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8 Bolivian Debt Management, 1985–88

We saw in the previous chapter that the cutoff in foreign lending to Bolivia in the early 1980s, combined with heavy debt-service payments during 1982–84, was a key factor in provoking the Bolivian hyperinflation. The commercial bank debt payments were unilaterally suspended in May 1984 by the Siles government at the insistence of the COB, the trade union organization. When President Paz came to office, the key intention with respect to the foreign debt was to avoid a resurgence of inflation that could be caused by a return to heavy debt-service payments.

The Paz government began negotiations with its various creditors on a differentiated package of debt relief. With respect to the IMF and the World Bank, there was no prospect of debt relief via reschedulings, since those institutions do not reschedule their debts. Thus, the government attempted to arrange new credits that would offset the debt servicing, thereby leading to a net resource inflow from these institutions. With respect to the bilateral creditors, the intention was to get a fully negotiated postponement of interest and principal payments through a settlement in the Paris Club and to arrange for net new credits from friendly governments.

Finally, with respect to the commercial creditors, the goal was essentially to get a new kind of settlement on the debt that would eliminate Bolivia's debt overhang and obviate the need to makc cconomically and politically destabilizing net transfers to the bank creditors. In the event, Bolivia has maintained a suspension of interest servicing to the bank creditors since 1985 and negotiated a novel "debt buyback," which eliminated approximately one-half of Bolivia's commercial bank debt by the end of 1988.

In this chapter we analyze both the conceptual underpinnings and the nature of negotiations that led to the Bolivian buyback, as well as discuss briefly the nature of Bolivia's settlement with the other creditors.

The chapter continues in three sections. In the next section, we explain why a comprehensive debt reduction mechanism, such as a debt buyback, can be highly desirable for the creditors as well as the debtor. Then, we describe the negotiations and implementation of the Bolivian buyback and argue that, indeed, the arrangement has been of benefit to the creditor banks as well as to Bolivia. Finally, we briefly describe the favorable debt relief that has been achieved by Bolivia in negotiations with its other creditors.

8.1 The General Theory of Debt Reduction Operations

If a country owes $1 billion on which it can only pay an expected $50 million, the country may suffer enormous costs from being unable to pay the full amount due. It will face a great difficulty in new borrowing, even for highly productive investments.[1] It will face high bargaining costs in handling the $1 billion of bad debt.[2] And, it will face sanctions from disgruntled creditors (e.g., a withdrawal of trade credits) that will hinder its future economic performance.[3] In addition, there will be a major internal dis-incentive to economic reforms which increase the debt-service capacity of the country, since the costs of reform are borne by the country, while many of the benefits of reform will be appropriated by the creditors (who receive higher repayments in the event of reform).[4]

For these reasons, it may well be beneficial for the country to pay an amount even more than the $50 million (in present value terms), in order to cancel the overhang of $1 billion of mostly bad debt. It will also be generally advantageous for the creditors to accept a partial payment on the debt, as long as it is in excess of the $50 million expected payments. The partial payments could come in the form of a direct cash buyback (especially if the country can borrow the funds for the buyback from friendly governments) or some other arrangement where future debt payments of over $50 million are guaranteed by the debtor country. A cash-starved country would obviously prefer to find ways to make the present value of payments in the future, rather than with current cash.[5] By eliminating the overhang, the country would avoid the costs of default and regain the incentives for internal reform.

In practice, even mutually advantageous debt reduction schemes (in which the debtor clears the debt overhang and the creditors raise the total value of payments that they receive) are hard to negotiate under the current debt management strategy of the IMF and the creditor governments. There are several decisive reasons why even mutually beneficial deals have not taken place. First, the few very heavily exposed banks have an inherent incentive to reject buyback deals, even when they are efficient from the point of view of the banks as a whole (i.e., when they raise the market value of overall debt repayments).[6] Second, the U.S. government is the main arbiter of the kind of deals that take place, and it has vetoed almost all comprehensive debt reduction schemes, on behalf of the most-heavily exposed money center banks. Third, for the smaller countries, the debt negotiations are guided by the creditors' concerns over precedent for the large debtors, rather than for the efficiency of the outcome for the small debtor. It is generally best to "strangle" a little country, even at the expense of the country's debt servicing, if it sends a convincing signal to Brazil and Mexico to keep paying their debt.

