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4 Developing Country Debt

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International Policy Coordination: The Case of the Developing Country Debt Crisis

4.1 Introduction

The LDC debt crisis has differed from other problems in the world economy in an important and fascinating way. From the beginning of the crisis, all leading governments have acknowledged the need for an activist and internationally coordinated policy response. Even the ostensibly laissez-faire Reagan Administration went swiftly into action in August 1982 when the global debt crisis exploded with Mexico's announcement that it would be unable to meet its international debt service obligations. Within days, the U.S. government arranged for billions of dollars of emergency financing for Mexico. Since then, the U.S. government has taken the lead in managing the international response to the crisis, a response that has called for the coordinated actions of the leading creditor governments, the debtor governments, the international banks, and the multilateral financial institutions.

The management of the crisis has been only a partial success. On the positive side, the dire predictions of pessimists in 1982 have not come to pass: the countries with the largest debts have serviced their debts and not defaulted; the international commercial banks have remained solvent; the international capital markets have continued to function and, indeed except for the debtor countries, have expanded in their scope and functions; and the world has not fallen into a default-induced depression. These favorable outcomes resulted in significant

part from the actions of policymakers at key junctures in the past five years.

On the other hand, the economic results for most of the debtor countries have been poor. Economic development for hundreds of millions of people has been halted or partially reversed. The long-term adequacy of the current debt strategy therefore remains very much in doubt, despite the success to date in avoiding a financial crisis. Contrary to the forecasts of the IMF, the creditor governments, and the commercial banks, the debtor countries have enjoyed neither sustained recovery nor renewed access to market lending under the current rules of the game. In some countries, the economic situation has become so desperate that governments have been forced into unilateral moratorium on debt servicing, even at the cost of a serious rupture of international financial relations.

This mix of success and failure is related to the kind of international policy coordination advocated and managed by the United States in recent years. The U.S. government and the other leading creditor governments (including the United Kingdom, Japan, and Germany) have worried more about continued debt servicing to the commercial banks than about the pace of economic development in the debtor countries. By opting to use their political and economic influence to bolster their banks' positions, the creditor governments have been able to sustain the flow of debt payments from the debtor countries, but often at very high economic and political costs to the debtor countries themselves.

The policy emphasis on debt servicing to the commercial banks is not surprising and was certainly not inappropriate in the first couple of years of the debt crisis. The threat of insolvency of the world's largest commercial banks was the most serious problem raised by the debt crisis at its inception. As shown in the data of table 4.1, the LDC exposure of the largest U.S. commercial banks greatly exceeded 100 percent of bank capital at the end of 1982. The same is apparently true of the largest banks in Europe and Japan, although data on bank exposures and bank capital are not generally available outside of the United States. Widespread debt repudiations could have easily triggered a global banking crisis, and it was not unreasonable for policymakers to fear that such a crisis could have pushed the world from a deep recession into a deep depression.

Moreover, various analyses suggested that if the short-term problems of the debt crisis could be contained, then most of the debtor countries had the longer term capacity to resume debt servicing and to restore economic growth, a viewpoint which has been bolstered by the continuing decline in world interest rates. Most of these analyses also stressed, however, the need for a continuing flow of new capital into

Table 4.1 U.S. Bank Assets in the Debtor Countries (nine major banks)

	End-1982	Mid-1984	March 1986
Total Exposure ($ billion)			
All LDCs	83.4	84.0	75.6
Latin America	51.2	53.8	52.2
Africa	5.6	4.9	3.6
Exposure as Percent of Bank Capital			
All LDCs	287.7	246.3	173.2
Latin America	176.5	157.8	119.7
Sub-Saharan Africa	19.3	14.3	8.1

Source: Federal Financial Institutions Examination Council, "Country Exposure Lending Survey." End-1982 figures from statistical release of October 15, 1984; March 1986 figures from release of August 1, 1986. Exposures are calculated using data for "total amounts owed to U.S. banks after adjustments for guarantees and external borrowing." Total exposures are calculated for all LDCs (OPEC, non-oil Latin America, non-oil Asia, non-oil Africa); Latin America (non-oil Latin America plus Ecuador and Venezuela); and Africa (non-oil Africa plus Algeria, Gabon, Libya, and Nigeria).

the debtor countries, a need which was widely recognized by policymakers but which has not been satisfactorily satisfied.

In the past two years, the nature of the debt management has provoked increasing opposition in the debtor countries, since the debtor countries have been making large sacrifices but without renewed growth, and since the spectre of a global banking crisis has lessened. Moreover, the worldwide drop in commodities prices since 1985 worsened the economic situation in many of the debtor countries, as did a further drying up of bank lending. Several smaller debtor countries have recently rejected the international rules of the game and have unilaterally restricted debt servicing, Peru being the best-known case. The threat of a breakdown in continued debt servicing led U.S. Treasury Secretary James Baker III to propose the "Baker Plan" in October 1985, which called for increased inflows of private and official capital into the debtor countries in return for internationally supervised policy adjustments in those countries. However, more than a year after the announcement of the Baker Plan, there is little evidence of a renewed flow of private foreign capital into the debtor countries.

This paper reviews the management of the debt crisis to date and considers several possible alternative approaches for international cooperation in the future. Section 4.2 briefly reviews the scope of the crisis and some of the reasons for its onset. Section 4.3 describes the internationally coordinated policy responses to the crisis. Section 4.4 describes the conceptual underpinnings of this coordinated response, and section 4.5 then describes some of the reasons for the incomplete

success of the policy response. Section 4.6 discusses several alternative measures for the future. Conclusions from the paper are summarized in section 4.7.

4.2 The Scope and Origins of the LDC Debt Crisis

The basic outlines of the LDC debt crisis are by now very well known, so only a brief summary of the onset of the crisis will be needed here.[1] Spokesmen in the developing countries sometimes insist that the debt crisis arose solely because of global economic dislocations, while creditor country policymakers sometimes suggest that mismanagement by the debtor countries is entirely to blame for the crisis. The truth is of course somewhere in the middle. The fact that more than forty countries simultaneously succumbed to crisis suggests that global factors were crucial to the onset of the crisis. But the fact that many countries affected by global shocks avoided a crisis (e.g., most of the debtor nations in East Asia) highlights the importance of country-specific factors, often involving important policy mistakes, in the onset of the crisis. We turn first to the global factors in the crisis, then to the mistakes of economic management in the debtor countries themselves.

4.2.1 Global Factors in the Onset of the Crisis

After the bond defaults of the Great Depression, international commercial lending to the developing countries virtually disappeared until the development of cross-border commercial bank lending in Eurodollars in the late 1960s.[2] During the period 1950 to 1970, foreign direct investment provided the bulk of international private capital flows, and private capital flows as a whole were smaller in magnitude than official flows from the multilateral institutions and from individual creditor governments. In the early 1970s, private capital flows to the developing countries began to exceed official flows, as private bank lending rose to become the dominant form of international capital flow. The sharp rise in world liquidity during 1971–73, related to overly expansionary U.S. monetary policies and the demise of the fixed exchange rate system, contributed to the expansion of the Eurodollar market and to an increase in bank funds available for lending to developing countries. Thus the rise in international bank lending predated the first OPEC oil shock of late 1973.

The first OPEC shock in 1973 dramatically increased the pace of LDC bank lending, as the new savings of the Persian Gulf countries were channeled to the international commercial banks, which lent (or "recycled") these savings to the developing countries. This burst of lending was not simply the result of oil-importing countries trying to maintain their real consumption levels after the rise in oil prices, as is

sometimes suggested. Indeed, many oil *exporting* LDCs outside of the Persian Gulf (i.e., countries such as Mexico and Nigeria) borrowed substantially from the international banks, so that by 1983, after the enormous rise in real oil prices during the previous decade, the top ten developing country debtors, as a group, were oil exporters.[3]

Most of the international lending during this period was undertaken by *official* borrowers (i.e., central governments, public sector development banks, parastatals, etc.) rather than by the private sector, though the proportion of public and private borrowing differed by country. In many cases, the borrowing was used to finance ambitious public sector investment programs that could now be funded with readily available international bank credits at low real interest rates. The strategy of a rapid growth takeoff, based on foreign financing of large-scale public investments, has been termed "indebted industrialization" by Friedan (1981), who has studied the politics of this strategy in some detail in the cases of Brazil, Korea, and Mexico.

