luis Inacio da Silva (the labor leader "Lula"), called for a moratorium on debt payments. Even in Mexico, the new president Carlos Salinas de Gortari had faced unprecedented domestic opposition in considerable part over the debt question, and his statements on taking office emphasized the need for debt reduction (but not through moratorium or confrontation). And the new president of Venezuela, Carlos Andres Perez, had similarly seemed to take a tough line on debt (and the country found itself compelled to suspend a large portion of principal payments at the end of 1988 as its non-gold reserves fell precariously low).

Political debt fatigue is easy to understand. In Mexico, real wages in 1987 stood almost 30 percent below their 1980 level. Inflation reached unprecedented dimensions in Latin America in 1987-88. Per capita income for the region in 1988 stood 6.6 percent below its 1981 level.¹³ The understandable but simplistic reaction was to blame external debt for all of these economic ills. An equally simplistic and dangerous tendency was to infer that some form of radical debt relief would mean renewed high growth and price stability.

¹³ ECLA 1988, table 3.

Yet the region itself had already generated two major lessons indicating that at least confrontational attempts to reduce the debt burden were counterproductive. In Peru, a unilateral ceiling on debt payments had been followed by a short-lived boom and then recession and extremely high inflation, and by 1988 the country was compelled to adopt harsh austerity measures and seek renewed ties with the IMF. In Brazil, a moratorium on debt during 1987 was subsequently characterized as a mistake by the President and the Finance Minister, and the loss of credit lines alone cost the country at least \$1-1/2 billion.

The Debt/Inflation/Growth Nexus

The proper reading of the experience of major Latin American debtors in the past six years is not that debt condemns them to stagnation and inflation, but instead that the countries which have adopted appropriate economic policies have shown the capacity to achieve economic growth, relative price stability, and reductions in relative debt burdens. The principal cause of stagnation in 1987 and 1988 was from domestic policy distortions and high inflation in particular, not the debt problem. Nor was inflation caused primarily by the debt burden.

RESOURCE TRANSFERS AND GROWTH -- The analytical framework that might suggest the opposite is of course the relationship of resource transfers to growth. Under a traditional, simple development model (Harrod-Domar), growth is determined by the resources available for investment. These resources equal domestic saving plus saving from abroad. As capital inflows fell far below

interest payments on external debt after the debt crisis, foreign saving shifted from positive to negative, and the traditional saving/investment model suggested lower growth would result. Similarly, in the "two-gap" model in which there can be a special role for foreign exchange available for critical imported inputs and capital goods, the reduction in net foreign exchange availability can slow growth.

The "resource transfer" argument becomes less relevant, however, when production is below full capacity, as has been true in many instances in recent years in debtor countries. Output can be expanded for a time without large new investment. Similarly, where domestic savings rates are abnormally low, correction of domestic policies to boost saving can substitute for foreign saving. At the same time, export expansion can serve as an engine of growth for the economy, so that ironically high exports and thus high outward transfer of resources may be associated with high growth. The extraordinary trade surpluses of Taiwan and Korea, coexistent with their high growth rates, are vivid examples.

The six major Latin American debtor countries provide a laboratory for testing the hypothesis that the outward transfer of resources imposed by the debt crisis has caused a collapse in growth. Figure 4 plots average real GNP growth in the Baker period 1986-88 against average outward transfer of resources as a

percentage of GNP for these countries.¹⁴ If the resource constraint were binding, one would expect the countries with the highest ratio of outward transfer of resources to GNP to have the lowest growth rates. As indicated in figure 1, just the opposite appears to be the case. During 1986-88, Colombia, Venezuela, and Chile had the highest ratios of outward resource transfer to GNP among the six large Latin American debtor countries (an unweighted average of 4.6 percent of GNP), yet they had relatively favorable growth rates (averaging 5.2 percent annually). In contrast, Argentina, Brazil, and Mexico had lower outward resource transfers (an average of 2.4 percent of GNP) but nonetheless had lower growth as well (an average of 1.9 percent annually). While few would conclude that larger outward resource transfers generate faster growth (although the notion of export-led growth tends in that direction), the data do contradict the view that it is outward transfers of resources that are causing economic stagnation in Latin America.

RESOURCE TRANSFERS AND INFLATION -- The obvious explanation for low recent growth in countries such as Brazil and Argentina is the adverse impact of their inability to control inflation. Truly high inflation, in the range of several hundred percent annually, is inimical to growth. It makes investment decisions difficult by making economic projections highly unstable. Figure 5 provides support to the idea that high inflation is a major cause of

¹⁴ The resource transfer estimates refer to the excess of net payments of interest and profits over net inflows of capital. The data are from ECLA 1988.

stagnation. The figure shows that among the six largest Latin American debtor countries, those with the lowest inflation in 1985-87 had the highest growth in 1986-88. Thus, in Chile,⁶ Colombia, and Venezuela, where inflation averaged 23.5 percent annually in 1985-87, economic growth averaged 5.2 percent annually in 1986-88. In contrast, in Argentina, Brazil, and Mexico, inflation averaged 177 percent annually in 1985-87 while growth was only 1.9 percent on average. Few would dispute the role of high inflation in causing slow recent growth in major Latin American countries.

There is, nonetheless, both a popular perception and an analytical argument that high inflation has been caused by the debt problem, so that in the end economic stagnation in the area is indeed attributable to the debt problem. The popular perception goes little further than the notion that debt has been the major cause of all economic disturbances. The analytical argument is two-fold. First, attempts to adjust externally have required sharp devaluation of the exchange rate, and devaluation boosts cost-push inflation. Second, the debt crisis suddenly thrust governments into a fiscal crisis because they could not mobilize the internal transfer of resources from the private sector to the public sector needed to replace the former inward transfer from foreign creditor to the domestic public sector. The internal transfer problem thus necessitated a higher inflation tax, the argument goes.

The best case for debt-imposed inflation can probably be made for Mexico. There the government adopted sharp exchange rate devaluation in 1986 when oil prices collapsed, and the devaluation

played an important role in the acceleration of inflation from the range of 65 percent to, by 1987, 160 percent. In Argentina and Brazil, however, inflation in the high triple digits has been essentially the consequence of a combination of high domestic fiscal deficits (on the order of 4 to 8 percent of GNP in real terms and over 30 percent in Brazil in nominal terms), on the one hand, and indexation mechanisms that perpetuate each successive plateau of inflation, on the other. Thus, the real exchange rate was almost constant in Brazil from 1983 through 1987, and actually appreciated by some 10 percent in 1988. Similarly, although there was a large real devaluation of the Argentine currency in 1982 after major overvaluation at the beginning of the 1980s, the real exchange rate in 1986-88 was not much different from the 1982 level.