8.2 The Bolivian Buyback

The Bolivian buyback must be understood against the following background. Bolivia was the only case up to 1988 in which the U.S. government actually supported a policy of debt relief, though it came to that position only after long and difficult negotiations with the Bolivian government.[7] The strategy has been highly beneficial for all parties, according to the theory of the "debt overhang" outlined earlier. Bolivia, alone of the high-inflation countries in the Southern Cone, has been able to stabilize and to resume growth because it has not been trapped by excessive debt repayments. There has also been a restoration of political stability in the country after the chaos and virtual anarchy of hyperinflation during 1984–85.

After the Paz government came to power in mid-1985 and undertook remarkable stabilization efforts to halt the hyperinflation, it remained official U.S. and IMF policy in the spring of 1986 that Bolivia should *resume* interest payments on its foreign bank debt. Indeed, in March 1986, only two months after price stability had been restored to the country, the IMF was urging a large devaluation in Bolivia in order to facilitate increased interest payments to the commercial banks. The Bolivian government was convinced that such a move, in addition to destroying the economic and political basis of the stabilization program itself, would cause a collapse of the government.

Instead, the Bolivian government urged a different approach in discussions with the U.S. government and the IMF.[8] Ultimately, the IMF agreed to treat the Bolivian case on its own merits and acknowledged that Bolivia's foreign bank debt could not be paid (at least, not without undermining economic and political stability in the country).[9] The IMF also agreed to grant Bolivia a program based on its successful stabilization efforts, despite the fact that the Bolivian government had not reached any understanding with the commercial bank creditors. This was the first time that the IMF loaned money to a debtor country that did *not* plan to make interest payments to the commercial banks (or even to clear the arrears on back payments).

In late 1986, the banks began to discuss with Bolivia a longer-term solution to Bolivia's debt overhang, once they saw that the U.S. government and the IMF were not going to defend the banks' position vis-à-vis Bolivia. Moreover, for several years, the U.S. regulators had been forcing writedowns of Bolivian debt in the banks' books, thereby eliminating any important incentives that the banks might have had to hold on to the debt. After two years of complicated discussions and legal work, the buyback was arranged. Note that during the entire period of discussions, Bolivia did not pay any interest to the commercial banks. At the same time, Bolivia received large net resource transfers (on the order of about 5 percent of GNP per year) from the official creditors.

As mentioned earlier, Bolivia repurchased with the buyback about one-half of its debt at 11 cents per dollar of face value. The money used for this purpose was donated from foreign governments. While some of the money might otherwise have come to Bolivia as foreign aid in other forms, much of it would not (of the $34 million spent on the buyback, Bolivia might have been able to get $15–20 million of the money in other forms of aid).

It might appear that the buyback could not have had much of a beneficial efficiency effect on Bolivia, since the country only repurchased one-half of the debt and the remainder still sells for 11 cents (indicating that most of the remaining debt also will not be paid, thus leaving Bolivia in a situation of default). But this abstract analysis misses the real point of Bolivia's situation post-buyback. Under current U.S. and IMF policy, Bolivia is not being pressed on the remaining part of the debt, except to settle that remainder on a similar basis to the buyback.[10] In effect, the official community is recommending a gradual process in which Bolivia will clear *all* of its commercial bank debts at a price of about 11 percent of face value, and the process seems to be occurring: after the buyback, Bolivia has continued to repurchase debt at the buyback price, through individual deals with creditor banks. Meanwhile, as this process goes forward, the official community has agreed not to impose sanctions on Bolivia for nonpayment on the remaining bank debt.

Was the debt strategy of the IMF and U.S. government successful in the case of Bolivia? The answer is a resounding yes, for *all of the parties concerned.* In effect, in 1986 the official community recognized the futility of trying to press Bolivia to pay unpayable debt. As a result, the Bolivian government got the time and international support to put in place a remarkably strong and effective stabilization program that has ended a hyperinflation and restored growth to the country for the first time in almost a decade. Bolivia's political stability has been enhanced, as have its democratic institutions. The creditors as a whole benefited as well, as shown by the fact that Bolivia's debt rose in value from 5 to 11 cents per dollar. This increase in the price of debt was not a giveaway by Bolivia.[11] It reflects, instead, the creditors' share of the remarkable turnaround of the Bolivian economy, from the worst in the world during the early 1980s (with the world's highest inflation in forty years) to one of stability and incipient recovery in 1988.

Bolivia's success story depended strongly on the supportive actions of the U.S. government and the IMF in providing a framework in which Bolivia could successfully negotiate with its bank creditors. Effective progress for other debtor countries will require similar *official* forbearance. As the Bolivian case has demonstrated, the debtor as well as the creditors (at least taken as a group) can benefit strongly from a realistic approach to comprehensive debt reduction.