An idea of the share of public and private borrowing can be gleaned from the *World Bank Debt Tables*, which separates public sector and publicly guaranteed borrowing from private sector borrowing (the World Bank data refer only to medium-term and long-term debt, since the data do not provide a breakdown of the short-term debt by kind of borrowing). For Latin America as a whole, about three-fourths of all long-term borrowing at the end of 1978 and also at the end of 1983 was public or publicly guaranteed. Note that this ratio might be biased upward to some extent because debts contracted by the public sector are probably more completely covered by the World Bank Debt Reporting Service than are debts contracted by the private sector.

The fact that the external debt is heavily concentrated in the public sector has had profound implications for adjustment to the debt crisis by the debtor countries. As I stress later, these countries have two fundamental problems to overcome. The first, and most widely recognized, is that of transferring national income (via trade surpluses) to the foreign creditors. The second problem, which is perhaps as difficult, is that of transferring income from the *private* sector of the debtor country to the *public* sector so that the public sector may service its debts. In many countries, the nation as a whole does not lack the resources to pay the foreign creditors, but rather the public sector is unable or unwilling to tax the private sector sufficiently to generate an adequate debt-servicing capacity.

As of 1979 the pace of international lending did not seem to pose a particular danger to the banks or to the world economy. Various debt indicators, such as the popular debt-export ratio, gave very few signs of danger. Exports from the borrowing countries were booming, so that debt-export ratios (table 4.2[d]) actually fell between 1973 and

Table 4.2 **Trade, Interest Rate, and Debt Indicators for the Developing Countries**

		1978	1979	1980	1981	1982	1983	1984	1985
(a)	Interest Rates[a]								
	Nominal	8.2	11.2	13.1	18.3	14.4	9.5	11.3	9.6
	Inflation	7.3	8.8	9.1	9.6	6.5	3.8	4.1	3.3
	Real	0.9	2.4	4.0	8.7	7.9	5.7	7.2	6.3
(b)	Trade Volumes and Values (annual change for nonfuel exporters)								
	Exports:								
	Volume	9.4	8.4	9.1	6.5	0.7	8.3	11.7	3.4
	Price	5.5	17.3	13.5	−2.6	−5.9	−4.4	0.5	−3.3
	Earnings	15.4	27.1	23.8	3.7	−5.2	3.5	12.2	0.0
	Imports:								
	Volume	8.9	9.3	6.5	1.5	−5.5	1.6	5.2	3.3
	Price	9.8	18.7	20.6	2.8	−3.3	−4.6	−1.0	−2.1
	Earnings	19.5	29.8	28.4	4.4	−8.7	−3.1	4.2	1.1
	Trade Balance ($ billion)	−34.8	−50.1	−75.0	−80.2	−62.7	−41.9	−19.9	−23.7
(c)	Trade Volumes (annual change) and Trade Balance for Western Hemisphere LDCs								
	Export Vol.	9.6	7.5	1.2	6.1	−2.2	7.1	7.3	−1.2
	Import Vol.	5.5	8.0	9.3	2.6	−17.7	−22.2	2.9	−1.3
	Trade Balance ($ billion)	−4.0	−0.8	−1.9	−3.2	7.2	28.7	37.0	33.6

		1973	1978	1979	1980	1981	1982
(d)	Debt Indicators for Non-Oil Developing Countries (ratios in percent)						
	Debt ($ billion)	130.1	336.3	396.9	474.0	555.0	612.4
	Debt/Exports	115.4	130.2	119.2	112.9	124.9	143.3
	Debt Service/ Exports	15.9	19.0	19.0	17.6	20.4	23.9
(e)	Debt Indicators for Western Hemisphere LDCs						
	Debt ($ billion)	44.4	114.3	135.1	154.7	192.6	208.9
	Debt/Exports	176.2	211.5	192.9	178.4	207.9	245.6
	Debt Service/ Exports	29.3	41.7	40.9	35.6	41.7	54.0

Source: IMF, *World Economic Outlook,* April 1986.

[a]Nominal interest rate is a three-month U.S. interest rate. Inflation is the annual change in the GDP deflator. The real interest rate is the nominal rate minus inflation.

1980 despite the jump in total debt of the non-oil developing countries (hereafter NOLDC's) from $130.1 billion in 1973 to $474 billion in 1980. With this happy state of affairs, international financial specialists, academics, and policymakers welcomed the continued "recycling" of OPEC money and worried little about a debt crisis.

The key to this happy state of affairs was that nominal interest rates on dollar loans were consistently below the rate of growth of dollar export earnings of the borrowing countries (or, to put it another way, real interest rates were consistently below the rate of growth of *real* export earnings). In 1979, for example, as shown in table 4.2(a) and (b), nominal U.S. interest rates averaged 11.2 percent, while the export earnings of the LDC nonfuel exporters grew by 27.1 percent. In these circumstances, a debtor country can borrow all the money that it needs for debt servicing (i.e., all of the interest and amortization due) without experiencing a rise in its debt-export ratio.[4]

However, if nominal interest rates exceed the growth of nominal export earnings, then a country that borrows all the money it needs for debt servicing will experience an ever-increasing debt-export ratio. Sooner or later, the country will be cut off from new borrowing, and it will have to pay for its debt servicing out of its own resources (i.e., by running trade surpluses). With nominal interest rates in the mid-to-late 1970s at 10 percent or so, and with LDC export earnings growing at more than 15 percent per year in dollar terms, debt-export ratios were easily kept under control. Very few observers suspected that in the near future the debtor countries would suddenly have to shift from *new borrowing* to *trade surpluses* as the way to meet their debt-servicing needs.

The second, devastating phase of international borrowing took place in 1980–82, after the heady and highly profitable experience of 1973–79. Almost none of the relevant actors, neither borrowers nor lenders (nor, it should be said, academic observers) understood quickly enough that the success of the first period was built squarely on the temporary condition of low interest rates and high growth in export earnings. Prudent debtors and bankers should surely have expected that within a few years interest rates might rise to exceed growth rates, but few could have anticipated the sudden and dramatic turnaround in the interest rate/earnings growth relation after 1980, which is shown in figure 4.1 and in the data of table 4.1.

The debt crisis followed relentlessly upon the rise in interest rates and the collapse in export earnings. Once this reversal took place, all of the debt warning signs started to fly off of the charts, as seen by the rapid increase in the debt-export and debt-service ratios after 1979 (table 4.2[d] and [e]). Bank lending itself dropped off, with gross Bank for International Settlements (BIS) claims on the NOLDCs rising at

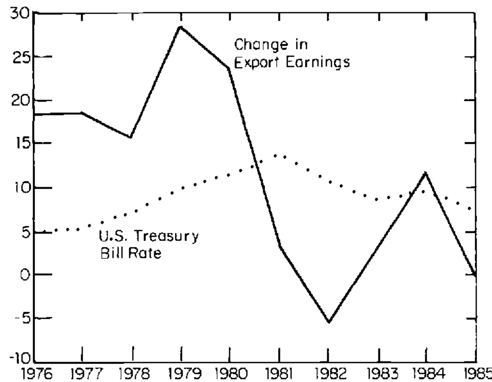

Fig. 4.1 Interest rates and annual percentage change in non-oil LDC export earnings. *Source:* 1976–79 "non-oil" LDCs export value growth, year over year, from IMF, *World Economic Outlook*, June 1981; 1980–85 "non-fuel exporter" LDCs export value growth, year over year, from the IMF, *World Economic Outlook*, April 1986. Interest rates are U.S. Treasury bills, 3-month.

the rate of 24 percent in 1980, 18 percent in 1981, and 7 percent in 1982, but the growth in export values declined even more sharply, from 26 percent in 1980, to 5 percent in 1981, and −4 percent in 1982. Consequently, the debt-export ratio rose quickly.

As is well known, the rise in interest rates had an especially pronounced effect because of the nature of the LDC debt to the commercial banks, most of which was in the form of medium-term (generally three to seven years) rollover credits, with interest rates at a fixed spread over a short-term reference rate (such as the London Interbank Offered Rate [LIBOR], or the U.S. prime rate). Thus, just as soon as short-term interest rates rose at the end of 1979, the interest rates charged on the existing syndicated bank loans to the LDCs rose by the same amount. Also, since the great bulk of the debt was dollar denominated, the rise in the dollar exchange rate (and the consequent fall in dollar prices of internationally traded commodities) was especially painful.

The reasons for the rise in interest rates and fall in the dollar value of trade have been widely discussed. After the second OPEC price shock, the leading industrial countries embarked on a widely endorsed policy of rapid disinflation, based on very tight monetary policies which raised interest rates around the world. No international organization, not the IMF nor the World Bank nor the OECD, gave any hint at the time that the suddenness and sharpness of the monetary tightening would be problematic. To the contrary, international officials everywhere applauded the seriousness of purpose of the anti-inflation fight.