The internal transfer argument is more ambiguous, but the essential issue is whether it would be appropriate for countries to sustain large fiscal deficits over several years, whether financed from abroad or domestically. Virtually all of the governments of major Latin American countries have by now come to the conclusion that high fiscal deficits are incompatible with growth and acceptable inflation, and it would seem to stretch a point to imply that if the debt crisis had not arisen, countries could have continued high fiscal deficits with high foreign financing over long periods of time.

Once again, the evidence for the Baker Plan period does not support the critique that the debt problem caused inflation.

Instead, there were major debtor countries that were able to achieve relatively low inflation and (usually) fiscal adjustment despite relatively high debt burdens. Figure 6 shows that Colombia, Venezuela, and Chile, with high outward transfers of resources (averaging 4.6 percent of GNP in 1986-88) managed to achieve relatively moderate inflation (averaging 22.9 percent annually for the same period), while Argentina, Brazil, and Mexico with relatively lower outward transfers of resources (an average of 2.4 percent of GNP) encountered extremely high inflation (an average of 245 percent annually for 1986-88). Indeed, as the figure shows, the relationship was almost exactly inverse rather than positive: the highest inflation was in Brazil, which had the lowest outward resource transfer, with successively lower inflation rates for each respective country at successively higher outward transfer levels. In short, cross country evidence suggests that it is possible to control inflation despite the debt burden, if proper domestic policies are pursued.¹⁵

¹⁵ A variant of the inflation argument warrants further attention. In Brazil, the Finance Minister has complained that the need for the central bank to buy up a large trade surplus has led to excessive money expansion. And there has been great criticism of the bank package for Brazil because of its use of debt-equity conversions, under the perception that these feed excessive money expansion and thus inflation. But the central bank could reduce money growth from the trade surplus by permitting exporters to sell foreign exchange to firms seeking to buy back external debt at a discount, instead of requiring that all of it be turned in to the central bank in exchange for local currency (and it could afford to do so because the trade surplus in 1988 well exceeded the amount required to service debt). As for debt-equity conversion, the amounts in Brazil in 1988 that passed through formal operations and thus potentially affected the money supply amounted to less than 3 percent of total money and quasi-money including overnight holdings of government paper, hardly the

The Next Phase

Because there has been considerable improvement in the key debt indicators, and because countries that have achieved domestic adjustment and moderate inflation have been able to sustain growth despite relatively high debt burdens, there is no reason to change the central strategic premise of the Baker plan: that the major debtors can achieve renewed growth while continuing to manage their debt on a market-related basis, and that resort to forced forgiveness of debt or interest is in most cases unnecessary and would be counterproductive for the future growth of the countries themselves. However, there is a need for a more intensified effort under a Baker-II (or Brady) Plan for the next few years.

For the banks (and the capital markets more generally), the next phase in the debt strategy should involve a three-track approach: multi-year new money programs, voluntary debt reduction, and return to voluntary lending based on more attractive instruments. For the public sector, the objective must be considerably higher actual net lending, at the least full realization of the increase for the public sector as a whole that had been implicit in the original Baker Plan targets. For the debtor countries, the objective must be actual achievement of adjustment programs, centered on fiscal balance for domestic stability and appropriate real exchange rates for export growth.

source of quadruple digit inflation.

In 1981 and 1982, the net resource transfer to the fifteen Baker countries amounted to an annual average inflow of \$8.9 billion.¹⁶ In the first three years after the debt crisis, the resource transfer averaged an annual outflow of \$38.4 billion. During the three years of the Baker Plan (1986-88), the outward transfer of resources from these countries averaged \$28.6 billion annually. Despite the evidence that domestic destabilization rather than outward transfer of resources has been the primary cause of recent stagnant growth in some major debtor countries, it is time for a more determined international effort to increase net capital flows to the debtor countries.

With domestic stabilization and forward growth, excess capacity would eventually be exhausted, and higher resource inflows can contribute to future growth even though stagnation in Latin America in 1988 was not primarily attributable to external debt or outward resource transfers.

Complete elimination of the outward transfer would be too ambitious over the next three to five years, as it would mean a sufficiently more rapid buildup in debt that progress in debt indicators could be halted prematurely. However, a reasonable goal would be to cut the outward transfer of resources in half, to some \$15 billion annually over the next three years. This objective

¹⁶ Estimated as the difference between the current account deficit (assumed equal to capital inflow, abstracting from reserves change) and net payments of interest and profits. Calculated from International Monetary Fund, World Economic Outlook, October 1988 (Washington: IMF, 1988), p. 104.

would require increasing net capital flows from foreign private and official creditors to the debtor countries by \$15 billion annually over the average achieved under the Baker Plan.

MULTI-YEAR NEW MONEY -- Debtor country governments would have much more certainty in planning if banks would agree to new lending programs over three year or even five year periods.¹⁷ Ideally the levels programmed for new bank money would decline over time (for example, from a benchmark in the first year equivalent to say half of interest due to perhaps 30 percent by the third and 10 percent by the fifth), with the objective of a progressive shift to voluntary private capital and to official lending sources. To the extent possible, countries should make new money options attractive to banks (debt-equity conversion rights, relending rights, new money bonds) to facilitate mobilization (as in the Brazil 1988 program). Moreover, those banks (primarily in Europe) preferring for tax or regulatory reasons to participate by capitalizing some interest due rather than making new loans could usefully be permitted to do so, although such banks would have no basis for insisting that all other banks also capitalize (and that outcome would be adverse because it could initiate a transition to unilateral insistence by the country that specified fractions of

¹⁷ Thus, President Carlos Salinas of Mexico stated as one of his four principles on debt that the country should be assured multi-year access to new loans. His three other principles were: reduction of the outward resource transfer, reduction of the stock of debt to closer to its secondary market value, and reduction of the debt/GNP ratio during his regime. Wall Street Journal, Dec. 2, 1988.

interest be capitalized each year).

VOLUNTARY DEBT REDUCTION -- By the end of the initial three-year horizon of the Baker Plan, perhaps the major change from what its authors anticipated was the low value of the debt in secondary markets, on the one hand, and the related activity in debt-equity conversions and discounted debt repurchases, on the other. Secondary market prices for Argentine debt were in the range of 20-25 cents on the dollar; for Brazil, 40 cents; Mexico, 44 cents; Chile, 58 cents; and Venezuela, 42 cents.¹⁸

Low secondary market prices offer the opportunity for mutually beneficial voluntary debt reduction operations between the countries and those banks desiring to exit. The banks are not monolithic, and many of the smaller banks in particular are prepared to accept 50 cents on the dollar or less if the asset they receive is secure, even as other banks (particularly those with long experience and, in many cases, local branches, in the countries) anticipate eventual recovery of the countries' economies and consider the true value of their claims much closer to face value than indicated by the secondary market. Yet the banks with the more favorable long-term expectations typically are not in a position to buy up the debt from the banks seeking immediate exit because they must be careful of their own exposure limits in the countries.