8.3 Bolivia's Relations with the Official Creditors

The key to Bolivia's debt strategy has been to maintain good financial relations with official creditors while at the same time pursuing debt reduction with the banks. To this end, Bolivia has kept current in payments to the IMF, World Bank, and Inter-American Development Bank; negotiated two standby programs with the IMF for 1986–87 and 1987–88, and a three-year Structural Adjustment Facility with the IMF for 1988–90; negotiated several loans with the World Bank on concessional terms (from the International Development Association fund); and renegotiated the debt with the Paris Club on highly favorable terms in 1986 and 1988.

The result has been a *positive* net resource transfer from the official creditor community at the same time that Bolivia has had essentially a zero net resource transfer to the banks. The relevant data are shown in table 8.1, where we see that after the stabilization program went into effect in 1985, Bolivia succeeded in *reversing* the overall net resource transfer by an elimination of net outflows to the banks and a reversal from outflows to inflows from the official community.

Table 8.1 **Net Resource Transfers on Medium- and Long-Term Debt, 1982–87 ($ million)**

Type of Creditor	1982	1983	1984	1985	1986	1987
Official	71	14	−53	−86	195	81
Multilateral	56	45	1	−41	142	49
Bilateral	15	−31	−54	−45	54	33
Private	−132	−149	−49	−30	−11	−9
Suppliers	−7	−17	−2	−4	−3	−1
Financial markets	−125	−132	−47	−26	−8	−8
Total	−61	−135	−102	−116	184	72
Net transfer as % of GNP	2.0	−4.6	−3.4	−3.6	4.8	1.7

Source: World Bank Debt Tables, 1988–89 edition.

9 Beyond Stabilization to Economic Growth and Development

The Bolivian stabilization has eliminated much of the panic conditions that surrounded the hyperinflation in 1984 and 1985. Also, significant progress has been made in easing the external debt overhang. Virtually complete price stability has been reestablished in Bolivia during 1987 and 1988. It is evident, however, that many of the deeper problems in the Bolivian economy and society that helped to cause the hyperinflation remain in place, and in some cases have deepened. We now mention some of the challenges that remain in converting the current stabilization period into the first phase of sustained economic development.

The end of the hyperinflation did not bring a sudden rejuvenation of the economy. Real growth during 1987 and 1988, while positive, was not even enough to maintain real living standards. Indeed, it is fair to say that once the hyperinflation was lifted, Bolivia's desperate underlying situation became even more apparent.

We noted in the introduction that Bolivia has survived for hundreds of years on the exports of a few commodities: silver until the nineteenth century, tin during the twentieth century, and natural gas and (illicit) coca paste in the 1980s. None of these commodities can continue to act as the engine of growth of the Bolivian economy. Silver and tin deposits have been heavily mined, and remaining exploitation of these minerals will have to be on a smaller and much more technologically advanced basis. Tin mining in Bolivia had already become unprofitable at $5.60 per pound, the price that prevailed before the collapse of the world tin market in October 1985. At the post-collapse price of about $3.00 per pound, the Bolivian government was forced to lay off most of the tin miners, and Bolivia now stands little chance of maintaining significant amounts of tin exports.

Natural gas is almost as problematical. The price on Bolivia's natural gas exports to Argentina was slashed sharply after the collapse of world petroleum prices in early 1986. What is more, Bolivia's export contract with Argentina expires in 1992. In view of Argentina's recent large discoveries of natural gas deposits, it is quite possible that the gas contract with Bolivia will be suspended after 1992 or at least renegotiated on a much smaller scale.

Coca paste is the most problematical and ironical case of all. As mentioned in chapter 1, starting in the early 1980s, when U.S. demand for cocaine soared, Bolivia was pulled into the extensive cultivation of coca leaf, the raw material input of cocaine. The coca leaf is processed into coca paste, a precursor of pure cocaine, and is then smuggled to Colombia. In the mid-1980s, it was estimated by the U.S. Drug Enforcement Authority (DEA) that Bolivian foreign earnings on coca paste exports roughly matched the sum total of all legal Bolivian exports.

Bolivia has demonstrated a natural comparative advantage in coca cultivation. The climate of the Yungas and Chapare regions of the country are well suited to coca cultivation, and coca leaf has played an important role in the Andean culture for centuries. Illegal narcotics traffickers have demonstrated an enormous entrepreneurial activity in mobilizing resources into the sector, developing transportation and communications lines, etc.