The rise in interest rates was particularly large in the United States in 1981 and after, because in addition to tight monetary policies there was the prospect of many years of large budget deficits caused by the tax cuts of 1981. As is now well understood, the especially high U.S. interest rates created a capital inflow into the United States and a sharp appreciation of the dollar.

4.2.2 The Role of Domestic Policies in the Onset of the Crisis

Without the global shocks, the debt crisis would not have occurred. However, in almost all countries that succumbed to an external debt crisis, domestic policy mistakes also played an important role, a point which makes commercial bank lending (especially after 1979) harder to understand, since the banks should have seen some of the policy disarray in these countries. Some economies that faced severe external disturbances, such as South Korea and Thailand, were able to surmount the shocks and maintain international creditworthiness and growth, at least after a short interval. Other economies, which actually could have benefited on balance from the external events, such as the oil-exporters Mexico, Nigeria, and Venezuela, collapsed under the weight of higher world interest rates. What were the crucial differences that led to successful adjustment in some cases but not in others?

In a recent paper (Sachs 1985), I explored some of the possible differences by looking at the experiences of the Latin American and the East Asian debtor countries. Among the major Latin American countries, all but Colombia succumbed to a foreign debt crisis (as indicated by the need for a commercial bank debt rescheduling and by the exclusion from continued borrowing on normal market terms), while in Asia all of the countries avoided the need for a bank rescheduling with the exception of the Philippines. Interestingly, the differences in experience were not fundamentally due to the differences in the *size* of the external shocks hitting the two regions. As an example, Mexico's debt crisis arose despite a nearly fourfold increase in export earnings (due to oil) during 1978 to 1982, so that Mexico benefited rather than suffered from the commodity price movements in the years preceding the debt crisis. Rather, as stressed also by Balassa (1984) among others, the orientation of trade policy and exchange rate policy was vital. Countries with export-promoting trade policies were far more successful in surmounting the external shocks. And, not sufficiently stressed in the 1985 paper, the short-run policy responses after 1979 were vital: a quick reaction to the change in the international environment was necessary for a successful adjustment.

The key economic difference in the two regions is the rapid export growth in Asia, which kept down that region's debt-export ratios. The export-orientation of the Asian economies, in contrast to the import-

substitution strategy in Latin America, is well known and well documented. It should be stressed that the export orientation of the Asian countries is decidedly a matter of policy choice rather than inherent structure, since two of the leading examples of export-led growth (South Korea and Indonesia) went through a Latin-American-styled, import-substitution phase in the late 1950s and early 1960s, with the result that exports were stifled and growth was retarded. Incredibly, South Korean exports were a mere 3 percent of GNP in 1960, compared with 37 percent of GNP in 1983. Indonesian exports rose from 5 percent of GNP in 1965 to 23 percent of GNP in 1983!

In addition to the question of long-term economic policy orientation, the external shocks imposed serious challenges for short-run policy after 1979. The rise in world interest rates placed direct and significant pressures on government budgets because of the rise in debt-servicing costs on both foreign and domestic debt (domestic debt in most countries experienced a rise in interest rates in response to the rise in world rates). It also provoked capital outflows and reserve losses in countries with fixed exchange rates (virtually all of the developing countries at the time). Exports dropped as world trade slowed, and investments fell in response to higher interest rates. Thus aggregate demand and employment tended to fall, at the same time that deficits were rising and foreign reserves were falling. The freedom of action for both monetary and fiscal policy was therefore extremely limited.

In Asia, budget deficits were kept under control and exchange rates were devalued after 1979 in response to these shocks (remarkably, Indonesia took a preventative devaluation to spur non-oil exports in 1978, in the belief that oil exports would remain weak). Starting from a diversified export base, these policy changes in Asia caused a fairly quick rise in the region's export volumes. Also, both policies helped these countries to avoid the problem of capital flight, which tends to occur in anticipation of a currency devaluation, an anticipation that in turn is naturally raised by large budget deficits.

In Latin America, the story is almost the opposite. In almost all of the countries concerned (certainly including Argentina, Bolivia, Chile, Mexico, Uruguay, and Venezuela) the exchange rate was allowed to become substantially overvalued during 1979 to 1981, with the result that export growth in the early 1980s was meagre. Brazil was the important exception to the exchange rate overvaluation, and it alone enjoyed an export boom between 1981 and 1984. To the extent that the Latin American governments endeavoured to maintain economic growth, they did so mainly through expansionary fiscal policy, which exacerbated the budget deficits that were already bulging because of higher interest payments on home and foreign debt. Money financing of the budget deficits increased in many countries, with the result of enormous

capital outflows and reserve losses during 1981 and 1982. After the reserves and access to borrowing ran out in 1982, the continuation of money-financed deficits led to sharp currency depreciations and an explosion of inflation (with triple-digit inflations in Argentina, Bolivia, Brazil, Peru, and now, in 1986, Mexico).

The data in table 4.3 show the differences in real exchange rates of the two regions (vis-à-vis the U.S.) during the years building up to the crisis. The real exchange rate is measured here as the country's consumer price level relative to the U.S. consumer price level, adjusted for exchange rate changes. A value above 100 signifies a real appreciation after 1978, implying that the country's goods and labor became relatively expensive in international markets. The results of these exchange rate policies are reflected in the superior export performance of the Asian economies, as shown by the annual changes in export volumes during 1980–84 (IMF, *World Economic Outlook,* 1986, p. 205):

	1980–84 (Avg.)	*1980*	*1981*	*1982*	*1983*	*1984*
Latin America	*3.9*	*1.2*	*6.1*	*−2.2*	*7.1*	*7.3*
Asia	*8.6*	*9.2*	*9.3*	*0.5*	*10.1*	*14.0*

4.2.3 The Collapse of Bank Lending in 1982

The warning signs of impending crisis were everywhere in 1981 but were virtually ignored. World interest rates were at historic highs and international trade was stagnant. Several countries, including Bolivia, Jamaica, Peru, Poland, and Turkey were already in serious debt difficulties by the end of 1980. By the end of 1981, massive capital flight

Table 4.3 Real Exchange Rate Behavior, Selected Countries (1978 = 100)

Year	1978	1979	1980	1981	1982	Average (1980–81)
Latin America						
Argentina	100	141	179	138	59	159
Brazil	100	92	76	80	77	78
Chile	100	102	116	126	100	121
Mexico	100	106	117	127	85	122
Venezuela		101	108	114	118	112
	100					
East Asia						
Indonesia	100	78	81	81	80	81
Malaysia	100	99	93	87	86	90
South Korea	100	106	96	94	89	95
Thailand	100	101	104	99	93	102

Source: IMF, *International Financial Statistics.*

Note: The real exchange rate is calculated as P/EP^*, where P is the CPI, E is the exchange rate in units of currency per \$US, and P^* is the U.S. CPI. A rise in the index signifies a currency appreciation.

was occurring in Argentina, Mexico, and Venezuela as unrealistic exchange rates came under attack, and as large domestic budget deficits (particularly in Argentina and Mexico) fed a rapid increase in the money supply. According to one estimate, by the end of 1983, cumulative capital flight accounted for 61 percent of Argentina's gross external debt, 44 percent of Mexico's debt, and 77 percent of Venezuela's debt.[5]

If the banks could be excused for their lending during 1973–79, it is much harder to justify a veritable explosion of bank lending to Latin America in the circumstances of 1980–82. Latin Americans by the thousands were lining up at their local banks to take money out of their countries during 1981 and 1982 at the same time the commercial banks were shoveling the money in. High-ranking Mexican officials have recounted, off the record, that at the end of 1981 Mexico had decided to undertake a desperately needed devaluation, but was discouraged from doing so by a leading New York bank, which assured the Mexican government that a large line of credit would be available to the government to continue to defend the prevailing parity.

Thus, as shown in table 4.4, the net claims of international banks on Mexico virtually doubled in the two years between the end of 1979 and the end of 1981, and the net claims more than doubled for Argentina. The combined claims on the three large debtors—Argentina, Brazil, and Mexico—almost doubled in the two-year period, increasing by $48 billion. In Asia, only the net claims on South Korea increased markedly, and then from a much lower level than in Latin America.