Much debt reduction has already occurred. Mexico has reduced

¹⁸ Salomon Brothers, International Loan Trading, Dec. 22, 1988.

its private sector debt from \$22.5 billion in 1983 to \$10 billion at the end of 1988, largely through debt-equity conversions and repurchases of outstanding debt on a discounted basis. The Institute for International Finance estimates that \$26 billion in external debt of the Baker-15 countries has been extinguished by voluntary debt reduction, with \$17 billion occurring in 1988 alone.¹⁹ The organization estimated that approximately three-fifths of this amount had occurred in debt-equity and local currency conversions, one-third in private sector restructuring with a relief component, and a small portion in debt buybacks and debt exchange into "exit bonds."²⁰

Countries with adequate reserves can make discounted repurchases of debt, as Chile did in late 1988 with its windfall gains from higher copper prices. Other countries can conduct debt-equity conversion programs, although the experience of Mexico and by early 1989 Brazil suggests that sensitivity to monetary expansion under these programs can limit their dimensions.

The most promising instrument for debt reduction would be an "enhanced exit bond." The concept of this instrument is that it converts the bank's existing claim into another asset which has a value closer to the secondary market price. The benefit for the country is alleviation of its debt. The benefit for the bank is

¹⁹ Institute for International Finance, The Way Forward for Middle-Income Countries (Washington: IIF, January 1989), p. 22.

²⁰ However, much of the "local currency conversion" also amounts to debt buybacks, as recipients then use the local currency to purchase dollars on the parallel exchange market.

greater security of the asset, combined with the understanding that the bank will no longer be expected to provide additional lending as part of any future concerted new lending packages.

The small magnitudes of both the early 1988 Mexico-Morgan Guaranty exit bond (which converted some \$3 billion into long-term bonds with principal but not interest guaranteed by US Treasury zero-coupon bonds, and sold at a price of 70 cents on the dollar) and the 1988 Brazil exit bond (which converted about \$1 billion into bonds paying 6 percent over 25 years) indicates that the real problem with these instruments so far has been their lack of blue-chip security. In particular, creditors continue to doubt that even the reduced instruments will be fully honored by the government. Thus, the Mexico-Morgan bond sold at a price that attributed full confidence only to the zero-coupon-backed principal but continued to discount unguaranteed interest at the going secondary market rate for Mexican obligations.

One of the most important potential changes in the debt strategy over the medium term would be joint action by the banks and the public sector in industrial countries to provide effective guarantees to exit bonds. If these instruments were fully reliable, it is conceivable that banks representing some 30 percent to 40 percent of the claims on debtor countries would be willing to accept them at a value of 50 cents or less on the dollar to make a clean exit from the debt problem.

So far the public sector has been unwilling to issue guarantees to back exit bonds. The political concern has been that

to do so would appear to be "bailing out the banks." It is time to discard this false argument. Any bank that accepted an exit bond worth say 50 cents or less on the dollar would by definition already be absorbing massive losses up front. It would not be meaningful to say that the public sector by guaranteeing the instrument would be making good the losses that the bank should otherwise absorb.

Two measures would make exit bonds gilt-edged. First, the banks themselves should agree that exit bonds have seniority over the other claims of banks. Here the idea would be that even those banks choosing to retain their full claims would benefit from the reduced burden on the country accorded by the banks choosing to exit at a cost. For this purpose, serious consideration should be given to new legislation that permits a two-thirds majority of bank creditors of a sovereign nation (by value of claims outstanding) to grant senior status over their own existing claims, to specific new instruments to be issued by the country. The legislation would provide for carefully controlled conditions, such as the presence of a program approved by the US Treasury and the International Monetary Fund. Moreover, the banking community as a whole would presumably authorize such instruments only up to specified amounts and over specified periods. The point, however, is that once it became unambiguous that exit bonds stood at the head of the queue, the instruments would have a high degree of reliability.

Because the bulk of Latin American debt is under contracts that specify New York as the jurisdictional area, it might be

sufficient for US law alone to make this change, although a similar law in the United Kingdom would cover the jurisdiction of most of the rest of the debt. While initially such laws could not be iron-clad assurance against constitutional challenge by a dissident bank, and while issues of extra-territoriality could arise, the fact that the class whose interests could be injured by the granting of such senior status, namely the banking community itself, would by the law be directly represented in the decision (and on a two-thirds majority basis) would throw into question the standing of such a plaintiff. In this regard, the conferral of seniority by a high majority of banks would differ sharply from attempts to legislate mandatory debt forgiveness, because the affected parties would (in their majority) approve in the first case and disapprove in the second.²¹ Moreover, there is precedent in domestic bankruptcy law for joint action by a class of creditors that supersedes claims of dissident individual members.

The second step to make exit bonds secure instruments would be, in addition to conferral of seniority by the banks themselves, the issuance of guarantees by the World Bank (and Inter-American Development Bank).²² Because the senior status accorded by the

²¹ Thus, the Institute of International Finance has recently warned that mandatory cancellation of debt would be "unconstitutional taking of property" and "would be contested in the courts." Institute of International Finance, The Way Forward, p. 20.

²² See John Williamson, Voluntary Approaches to Debt Relief (Washington: Institute for International Economics, Policy Analyses in International Economics No. 25, September 1988).

banks would already make the instruments relatively secure, it would be appropriate if necessary to count only a fraction (such as 20 percent) of the value of the exit bonds against the capital of the institutions, rather than require one-for-one capital backing as is the usual case for lending by these institutions.

The structure of the exit bonds would usually need to be relatively long-term (such as 20 to 25 years). Otherwise, the payments on the instruments would be as high as the interest payments on existing bank claims.²³ Yet for most countries voluntary debt reduction needs to make a contribution to near-term cash flow as well as long-term balance sheet improvement.

In September of 1988 Japanese authorities proposed the establishment of a window at the IMF that would take deposits of reserves from debtor countries for use in providing collateral for exit bonds, and the Japanese apparently had in mind parallel lending from industrial countries to the debtor countries that would provide the reserves required for this purpose. This proposal was moving in the direction of official support to enhance exit bonds. While industrial country officials have disavowed the use of World Bank guarantees for this purpose, a reconsideration of this position is in order, especially under the condition that the banking community would be prepared to minimize the potential

²³ For example, 7-year bonds bearing 9 percent interest would involve cash outflow equal to 23 percent of face value in the first year. Even if the face value were set at one-half the original loan, the resulting payments would stand at 11-1/2 percent of original loan value, higher than interest payments on the original claims (with all principal rolled over).

risk to the World Bank by granting seniority to the instruments.