And yet, of course, the industry has been a disaster for the country from almost all points of view. It has encouraged the development of an internal mafia, linked with an international mafia of traffickers. This internal mafia poses life-and-death risks for Bolivia's democratic institutions and civil society. Coca cultivation has jeopardized Bolivia's foreign relations with the United States and other industrialized countries.[1] It has thereby created enormous uncertainties, as the U.S. government has repeatedly threatened to suspend foreign aid and international support to Bolivia.

Coca production has also drained economic vitality from other economic sectors à la the "Dutch disease."[2] It has debilitated the tax system, since a "leading sector" is outside of normal tax collection.[3] Hundreds of thousands of well-organized (and in many cases well-armed) peasants now derive their meager livelihood from the cultivation of coca leaf, meaning that any plan for limiting coca cultivation must confront an enormous political and economic challenge from a large part of the population. Despite all of this, the Bolivian government has devoted a large share of its scarce resources and political capital to reducing coca cultivation and trafficking.[4]

For these reasons, Bolivia must now develop a new export base, indeed a completely new economic orientation, one that is a radical departure from its entire past history. As the planning minister, Gonzalo Sanchez de Losada, has said many times, "Bolivia must reinvent itself." The basic strategy is to follow the lead of the outward-oriented developing countries: make the environment fertile for new exports, and then wait to see which industries respond to the incentives. Few observers could foresee that Chile's brisk growth in recent years would be based on kiwi exports or that Korea's export surge in the 1960s would be initiated with the export of wigs to the U.S. market! The key policies for promoting the new export base in Bolivia are a realistic exchange rate, an open trading system, and—budget permitting—fiscal incentives for nontraditional exports. Bolivian export potential seems to be greatest in three broad areas. First, there is obvious potential in agricultural exports. The Bolivian lowlands in the East offer a vast and fertile area for grains (e.g., soybeans), tropical fruits, cut flowers, timber, etc. Bolivia has already begun to make soybean exports to world markets since the mid-1980s. Second, there is the potential for light manufacturing (e.g., yarns, textiles, furniture), especially for export to the Brazilian market. In July 1988, Brazil and Bolivia signed a new trade accord to open up some of the Brazilian market to new Bolivian goods. Third, there is the remaining potential in the mining and petroleum sectors. With new technologies for secondary recovery, some old silver and tin mines might once again become profitable. There also remains the potential, long under discussion, for a natural gas pipeline to Brazil.

All of these new industries will require time, learning, and, above all, heavy investment expenditure. In turn, the investments must be predicated on a long period of social peace and political stability. Whether that stability can be achieved is certainly Bolivia's most important question. There remain three sociopolitical cleavages that are serious obstacles to economic stability and long-term growth: income distribution, ideology, and region.

The income distributional cleavage remains profound and is the source of considerable political conflict. The key political problem is to moderate the nearly continuous confrontation between powerful social groups, such as organized labor and private capital, and the various regional forces. The state-capitalism model attempted to finesse the income distribution problem through a combination of the inflation tax, heavy foreign borrowing, or internal repression of the lower classes. None of these alternatives is workable for a long-term development strategy.

A key to a more equitable distribution of income in Bolivia is an increased tax burden on the higher income individuals. Rather than balancing the budget by eliminating the basic services of the state, such as health and education, considerations of equity and stability require that the government make increased efforts to secure an adequate tax base on the higher incomes. This might include a tax on land holdings and higher taxes on luxury consumption goods. A second key to a more equitable distribution of income would be greater public spending on education in the rural sector, where most of Bolivia's poorest citizens live. Investment in the human capital of the rural peasantry is essential for long-term economic development.

The second division to overcome is ideological, involving competing conceptions of the role of government. With the evident failures of state capitalism in the past two decades, there is a temptation on one side for a strict laissez-faire economic approach and, on the other side, for a fortified socialism. A more modulated approach is more likely to succeed. Such an approach would recognize the government's responsibilities for infrastructure and social investments in health and education, but also recognize the limitations to the role of the state in the productive sector. Part of the push toward laissez faire in Bolivia is a frank acknowledgement of the limited capacity for honest, capable public administration in the country. But this limitation could be lessened by a concerted effort to raise the standards and capacity of the state bureaucracy. A determined effort at improved training of civil servants is vital in this regard.

The third division is sectoral and regional. As we have noted, export diversification will require a change in emphasis to agriculture and light manufacturing, which in turn will surely entail some geographical shift in the locus of economic activity from the highlands to the lowlands. This kind of shift can be politically bruising and destructive if not handled with foresight and planning. The government will have to tread carefully between goals of allocating investment expenditures heavily toward the new sectors and regions, and the need to distribute the burdens and benefits of public spending in an equitable manner.