By early 1982, the international commercial banks began to understand the longer term implications of the rise in world interest rates and the fall in export growth rates. Projections of debt-export ratios prepared in these new international circumstances showed that the debt-export ratios of the developing countries would rise rapidly in the near future unless these countries shifted toward a trade surplus,

Table 4.4 Net Liabilities of Countries to International Banks in the BIS Reporting Area ($ billion)

Country	December 1979	December 1981
Argentina	5.3	16.3
Brazil	28.8	44.8
Mexico	22.5	43.4
Subtotal	56.6	104.5
Indonesia	−0.1	−1.5
Malaysia	−1.3	0.2
South Korea	7.2	13.7
Thailand	1.6	1.8
Subtotal	7.4	14.2

Source: BIS.

something that was hard to imagine at the time. Bank jitters were increased by the growing number of countries with "special" problems, such as Poland in 1981, and Argentina (at war in the Falklands) in the spring of 1982. Banks also came to appreciate the possibility of a classic liquidity squeeze. Given the buildup of debt and the large share that was short term, the total debt servicing due in 1982 (including all short-term debt as well as amortizations and interest on medium-term and long-term debt) came to exceed 100 percent of exports in 1982 for several Latin countries, though not for the Asian countries. Taking the average debt service to export ratios for 1980–83 for the two regions, we see the difference in table 4.5. Thus, a cessation of new lending (including an inability to roll over short-term debts) would inevitably force the Latin countries into a moratorium on debt servicing, even if *all* of their exports were to be used for that purpose!

Mexico, of course, set off the global shock in 1982. In the beginning of 1982, Mexico finally devalued its grossly overvalued currency, but then almost immediately lost international confidence by giving a large public sector wage increase as compensation for the devaluation. The budget deficit remained enormous (an estimated 17.6 percent of GDP in 1982), meaning that even the new pegged level would soon become unsustainable. In the spring of 1982, Mexico canvassed the banking community for a new large international loan, but received a cool response. International reserves fell sharply throughout the spring and summer, and the Mexican public speculated against the new exchange rate. Unable to win bank confidence under these unsettled circumstances, the Mexican government took several remarkable steps in August, including: a freezing of dollar accounts in Mexican banks; a renewed depreciation of the currency under a new dual-rate system; an imposition of new exchange controls; and most important, a declaration of a temporary suspension of debt-service payments. Soon thereafter, in a parting shot, outgoing Mexican President Lopez Portillo nationalized the Mexican banks.

Table 4.5 Debt Service to Export Ratio, Average 1980–83

Latin America	
Argentina	214.9
Brazil	132.6
Mexico	161.8
Venezuela	117.8
East Asia	
Indonesia	n.a.
Malaysia	16.9
South Korea	90.1
Thailand	58.1

Source: Sachs (1985, table 4, p. 533).

These events of course stopped all new lending to Mexico, and the drop in lending rapidly spread to the other debtor countries, especially in Latin America. In quick response, more than a dozen debtor countries began negotiations with the banks and the official bilateral creditors on rescheduling debt payments for 1982 and 1983. The list of reschedulers eventually ran up to more than forty countries.

4.3 The Creditor Response to the Debt Crisis

So far we have established, in rough terms, how the debt crisis arose. Now we turn to the international policy response to the crisis itself. The theme of this section is that a credit crisis poses certain key and identifiable needs for international coordination and that, to an important extent, such needs were fulfilled by international policy coordination. The style of international management was set first in the Mexican bailout of 1982.

4.3.1 The 1982 Mexican Bailout

The events in Mexico prompted strong and almost immediate actions in support of Mexico from the official international financial community, under the leadership of the U.S. government, especially the U.S. Treasury and the Federal Reserve Board. Within days of Mexico's announcement of a suspension in debt servicing, the following actions were taken: (1) the U.S. government committed nearly $3 billion to Mexico, including $1 billion in prepayments for oil purchases for the strategic petroleum reserve, $1 billion in finance of agricultural exports to Mexico from the Commodity Credit Corporation, and a $925 million bridge loan from the Federal Reserve Board; (2) the Bank for International Settlements extended a bridge loan to Mexico of nearly $1 billion; (3) the export credit agencies of the leading creditor countries agreed to increase their lending to Mexico by $2 billion; and (4) talks got underway for a large IMF loan. By November 1982, the IMF agreement was reached, providing for $3.7 billion of lending over three years. The IMF agreement called for budget and monetary austerity in Mexico in view of the country's reduced access to foreign borrowing. In the following year, Mexico rescheduled it debts with its official creditors in the Paris Club forum.

The great novelty of the IMF agreement was to link the IMF financing to new lending from Mexico's bank creditors. The IMF declared that it would put new money into Mexico only if the existing bank creditors also increased their loan exposure. The requisite agreement with the commercial banks took effect in early 1983. The bank agreement called for a rescheduling of Mexico's existing debts falling due between August 1982 and December 1984 (the term of the IMF program), as well as a new loan of $5 billion, to be extended by the existing banks in

proportion to their existing exposure. The rescheduling provided for continued and timely payments of interest on market terms on Mexico's existing debts, and in fact the spread over LIBOR on Mexican debt was increased in the agreement. Thus, in present value terms there was no sacrifice made by the banks in the debt rescheduling or in the new loan, assuming that both would continue to be serviced.

Moreover, under prevailing accounting conventions, the U.S. banks would not have to show any loss at all under the rescheduling agreement, since what is crucial for income accounting for the banks is the continued and timely servicing of interest on the loan, not principal. Indeed, the rise in spreads on Mexico's rescheduled debts meant that the banks would report higher, not lower, income as a result of the rescheduling operation. This concern of U.S. bank accounting with the interest flow on bank claims, rather than with changes in the underlying values of the claims, helps to explain the single-minded concern in the bank agreements with a continued and timely servicing of interest: no interest relief, then no loss of short-term profits.

In the discussion that follows, I will use the terms "debt relief" or "debt forgiveness" for arrangements that reduce in present value terms the contractual obligations on debt repayments. The term "debt rescheduling" will be taken to imply (as in the Mexican program) a postponement of repayments, but one that maintains the present value of contractual debt-servicing obligations.

4.3.2 Generalizing the Mexican Example

The Mexican program was rather quickly improvised, but it nevertheless became the norm for the dozens of reschedulings that followed. Like the Mexican program, virtually all of the debt restructurings have had the following characteristics:

- The IMF has made high-conditionality loans to the debtor government, always contingent on a rescheduling agreement being reached between the country and the commercial banks;
- The commercial banks have rescheduled existing claims by stretching out principal repayments, but without reducing the contractual present value of repayments;
- The debtor countries have agreed to maintain timely servicing of interest payments on all commercial bank loans;
- The banks have made their reschedulings contingent on an IMF agreement being in place;
- The official creditors have rescheduled their claims in the Paris Club setting, and have also made such reschedulings contingent on an IMF agreement.

While it has been true that all bank reschedulings have preserved the contractual present value of the bank's claims, only some of the re-

scheduling agreements have involved concerted lending. The amounts involved in the concerted lending dropped significantly in 1985 and revived only partially in 1986, entirely on the basis of a new loan to Mexico, as shown by the data in table 4.6. The fall off in concerted lending occurred not because of diminished needs for such loans, but because the banks have strongly resisted new lending in the past two years except in cases when default appeared to be a plausible alternative for the country in question (such as Mexico in 1986).

In cases with concerted lending, the packages have followed the initial Mexican pattern:

- Explicit backing for the loan by the IMF and U.S. government, often with pressure exerted on the banks by the U.S. Treasury and the IMF Managing Director;
- A pro rata allocation of the new loan among the existing banks, with a possible proviso excluding the smallest of the bank creditors;
- A linkage of the bank loan to the debtor country's compliance with an IMF agreement.

In addition to orchestrating the relationship between the debtor countries and the banks, via the IMF, the creditor governments also confront the debtor countries directly as official bilateral creditors, mainly through export credit agencies. For the most heavily indebted countries, most external debt (about three-fourths of the total) is owed to commercial banks and other private creditors, but for many of the smaller debtors, especially those with lower per capita income levels, much more than half of the debt has been extended by official creditors, often at concessional terms.[6] In general, official lending to the heavily indebted countries did not decline in the years after 1982, though there is some hint in the data of a slowdown of official bilateral lending in 1985 and after.

Official bilateral debt (but not the debt of the multilateral institutions) is rescheduled in the Paris Club setting. Paris Club reschedulings differ from commercial bank reschedulings in two important ways. First, reschedulings of debt in the Paris Club often represent a form of forgiveness, since some of the debt in question is already set at a concessional interest rate. Second, the Paris Club does not object as a rule to rescheduling part or all of the interest payments due, something that is an anathema to the commercial banks. This discrepancy is consistent with the overall strategy of the creditor country governments, which is not to maximize debt-service payments by the debtor countries but rather to protect the servicing of interest on the *bank* debt.