The World Bank and other official lenders could in principle also contribute to voluntary debt reduction by making policy-related (non-project) lending available for the purpose of country repurchases of debt from the secondary market at a discount. However, any such lending would have to be truly additional to official flows that would otherwise occur. If lending for buybacks were not additional, the net effect for the country would usually be a negative cash-flow impact for the first five years or so.²⁴

A major push for voluntary debt reduction (VDR) by the banks and the international financial institutions would have the potential to reduce the debt owed to banks by perhaps 15 to 20 percent (that is, a reduction by half in the value of the debt held by banks accounting for 30 to 40 percent of bank debt). This reduction would be important economically and perhaps even more important politically, as it would enable leaders in debtor countries to point to an important supportive shift by creditors. If the debt problem were as intractable as many believe, this

²⁴ Thus, suppose that in case A the country would receive fast-disbursing policy lending which it would use for general purposes, while in case B it would dedicate the same funds to debt buybacks. In case A there would be one dollar of freely available foreign exchange for each dollar of World Bank policy lending. In case B, the country would spend the dollar to repurchase two dollars' worth of debt owed to the banks. The interest on the two dollars debt would be some 20 cents for the current year. The net effect on cash flow for the country would thus be one dollar in case A but only 20 cents in case B. Indeed, unless the secondary market price falls to as low as the interest rate (that is, 10 cents on the dollar), buybacks have negative cash flow in the first year.

amount of debt reduction would not be enough; more thorough-going relief of a bankruptcy nature would be required. But as analyzed above, at least for the major debtors the progress on debt to date is compatible with the moderate alleviation that voluntary debt reduction offers rather than requiring more radical measures.

One important side effect of more energetic voluntary debt reduction would be an increase in the secondary market price. The secondary market is extremely thin, and VDR would boost the demand substantially. Sometimes officials and analysts in debtor countries express concern that debt-equity conversion and other VDR measures would raise the secondary market price; their implicit fear is that somehow the country would lose the opportunity to cancel the debt at low prices such as 30 to 50 cents on the dollar if the secondary market price rebounded to the 60-80 cent level. The flaw with this reaction is that in the absence of conversion the debt continues to accrue interest at the full face rate regardless of its low secondary market price, so that the seeming lost opportunity is in fact not a loss at all. Instead, the proper way to view the rising secondary market price likely to follow VDR is as a sign of restored health and return toward creditworthiness. Until the secondary market price returns far closer to the 80 cent - 100 cent range, it will be difficult to reestablish truly voluntary capital flows.

NEW VOLUNTARY LENDING MECHANISMS -- The third track for capital flows in the near term should be a range of instruments designed to revive voluntary lending even as the secondary market price

rises. Direct investment is a crucial component of these flows.

Control of high domestic inflation and a return of domestic economies toward more normal conditions would help spur renewed interest of foreign investors, but in addition the liberalization of restrictions (in such countries as Mexico) could help.

For existing bank creditors, it would make sense to supplement new money packages that involve all creditors (except those choosing exit bonds) with club loans involving a more limited number of large players. These loans would ideally have elements to make them attractive in their own right so that they would not have to be coerced. One example would be the issuance of bonds convertible into commodities as the instrument for club deals. Banks could thus anticipate some chance of profit, while actual convertibility (for example, into oil at \$20 per barrel if the current price is \$15) would provide an inherent in-kind guarantee (in this example, equivalent to 75 cents on the dollar, well above the secondary market price for standard obligations of the country). It would be desirable to bring new actors into the club operations, such as insurance companies.

PUBLIC SECTOR LENDING -- Beyond these approaches for bank lending, it will be necessary in the next phase of the international debt strategy to make good on the promise of increased official support implicit in the original Baker Plan. As indicated above, with the period 1983-85 considered as a base, net capital flows from the consolidated public sector (IMF, multilateral development banks, and bilateral export credit agencies) fell from \$9.3 billion

annually to only \$5.2 billion annually in the Baker Plan period (1986-88). The public sector could well seek a goal of increased net disbursements to the large debtors in an amount of some \$10 billion annually, of which half would be merely returning to the levels of 1983-85. Private capital flows could then pick up the other \$5 billion of the \$15 billion increase in net flows to the highly indebted countries identified above as the increment required to cut their outward transfer of resources by half.

CAPITAL FLOW OBJECTIVES -- Table 4 shows an illustrative set of capital flow objectives for the period 1989-91 for the highly indebted (Baker Plan) countries. Net disbursements by multilateral development banks could double to approximately \$8 billion annually; export credit and other bilateral agencies could increase net flows to \$4 billion annually (with perhaps an especially large rise by the Japanese). The private banks would double the new-money equivalent of their lending and debt-reduction efforts, returning their net flows to slightly below the 1983-85 average. Some further expansion in direct investment would be expected, bringing the total increase to the \$15 billion needed to cut outward resource transfers by half. These objectives are feasible, although they would require an intensified commitment to the multilateral agencies (but not necessarily immediate increases in capital, except for the Inter-American Bank) as well as increased dynamism in new money arrangements, voluntary debt reduction, and club loans as well as other voluntary finance from the banks.

Above all, however, it will be the pursuit of sound economic

policies in the debtor countries themselves that will determine the feasibility of such a program. With poor policies, official donors will be unprepared to move ahead, and banks may allow arrears to build and set aside more reserves rather than provide additional new money or voluntary debt relief. With sound policies in debtor countries, there is every reason to believe that financing in the ranges shown in the table could be mobilized, and more broadly that most of the debtor countries will be able to achieve politically acceptable economic growth and moderate inflation while continuing to make progress in restoring external creditworthiness.

Table 1
Total External Debt, 1982 and 1987
(\$ billions and percentages)

	<u>1982</u>	<u>1987</u>	<u>Percent Change</u>
All Developing Countries	781.2	1,167.1	49.0
Highly Indebted	391.2	527.3	34.8
Other	392.1	639.9	63.2
of which:			
Algeria	16.7	22.9	37.1
China	8.4	30.2	259.5
Egypt	26.2	40.3	53.8
Greece	11.2	23.1	106.3
Hungary	9.0	19.0	111.1
India	25.6	46.4	81.2
Indonesia	26.5	52.6	98.5
Malaysia	11.3	21.7	92.0
Pakistan	11.6	16.3	40.5
Poland (a)	31.0	42.1	35.8
Portugal	13.6	18.2	33.8
Thailand	12.2	20.7	69.7
Turkey	19.7	40.8	107.1
Subtotal	223.0	394.3	76.8
Latin America			
World Bank	332.8	442.0	32.8
ECLA	331.0	410.5	24.0
Latin America-6 major			
World Bank	281.2	363.3	29.2
ECLA	285.1	331.3	16.2

a. Initial year is 1985.

Source: Calculated from World Bank, World Debt Tables 1988, Vol. II; ECLA, Balance Preliminar de la Economia Latinoamericana, 1987 and 1988.

Table 2
Capital Flows Under the Baker Plan: 1986-88
 (\$ millions)

	<u>Banks(a)</u>	<u>Public Sector</u>			<u>Total</u>	<u>Total</u>
		<u>Multilateral</u>	<u>Bilateral</u>	<u>IMF</u>		
Argentina	2,607	1,680	716	844	3,240	5,847
Bolivia	0	555	230	111	896	896
Brazil	4,000	1,556	-385	-2,032	-861	3,139
Chile	215	1,132	87	-3	1,216	1,431
Colombia	1,957	952	286	0	1,238	2,195
Costa Rica	0	134	-17	-146	-29	-29
Cote d'Ivoire	0	502	357	-226	633	633
Ecuador	0	858	264	-39	1,083	1,083
Jamaica	0	154	110	-327	-63	-63
Mexico	5,472	2,190	2,301	1,166	5,657	11,129
Morocco	0	949	553	-495	1,007	1,007
Nigeria	0	1,009	704	0	1,713	1,713
Peru	0	314	180	-52	442	442
Philippines	525	355	928	-185	1,098	1,623
Uruguay	0	174	-9	-113	52	52
Venezuela	0	145	-215	0	-70	-70
Yugoslavia	0	-59	-280	-1,171	-1,510	-1,510
Total	13,776	12,601	5,809	-2667	15,742	29,518

a. Disbursements under new money packages.

Source: World Bank, World Debt Tables 1988, Vol. I, p. ixliiii; Vol. II; IMF, International Financial Statistics, January 1989; and World Bank, by communication. Estimates include bank lending of \$4 billion to Brazil completed in late 1988.

Table 3
Capital Flows to Highly Indebted Countries, 1981-88
 (\$ millions)

Public Sector	1981	1982	1983	1984	1985	1986	1987	1988
Multilateral	2,719	3,881	3,069	4,522	3,997	5,150	3,370	4,082
Bilateral	3,158	1,719	2,539	1,525	697	1,158	1,919	2,738
IMF	1,213	2,110	6,517	3,334	1,686	-206	-1,384	-1,077
Total	7,000	7,710	12,125	9,381	6,380	6,102	3,905	5,743
Banks (a)	20,205	23,263	13,575	10,427	5,345	3,455	4,931	5,450
Total	27,205	30,973	25,700	19,808	11,725	9,557	8,836	11,193

Source: World Bank, World Debt Tables 1988, Vol. I, pp. xliii, 30-31 and by communication; table 2.

a. For 1981-82: net disbursements from "financial markets". For 1983-88: disbursements under new money packages.

Table 4

Annual Average Capital Flows to Highly
Indebted Countries by Period, 1983-91
(\$ billions)

	1983-85	1986-88	1989-91
Public			
Multilateral Banks	3.9	4.2	8
Bilateral	1.6	1.9	4
IMF	3.8	-0.9	2
Total	9.3	5.2	14
Private			
Banks	9.8	4.6	9
Direct Investment	14.5	8.1	10
Total	33.6	17.9	33

Source: Table 3; IMF, World Economic Outlook October 1988, p. 115
(for "non-debt-creating" flows).

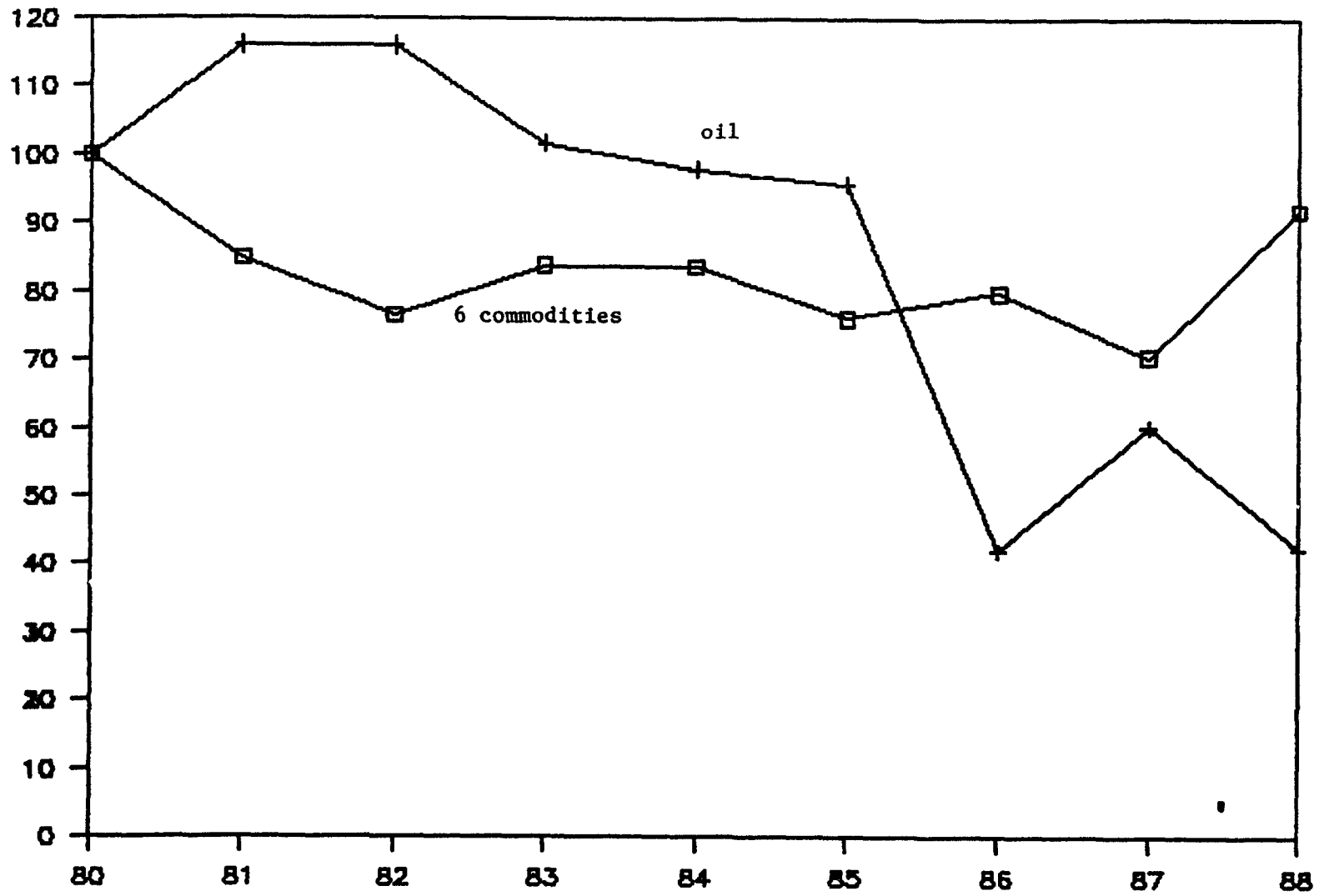


Figure 1
 Commodity Price Indexes for Latin American Exports
 (1980=100)