The World Bank and the multilateral development banks (MDBs) are the other major actors in the international management of the debt crisis, and their role has been growing under pressure from the United States since 1985. The World Bank has recently increased its lending to the heavily indebted countries, with many loans now coming as part

Table 4.6 **Concerted Lending: Commitments and Disbursements, 1983–Third Quarter, 1986[a] (in millions of U.S. dollars; classified by year of agreement in principle)**

	1983		1984		1985		1st–3rd Qtr., 1986	
	Commitments	Disbursements	Commitments	Disbursements	Commitments	Disbursements	Commitments	Disbursements
Argentina								
Medium-term loan	1,500	500	3,700	—	—	2,500	—	1,200
Trade deposit facility	—	—	500	—	—	500	—	—
Brazil								
Medium-term loan	4,400	4,400	6,500	6,500	—	—	—	—
Chile								
Medium-term loan	1,300	1,300	780	780	785	520	—	216
Cofinancing agreement with World Bank	—	—	—	—	300[b]	194	—	106
Colombia								
Medium-term loan	—	—	—	—	1,000	—	—	—
Costa Rica								
Revolving trade facilities	202	202	—	—	75	75	—	—
Ivory Coast								
Medium-term loan	—	—	104	—	—	104	—	—
Ecuador								
Medium-term loan	431	431	200	—	—	200	—	—

Mexico								
Medium-term loan	5,000	5,000	3,800	2,850	—	950	5,000	—
Cofinancing arrangement with World Bank	—	—	—	—	—	—	1,000[b]	—
Contingent investment support facility	—	—	—	—	—	—	1,200	—
Growth contingency co-financing with World Bank	—	—	—	—	—	—	500[b]	—
Panama								
Medium-term loan	278	131	—	147	60	—	—	21
Peru								
Medium-term loan	450	250	—	100	—	—	—	—
Philippines								
Medium-term loan	—	—	925	—	—	400	—	175
Uruguay								
Medium-term loan	240	240	—	—	—	—	—	—
Yugoslavia								
Medium-term loan	600	600	—	—	—	—	—	—
Total	14,401	13,054	16,509	10,377	2,220	5,443	7,700	1,718

Source: IMF, *International Capital Markets*, December 1986, table 45, p. 121.

[a]These data exclude bridging loans.

[b]These loans have an associated guarantee given by the World Bank in the later maturities equivalent to 50 percent of the nominal amount disbursed.

of an elaborate package including IMF, commercial bank, and creditor government loans (as in the 1986 Mexican package). The role for the World Bank is expanding under two pressures. First, the direct lending of the IMF is somewhat constrained, as many of the important debtor countries are near their ceilings on drawings from the IMF and, in fact, will be net repayers to the IMF in the next three years. Second, as the problems of the debtor countries are increasingly seen as structural and medium term (rather than simply reflecting a short-run liquidity squeeze), the long-term development finance of the World Bank is seen as increasingly relevant.

One substantive change in World Bank lending since the onset of the debt crisis is the shift from project lending to so-called policy-based lending. In policy-based lending, money is made available to facilitate policy changes on a sectoral or national level, mainly involving the liberalization of internal and external markets. In March 1986, the World Bank Executive Directors expressed support for a rise in policy-based lending to between 15 and 20 percent of all World Bank lending during 1986–88, up from around 10 percent in the early 1980s. For the heavily indebted developing countries, policy-based lending accounted for as much as 35 percent of all lending by the World Bank to the countries during 1986. A second substantive change in World Bank lending is the increasing resort to cofinancing arrangements with private sector creditors as a way to stimulate new private lending via new public lending.

The regional multilateral development banks (Asian Development Bank, African Development Bank, Inter-American Development Bank) are also attempting to increase their lending to the heavily indebted countries in conjunction with increased World Bank lending. In fact, these MDBs have had great difficulty in disbursing more loans in the past two years because MDB lending generally requires counterpart funding from the developing country itself, much of which has been dropped from austerity budgets. In fact, despite the extensive talk of increased public lending in recent years, the combined loans of the World Bank and the MDBs have grown rather slowly since 1980. To the fifteen largest debtor countries, the net disbursements per year have risen from $2.1 billion in 1980 to $3.7 billion in 1985, a rather meagre increase of $1.6 billion.[7]

4.4 The Conceptual Basis of the Debt Management Strategy

An interesting aspect of the management of the debt crisis is one thing that did *not* happen: no leading official in the Reagan Administration or in other leading creditor governments said that the crisis was a matter for the private markets only, with no role for government

intervention. From the very first days of Mexico's August 1982 crisis until now, the U.S. government has been deeply involved in managing the crisis. One reason for this involvement was gut fear. At the end of 1982, the LDC exposure of the nine U.S. money-center banks was $83.4 billion, or 287.7 percent of bank capital (see table 4.1). In Latin America alone, the exposure was 176.5 percent of bank capital, and more than 70 percent of that was to Brazil and Mexico alone. It seemed obvious that if the largest debtor countries unilaterally repudiated their debt, then the largest U.S. banks could fail, with dire consequences for the U.S. and world economies. The creditor governments therefore recognized the importance of continued debt servicing and were willing to provide official financing for that purpose. But the motivation for official management of the crisis went deeper than fear, and that was the widely shared assumption, anchored in the experience of the Great Depression, that one can't simply "leave it to the markets" in the case of a financial crisis.

The policymakers took the view that the debt crisis reflected a short-term to medium-term liquidity squeeze, rather than a fundamental problem of solvency. It was felt from the beginning that if the debtor countries could be nursed along for a few years without a breakdown of the system, they would enjoy an economic recovery and be able to resume normal debt servicing and normal borrowing from the international capital markets. This conclusion, which must be tested on a country-by-country basis (since there are clearly some countries where solvency is really at stake), has been reached by a number of analysts, including Cline (1984), Cohen (1985), and Feldstein (1986).

For all of these analysts, the basic point is the same. Since the debt of a typical Latin American debtor country stands at about 70 percent of GNP, the interest charges on that debt represent approximately 5–7 percent of GNP (with an interest rate of 8–10 percent per year). This is a heavy, but not insurmountable, burden for a debtor country, particularly for a growing debtor country. With growth, the debt-GNP ratio of the country can be stabilized, even if the country does not pay the full interest burden but only the interest burden net of the growth rate of the economy. For an economy growing in dollar terms at 5 percent per year, the annual net interest burden is reduced to perhaps 2–4 percent of GNP, with the country borrowing approximately 2 percent of GNP in new loans each year.

While calculations such as these oversimplify the problems facing the debtor countries, they do highlight the potential for a long-term successful resolution of the crisis.[8] As viewed from the perspective of the creditor governments and the IMF, the problem is one of surmounting the short-term emergency problems without an economic collapse in the debtor countries and without a breakdown in debtor-creditor relations.

In this regard, the policymakers of the creditor countries recognized three distinct areas for international policy coordination. First, it was well understood that international loan agreements are difficult to enforce, so official pressures would be needed in order to keep countries from repudiating their debts. Second, if left on their own, the private international lenders would tend to withdraw too abruptly from the debtor countries, to the detriment of both the borrowers and the lenders. Third, the increased lending would have to be conditioned on better macroeconomic policies in the debtor countries. Only official institutions, rather than the private market, could arrange, monitor, and enforce such conditionality. The creditor governments did not of course always recognize the precise implications of these problems. There are good reasons to believe that enforcement of debt servicing has been too strict; that new lending has been inadequate; and that conditionality has lacked finesse. But to give due praise, the United States and other creditor country governments quickly recognized the need for official action and usually for the right reasons.

In any event, let us turn to a more detailed discussion of these three areas of public policy intervention.

4.4.1 Enforcement of International Loan Agreements

The creditor governments have played a major role in recent years in raising the costs of debt default for the debtor countries. The leading governments have steadfastly opposed all forms of debt forgiveness or moratoriums on debt payments, no matter how dire the situation in a debtor country. The IMF, pushed no doubt by the U.S. Treasury, has insisted that all IMF programs be based on the commitment of debtor countries to *complete servicing,* at market rates, of the interest on their commercial bank debts. Countries refusing to abide by this dictate risk forfeiting an IMF program, which is in turn the admission ticket for bank debt reschedulings, Paris Club reschedulings, and new lending from other multilateral lenders. They also risk the foreign policy displeasure of the creditor nations, and they fear the adverse reaction on private sector investors of stirring up that displeasure. It should be noted that such foreign policy "displeasure" can jeopardize the country's foreign relations with the creditor governments in a wide variety of areas, including military support, arms sales, trade policies, technology transfers, and foreign aid.