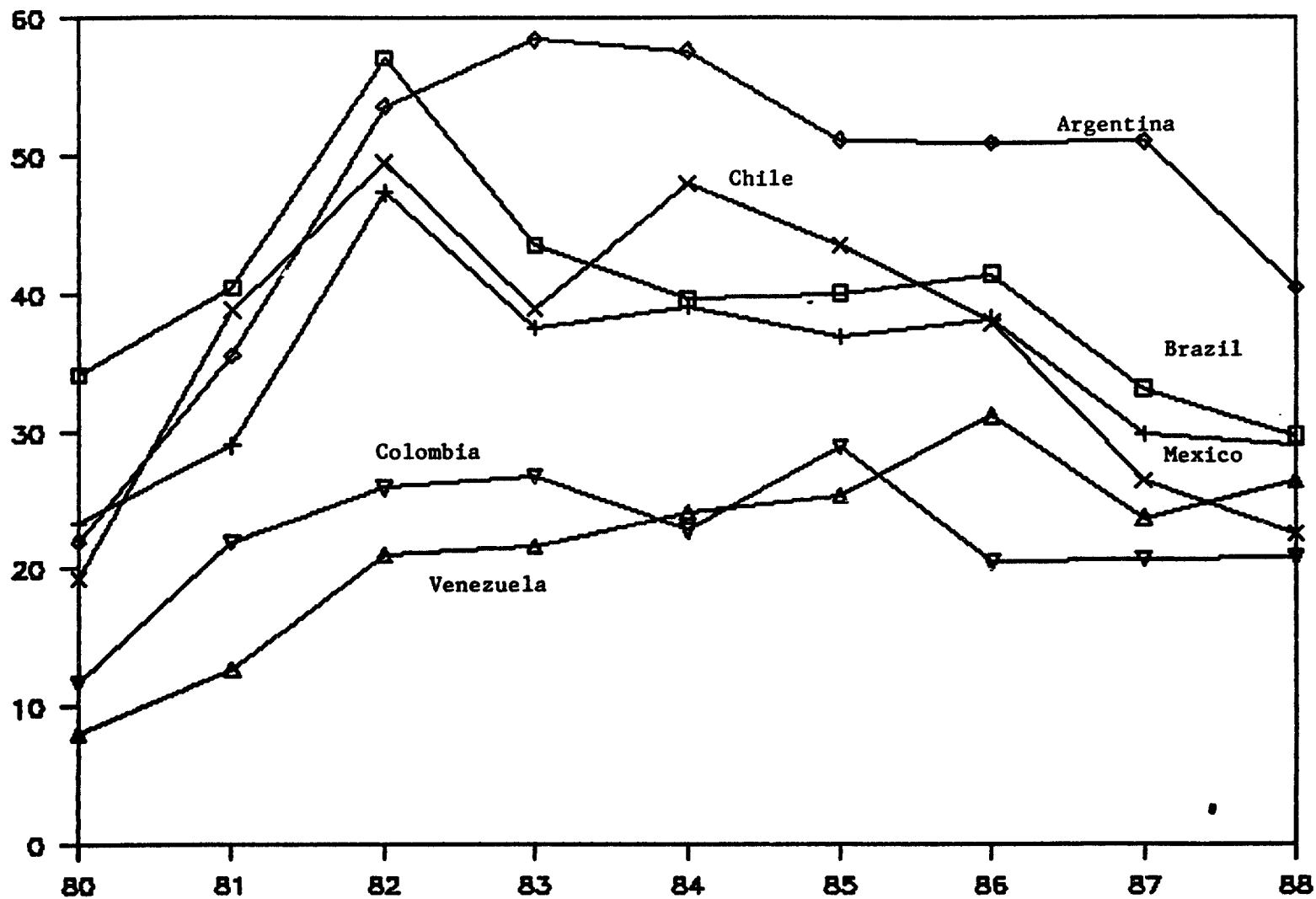


Figure 2
 Ratio of Interest Paid (Accrual Basis)
 to Exports of Goods and Services
 (percentages)