Later in the paper I question whether the creditor governments have pushed too far in support of full debt servicing. This is not easy to answer since two competing objectives are at stake. The higher the penalty of default, the safer international lending will be in general, and the easier it will be for debtor governments to obtain loans. On the other hand, when a debtor gets into trouble, a lower penalty is

important as a kind of insurance or safety valve, to prevent too large a collapse of debtor country living standards. The opposition of the U.S. government to a debt moratorium in any of the major debtor countries was probably crucial to avoidance of a banking crisis in 1982 and 1983. Moreover, the fact that loans are still being serviced today is important for the future viability of the international loan market (which could hardly exist if loans became unenforceable). On the other hand, for some countries the enforcement has gone too far: the absence of the safety valve has forced some countries into situations of extreme economic misery and social instability.

4.4.2 Encouragement of International Lending

The creditor governments also recognized a second role: encouraging new lending from the private markets and from official sources. When a debtor is in financial distress, individual creditors have an incentive to withdraw credits even when collectively it is in the creditors' interests to continue to make loans. The collective withdrawal of credits can even provoke a default, with all of the attendant inefficiencies and costs, just as a panicked withdrawal of bank deposits can cause a healthy bank to fall victim to a run (see Sachs 1984 for a more formal discussion of this point). This kind of behavior is well recognized in the context of domestic bankruptcy law (especially in corporate reorganization), which stops individual creditors from collecting on their claims and thereby enforces collective decision-making by the creditors. In this sense, the IMF pressure for concerted lending played some of the role of the bankruptcy code in a corporate reorganization.

The possibility that banks might cause a "run" on a country, just as bank depositors might cause a run on a bank, was heightened by a fact that we noted earlier: debt service to export ratios exceeded 100 percent in 1982 for many of the Latin American countries. This meant that a freezing up in lending by any substantial group of banks would force these countries into a unilateral suspension of debt servicing. This vulnerability by itself became a good reason not to lend to the region after mid-1982. Even if an individual bank felt that Mexico's long-term prospects were good, it would not make sense to lend if the bank felt that *other banks* might soon be withdrawing their credits. Moreover, many of the traditional risk indicators (e.g., the debt-export ratio) began to flash red in 1982, so it was rational for any lender to fear that other lenders would soon stop lending.

This reasoning has been central to the IMF's insistence on concerted lending by the commercial banks. The IMF has insisted that the debtor countries have the *long-term* capacity to repay their loans and are just stuck in a short-term credit squeeze. The IMF also recognized correctly that even if each bank agreed with such reasoning, there is no guarantee

that the loan market on its own would spontaneously provide sufficient capital to the debtor countries.

Concerted lending takes place without legal compulsion, as individual banks have to agree to sign on to the cooperative agreement. Economic theory predicts, and experience confirms, that such a situation gives enormous bargaining power to the smaller banks, who know that their small contribution of money will not make an economic difference to the debtor country, and who can therefore threaten to "free ride" on the lending decisions of the bigger banks. Indeed, it has been hard to keep the smaller regional banks in the concerted lending game. In some cases, the large banks have agreed to contribute the share of some of the smaller banks to make an agreement sail. In other cases, the initial concerted lending package is designed solely for the largest creditor banks. An illustration of the "exploitation of the large by the small" is shown in figure 4.2, reproduced from Sachs (1984), which shows the contributions of large and small banks to a concerted loan package to Brazil in 1983. As seen in the figure, the smaller banks were able and eager to escape from new lending.

The same kind of need for coordination of the creditors arises, even more acutely, when the debtor is truly insolvent. In that case there will again be a natural scramble of creditors to get out of the country, even if the resulting decapitalization of the country depresses the overall debt-servicing capacity of the country to the detriment of the creditors collectively. Assets will be removed from the country even if they earn more than the market return, because the individual creditor knows that he will not receive the asset's full return in any event, since it will have to be shared with the other creditors (and perhaps on a "first come, first serve" basis). Unless the creditors find some consensual

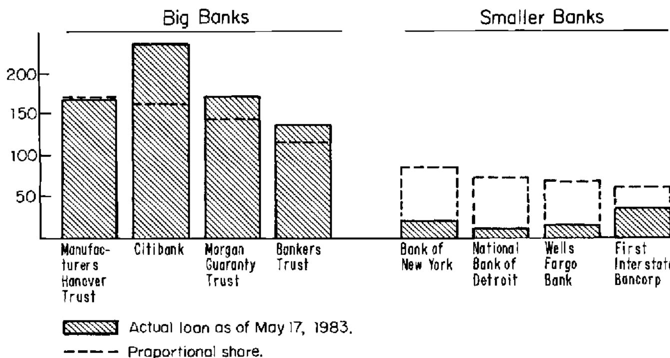

Fig. 4.2 Rescheduling package of interbank loans to Brazil in 1983 (in $ millions). *Source: Fortune Magazine*, July 11, 1983. © 1983 Time Inc. All rights reserved.

way to reduce the value of the debt or to convert it to equity, as in a bankruptcy proceeding, the debtor will inevitably be forced into an involuntary default, with the attendant inefficiencies of lawsuits and restrictions on international trade, and the absence of new financing for worthwhile new investment projects.

Note that merely because a debtor government has a negative net worth does not mean that it doesn't have many worthwhile *new* investment projects, each of which individually would meet the market test. These projects simply cannot be financed until the existing overhang of debt is resolved, which can occur in one of three ways: (1) the existing creditors can agree to write down some of the debt, perhaps taking an equity position in the debtor; (2) the existing creditors could agree jointly to finance the new project and share in the net returns; or (3) the existing creditors could agree to give senior status to a new creditor, who would finance the project on the basis that the *new* loan would be repaid in advance of the previous debt. In any of these cases (which are all familiar from bankruptcy law), official intervention will probably be needed to help the creditors arrive at a consensual agreement that will allow the investment to go forward.

4.4.3 The Conditionality Problem

The creditor governments recognized a third reason for joint action: the fact that the new lending would, at least to some extent, have to be predicated on improved macroeconomic performance in the debtor countries. To illustrate this role for policy intervention (in this case intervention by the IMF and to a lesser extent the World Bank), consider a country that would be in default in the absence of a new loan. Suppose that the new loan will be repaid only if it is used for investment purposes, not for consumption purposes. The country would prefer to receive the loan and to invest rather than simply to default. However, best of all, it would like to get the new loan, use it for consumption, and *then* default. If the creditors know this preference ranking and have no way to constrain the manner in which the country uses a new loan, the creditors would see clearly that the country would use any new loan for consumption rather than for investment, and the creditors would choose not to lend to the country. The market result would be one of no lending and subsequent default.

Now, suppose that an outside institution can impose performance terms on the debtor, forcing the debtor to use the loan for the purposes of investment. In this case, both the debtor and the creditors will be able to reach a better outcome, since the debtor will willingly submit to the conditionality and end up with the loan, the new investment, and the avoidance of default. This is a simple explanation of the role for IMF conditionality on loans to debtor countries. The debtor countries

willingly tie their own hands in order to convince creditors that they are indeed worthy of new loans.

Such an argument for the IMF and World Bank role in conditionality supposes that the enforcement of conditionality is a kind of public good that can only be carried out effectively by a centralized public institution and not by hundreds of independent and competing banks. It also supposes that the IMF is effective in enforcing its conditionality and, most important, that the conditionality terms provide a plausible basis for raising debtor country welfare and for making it safe to lend new money to the debtor country. These assumptions are of course controversial, as I discuss in the next section.

4.5 The Mixed Success of the Debt Management Strategy

The strategy of the creditor governments has surely been successful to date in keeping the foreign debts serviced. A good measure of this success is the net resource transfer to the debtor countries, which measures the net flow of new capital into the debtor countries minus the repayment of interest and profits on foreign investment. Since 1982, the net transfer has been negative, since the debtors have paid back in interest much more than they have received in new loans. For Latin America, the negative net resource transfer between 1982 and 1985 totaled more than $95 billion (see Sachs 1986, table 1).

Moreover, the long-term prospects for the debtor countries has brightened with the recent decline in world interest rates, which will tilt the balance to the benefit of the debtor countries in the future. Indeed, export growth rates of the debtor countries might soon again exceed nominal interest rates on debt, thus giving rise to a significant restoration of confidence in the long-term debt-servicing capacity of the debtor countries and thereby easing the flow of new lending to these countries.

On the other hand, as mentioned in the introduction, the years under the debt crisis and IMF-managed austerity programs have been ones of extreme economic hardship and declining living standards in most of the debtor countries. The prospects in the next couple of years also appear bleak. In some of the worst cases, the declines are shocking, with real output per capita down by over 20 percent since 1980. The stunning declines in Latin American per capita output are shown in table 4.7. Also worrisome is the fact that investment in the debtor countries has declined sharply, so the underpinnings for renewed growth in the coming years are not now being put in place. Table 4.8 shows the large decline in national investment as a percent of GDP. Private savings in the debtor countries is today spilling over into capital flight rather than new domestic investments.

Table 4.7 Changes in Per Capita GDP in Latin America

Country	Cumulative Change in Per Capita GDP, 1981–85
Argentina	−18.5
Brazil	−2.0
Bolivia	−28.4
Colombia	−0.1
Costa Rica	−11.2
Chile	−8.7
Ecuador	−3.9
El Salvador	−24.0
Guatemala	−18.3
Jamaica	−2.2[a]
Mexico	−4.3
Panama	0.7
Peru	−14.8
Uruguay	−18.6
Venezuela	−21.6

Source: Economic Commission for Latin America and the Caribbean, "The Economic Crisis: Policies for Adjustment, Stabilization, and Growth," April 1986, Santiago, Chile.

Table 4.8 Ratios of Gross Investment to GDP, Debtor Nations, Various Years, 1980–85 (percent)

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

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

These declines in investment and output are intrinsic characteristics of economies responding to a sharp cutoff in new lending, combined with a sharp increase in interest servicing costs on existing debt. The immediate result of the credit crisis was a remarkably sharp drop in imports in the debtor countries. Import volumes in Latin America fell by about 40 percent in the two years 1981 to 1983, as shown in table 4.2(c), producing a swing in the Latin American trade balance from a deficit of $3.2 billion in 1981 to a surplus of $28.7 billion in 1983. Since the improvement in the trade balance resulted from a cutoff of imports rather than a rise in exports, the shock had a deeply contractionary effect on the debtor economies.

The question for policymakers is clearly posed by these facts. Is there a better way to manage the crisis that would prevent a financial collapse but at the same time encourage more growth? The answer would seem to be yes. Several concrete suggestions for reform have been broached, some of which are discussed in the following section. Before those suggestions are discussed, however, I will outline some of the main problems with the current strategy.

4.5.1 Problem 1: The Overemphasis on the Large Debtors

To a remarkable extent, the debt crisis has been managed with just a few of the largest debtor countries in mind, specifically those few countries that pose a real risk to the international banking system. The commercial bank debt is remarkably concentrated. Mexico and Brazil account for 40 percent of all U.S. money-center bank exposure in the Third World. Mexico, Brazil, Argentina, and Venezuela account for 56 percent. None of the other troubled debtor countries has enough bank debt to pose a serious risk by itself to the banking system. A detailed breakdown of U.S. bank exposure in the developing countries shown in table 4.9 clearly illustrates the high concentration of debt.

The current management of the debt crisis has been viewed as successful to the extent that these four major debtors are sustained politically and economically and continue to pay their debts. But at the same time, many other debtor countries are collapsing, and an adequate strategy should handle these cases as well. Indeed, with more than forty countries in crisis, it is inevitable that some extreme cases will need special help. Yet to date all countries have been required to play by the same rules as Brazil and Mexico.

A concrete example illustrates the problems of the current situation. Because of extreme political instability and economic mismanagement under several military regimes, as well as the devastating external shocks of the early 1980s, Bolivia fell into a deep debt crisis by 1982. When international lending to Bolivia dried up in 1981, the net transfer of resources to Bolivia shifted from large net inflow to large net outflow as a percent of Bolivian GNP (see Sachs 1986 for details). Since the foreign borrowing had been supporting government expenditures, the loss in foreign funds created a fiscal crisis. A new, weak democracy, which had come to power at the end of 1982, presided over this fiscal crisis and ended up creating one of the worst hyperinflations of this century. By mid-1985, the inflation rate had hit a 50,000 percent annual rate.

During mid-1985 to mid-1986, even after a new democratic government came to power committed to ending the hyperinflation, the IMF never relented from its position that Bolivia must settle with the commercial banks on normal rescheduling terms. Fierce battles were fought between a desperate government and the IMF staff, with the IMF

Table 4.9 Exposure to U.S. Banks to the Debtor Countries, March 1986

	9 Money-Center Banks			All Other U.S. Banks		
Region	$b	% of Capital	% of Lending to LDCs	$b	% of Capital	% of Lending to LDCs
Large Four Debtors (Argentina, Brazil, Mexico, Venezuela)	42.7	97.5	56.5	23.4	36.2	59.5
Latin America	52.20	119.7	69.0	28.4	43.0	70.5
Africa	3.6	8.1	4.8	1.0	1.5	2.5
All LDCs	75.6	173.2	100.0	40.3	61.0	100.0
Individual Countries in Debt Crisis:						
Brazil	16.0	36.7	21.2	7.7	11.6	19.1
Mexico	13.8	31.2	18.3	10.4	15.7	25.8
Venezuela	6.9	15.8	9.1	3.4	5.1	8.4
Argentina	6.0	13.8	7.9	2.5	3.8	6.2
Chile	8.0	9.2	5.3	2.3	3.5	5.7
Philippines	3.6	8.2	4.8	1.4	2.1	3.5
Yugoslavia	1.3	3.0	1.7	0.7	1.1	1.7
Ecuador	1.2	2.8	1.6	0.8	1.2	2.0
Peru	0.8	1.8	1.1	0.6	0.9	1.5
Uruguay	0.7	1.6	0.9	0.2	0.3	0.5
Panama	0.7	1.6	0.9	0.3	0.4	0.7
Nigeria	0.6	1.4	0.8	0.2	0.3	0.5
Morocco	0.6	1.4	0.8	0.2	0.3	0.5
Ivory Coast	0.3	0.7	0.4	0.1	0.2	0.2
Dominican Republic	0.3	0.7	0.4	0.1	0.2	0.2
Costa Rica	0.2	0.4	0.3	0.2	0.3	0.5
Jamaica	0.1	0.2	0.1	0.03	0.0	0.0
Romania	0.1	0.2	0.1	0.04	0.0	0.0
Zambia	0.08	0.2	0.1	0.00	0.0	0.0
Honduras	0.06	0.1	0.1	0.05	0.0	0.0
Malawi	0.05	0.1	0.1	0.05	0.0	0.0
Liberia	0.05	0.1	0.1	0.03	0.0	0.0
Senegal	0.05	0.1	0.1	0.01	0.0	0.0
Nicaragua	0.04	0.1	0.1	0.04	0.0	0.0
Sudan	0.03	0.1	0.0	0.00	0.0	0.0
Zaire	0.01	0.0	0.0	0.00	0.0	0.0

Source: Same as table 4.1.

insisting that it would support no program that did not include an adequate amount of bank debt servicing. The IMF program was vital to Bolivia's interests, both directly for the IMF loan and as a prelude to the Paris Club and a normalization of relations with the outside world. In the end, the government maintained a unilateral moratorium

on bank debt servicing at whatever cost to its IMF program. The IMF finally backed down from its threats to block the program, though it continued to pressure the government to resume debt servicing.

The IMF advice to Bolivia in 1986, in the midst of a hyperinflation, is problematic. Bolivia was a clear case of a country crumbling under the weight of foreign debt pressures. Safety valves, such as internationally sanctioned debt-servicing moratoria, should be provided in such cases. Note that a cessation of interest on Bolivia's bank debt probably involved an income loss of about $40 million per year to all U.S. banks, or less than one-twentieth percent of U.S. bank capital.

4.5.2 Problem 2: The Overemphasis on the U.S. Money-Center Banks

Just as four countries represent "the debtor nations" in the minds of many policymakers, so too do nine U.S. banks represent the "world financial system." The U.S. bank debt is concentrated not only among countries but also among banks, with the money-center banks holding the great bulk of the LDC claims. At the end of March 1986, for example, the nine top U.S. banks held 65 percent of the LDC debt held by all U.S. banks, although the money-center banks accounted for only 40 percent of U.S. bank capital. The money-center bank exposure in Latin America was 119.7 percent of capital, while for the rest of U.S. banks the exposure was only 43 percent of bank capital. Thus, the risks to the U.S. banking system from the debt crisis can be isolated among a handful of banks, a fact that is often not appreciated in thinking about the debt crisis.