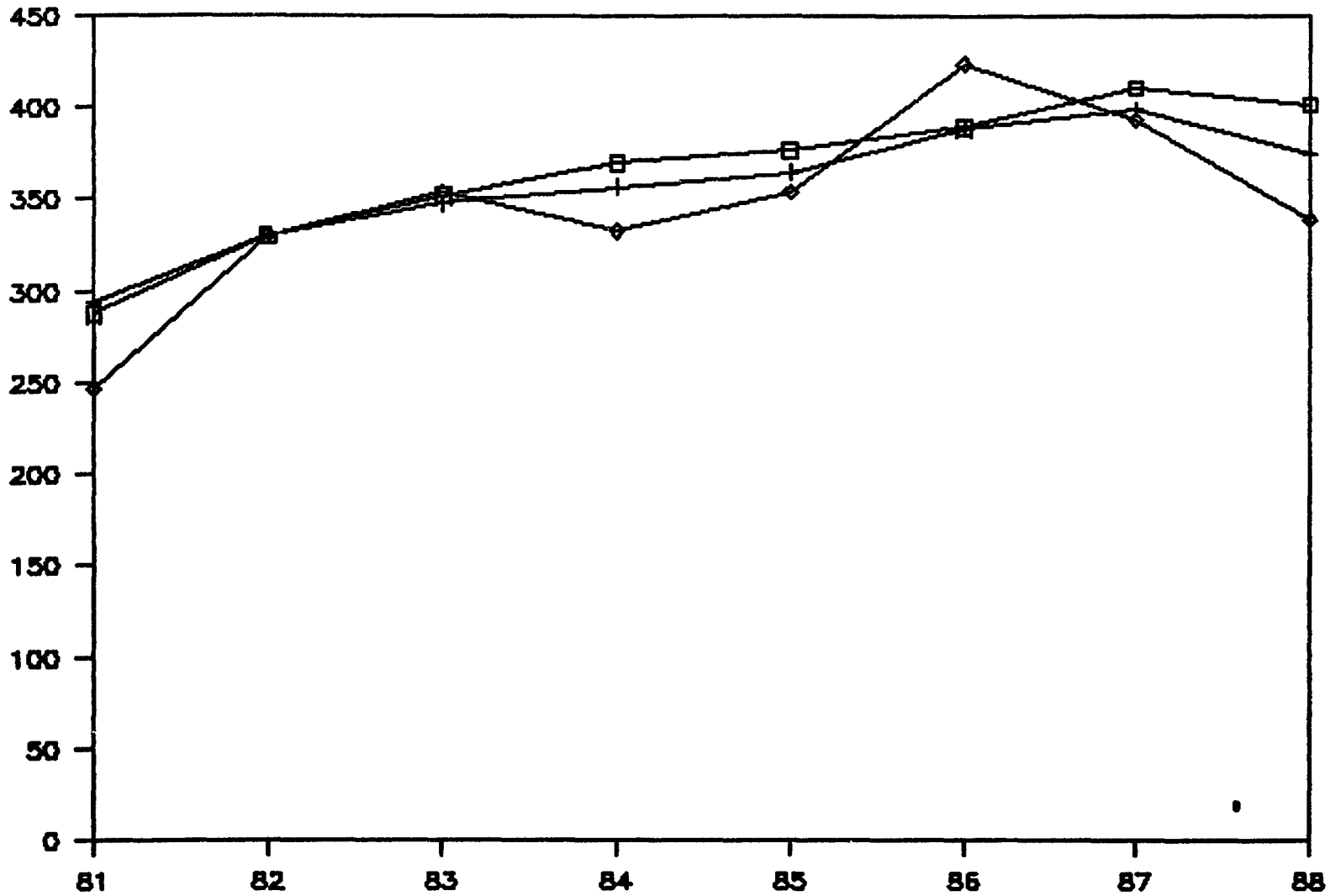


Figure 3
Latin America: Total and Relative Debt

- Nominal External Debt (\$ billion)
- + Real External Debt (\$ billion, 1982 prices)
- ◇ Debt/ Exports of Goods and Services (percent)

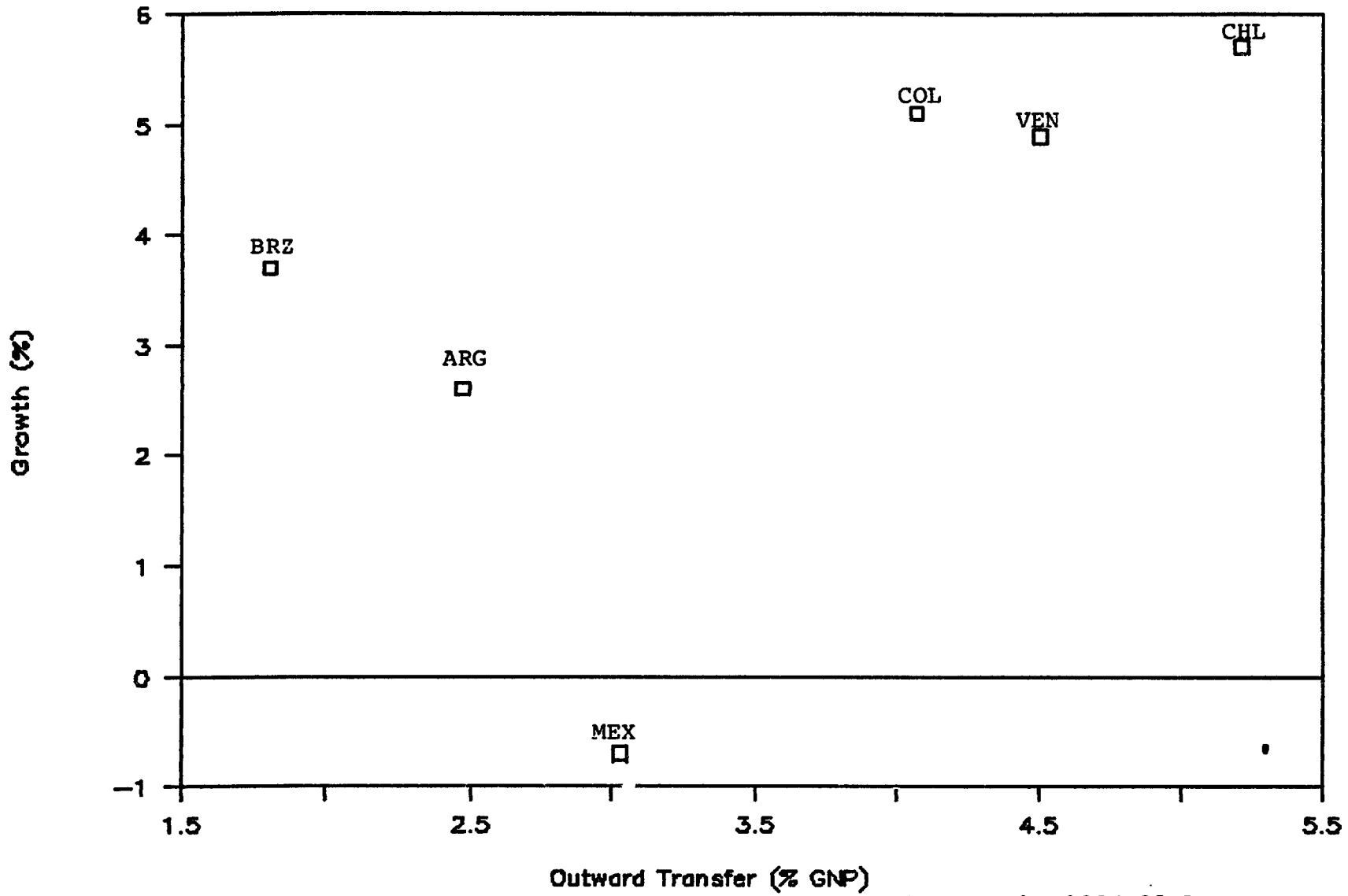


Figure 4 Outward Resource Transfers and Economic Growth, 1986-88 Averages
Six Latin American Countries

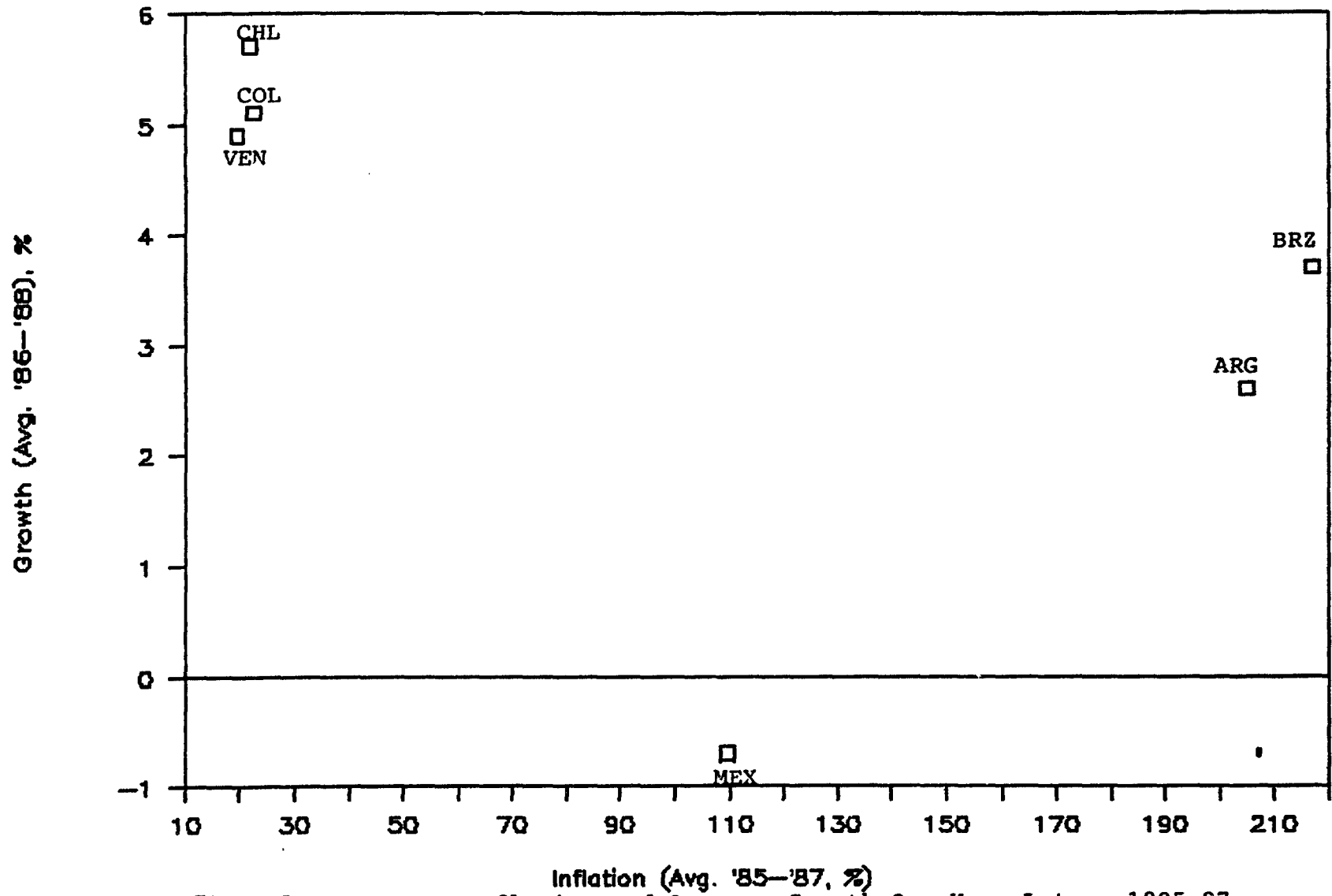


Figure 5 Average Inflation and Average Growth One Year Later, 1985-87
Six Latin American Countries

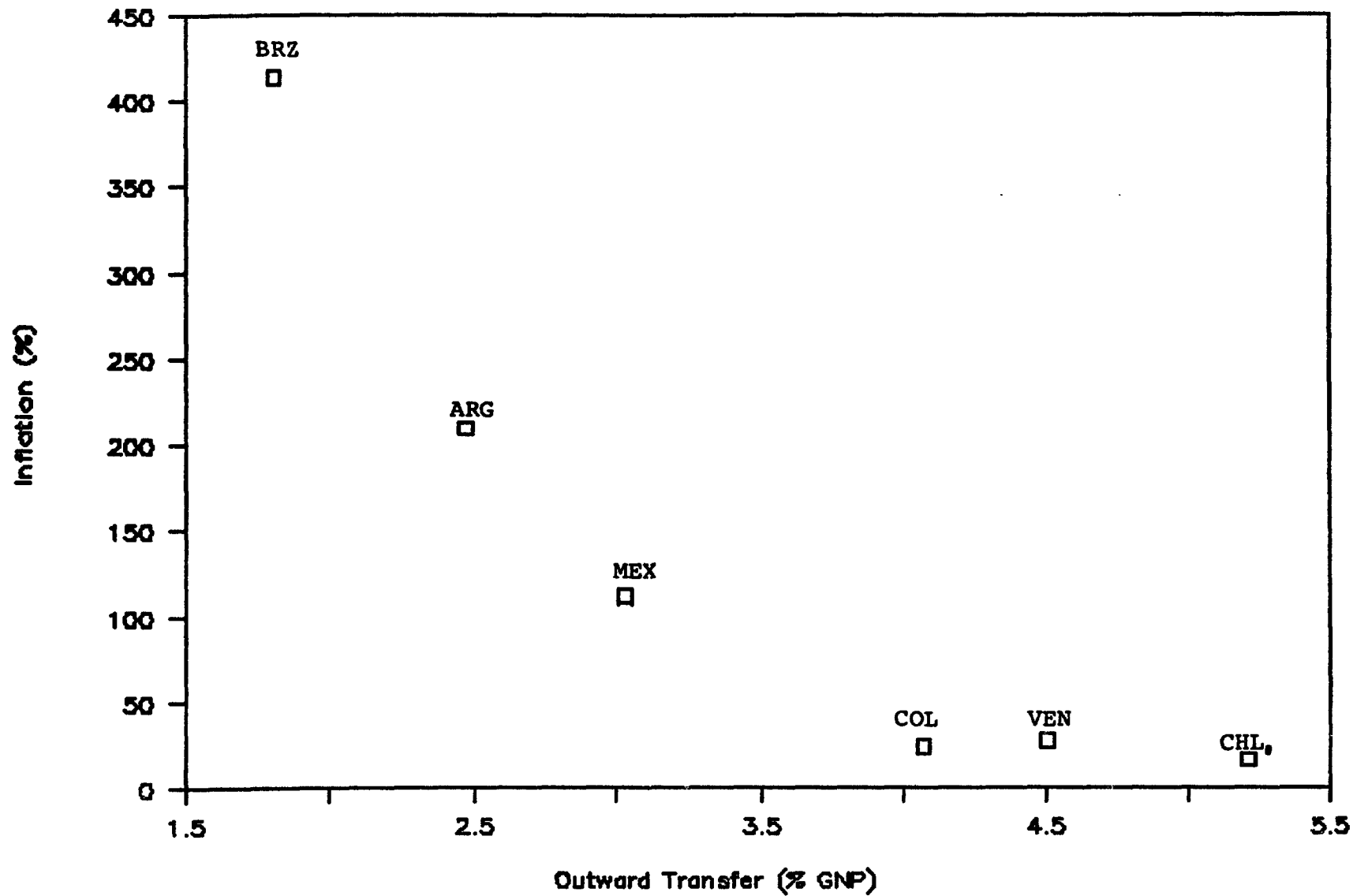


Figure 6 Outward Resource Transfers and Inflation, 1986-88 Averages
Six Latin American Countries

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