Note that even for the heavily exposed U.S. money-center banks, the risks of the debt crisis have diminished. Exposure in the LDCs relative to capital has declined significantly. The 119.7 percent of capital exposure in Latin America, for example, is down from a level of 176.5 percent at the end of 1982. Thus, even the big U.S. banks have some breathing room now, though the capital data probably overstate the cushion for the big banks, since measured bank capital includes subordinated bank debt in addition to true equity capital.

In the United States, bank regulators have required write-downs of loans in only the very worst cases, such as the Sudan, Bolivia, Peru, North Korea, and Nicaragua. This treatment of course postpones a realistic adjustment by the banks to cushion their positions, and it seems to be much more generous to the banks (and shortsighted) than comparable policies in other countries. The banks can report high earnings and pay large dividends on the basis of their LDC exposure even though future debt servicing is in question. The U.S. taxpayers thereby bear much of LDC risk (via potential claims on the FDIC in the event of bank failures), while the banks continue to make dividend

payments. In other countries, the regulatory treatment of the debt seems to be much more realistic. In Canada, for example, there have been forced partial write-downs for thirty-two developing countries. In Europe, write-downs of debt are encouraged by a system of hidden reserves, which are given favorable tax treatment. By all reports, which admittedly are difficult to verify in view of the lack of published European data, the European banks have written off far more of their LDC debts than have the U.S. banks and are therefore in a stronger position to handle any new shocks or any program of debt relief.

The U.S. money-center banks have sought, and obtained, by far the greatest influence of the international commercial banks in designing banking policy vis-à-vis the problem debtor countries. The policy influence is felt most directly in the bank steering committees that negotiate with the debtor countries. As shown in table 4.10, U.S. money-center banks chair the bank negotiating committees for *all* of the largest debtor countries, including Argentina, Brazil, Chile, Mexico, the Philippines (Bank of Tokyo co-chair), and Venezuela (Lloyds Bank co-chair), and the U.S. banks have a plurality of votes in the case of every debtor country shown in the table except for Cuba, Madagascar, Morocco, Poland, and Romania. No doubt the European and Japanese banks find the hard-line position of the U.S. banks a convenient one, since it has produced years of complete debt servicing by the largest debtors. But it should be recognized that the European banks could readily accept a debt strategy that is more generous to the debtor countries.

One of the ironies of the current situation is that while the U.S. banks have vociferously opposed write-downs of LDC debt and all plans involving debt forgiveness, the market value of these banks has already declined in anticipation of future debt write-offs. The stock market puts a value on the commercial banks according to the values of the underlying assets and liabilities of those banks. Not surprisingly, the market appears to value the banks' claims on the problem debtor countries at much less than the face value of those claims, as seen by a decline in bank stock prices relative to the book values of the banks (see Kyle and Sachs 1984). Evidence of depressed stock prices is fully consistent with the discounts on LDC debt that trade among the banks is a secondary market. Recent quotations (Salomon Brothers, December 1986) on LDC debt show the following bid prices (per $100 of face value):

Argentina	66	Mexico	56
Bolivia	7	Peru	18
Brazil	75	Venezuela	74
Chile	67		

Thus, in a sense, a market write-down of LDC claims has already occurred. However, *the debtor countries have enjoyed no benefit from*

Table 4.10 **Composition of Bank Advisory Committees**

	Total	USA	Canada	Europe	U.K.	Japan	Others	Chair
Argentina	11	5	1	3	1	1	—	Citibank
Bolivia	9	7	1	1	—	—	—	Bank of America
Brazil	14	7	1	3	1	1	1	Citibank (Deputy: Lloyds Bank International/ Morgan)
Costa Rica	11	6	2	1	1	1	—	Bank of America
Chile	12	7	1	2	1	1	—	Manufacturers Hanover
Cuba	9	—	1	6	1	1	—	Credit Lyonnais
Dominican Republic	9	7	2	—	—	—	—	Royal Bank of Canada
Ecuador	12	8	1	1	1	1	—	Lloyds Bank International
Jamaica	10	5	3	1	—	1	—	Nova Scotia
Liberia	3	3	—	—	—	—	—	Chase
Madagascar	7	2	—	4	—	—	1	Chase
Malawi	5	1	1	—	3	—	—	National Westminster

Mexico	13	7	1	3	1	1	—	Citibank
Morocco	10	3	—	4	1	1	1	Citibank
Nicaragua	17	9	2	3	1	1	1	Deutsche Süd-amerikanische/ Bank of America*
Panama	11	4	1	2	1	3	—	Bank of America
Peru	12	6	1	3	1	1	—	Citibank
Philippines	12	6	1	2	1	2	—	Manufacturers Hanover (Deputy: Bank of Toyko)
Poland	14	1	1	7	2	1	2	Dresdner
Romania	9	2	—	5	2	—	—	Bank of America
Uruguay	6	3	1	1	1	—	—	Citibank
Venezuela	13	6	1	4	1	1	—	Chase Manhattan/ Lloyds Bank International/ Bank of America*
Yugoslavia	16	8	1	5	1	1	—	Manufacturers Hanover
Zaire	4	2	—	1	1	—	—	Citibank/Bankers Trust*
Zambia	7	3	—	—	3	—	1	Citibank

Source: Lomax (1986).
*Co-chairman.

this write-down (since it has not been matched by actual debt forgiveness), and the regulators have not forced the banks to bring reported earnings and dividends into line with these more realistic asset values.

4.5.3 Problem 3: The Instability of New Private Lending

The bargain between debtors and creditors since 1982 has been clear: the debtor countries are to continue servicing the interest on their bank debts in return for a postponement of principal repayments, easy terms on official credits (both old and new), and new concerted lending from the commercial banks. The third leg of this strategy has been shaky in the past two years, despite the stated support for new lending from the U.S. government in the context of the Baker Plan.

Three things have happened. First, for reasons described earlier, the U.S. regional banks have been able to avoid their pro rata share of new lending, as have many European and Japanese banks. The burden of new debt servicing has (predictably) been left to those banks that are already most deeply exposed, since the lesser exposed banks are able to free ride. Second, the willingness of the large U.S. banks to engage in concerted lending has also waned. As was shown in table 4.6, the amounts of money provided in concerted lending declined in 1985 and 1986 relative to the two previous years. In 1986, concerted lending rebounded somewhat over 1985, but only because of loans to a single country, Mexico, and only after a bitter fight between the banks and the U.S. Treasury (a battle not yet completely over at the time of writing this paper). Third, while the concerted lending has provided some new money to the public sectors of the debtor countries, the private sectors have been net debt repayers, so that the banks are reducing their total exposures in the debtor countries even while their loans outstanding to the debtor country governments are rising.

The result is an enormous breach between rhetoric and reality. During the year since the Baker Plan was unveiled, banking exposure has declined sharply. A recent report of the IMF contained the stunning news that, in the first half of 1986, the developing countries repaid $7.1 billion (in addition to making interest payments!), in contrast to a net borrowing of $9 billion in 1985, $15 billion in 1984, and $35 billion in 1983. (IMF *Survey*, December 15, 1986). Among the fifteen countries singled out by Baker for special attention under the Baker Plan, bank exposure fell by $3.4 billion. Data showing the decline in bank lending, by region of LDC borrower, are shown in table 4.11.

The 1986 bank settlement with Mexico, which included $6 billion of new financing for Mexico over an 18-month period, might be seen as revitalizing the process of concerted lending, but it is just as likely to cause a backlash against concerted lending, since many of the banks deeply resented the pressures to lend more to a collapsing Mexican

Table 4.11 Bank Lending to Developing Countries, 1984–First Half 1986 ($ billion)

	1984	1985	1st Half 1986
Developing Countries	15.0	9.1	−7.1
Africa	−0.3	1.4	−1.2
Asia	8.2	6.9	−1.3
Europe	2.1	3.2	0.5
Middle East	0.6	−0.2	0.0
Western Hemisphere	6.0	−0.1	−4.1
15 Heavily Indebted Countries	5.4	−1.9	−3.4

Source: IMF, *International Capital Markets*, December 1986, table 7, p. 46.

economy in which inflation was surging above 100 percent per year. As evidence for this resistance, countries such as the Philippines, which followed Mexico in the "queue" for bank rescheduling, hit a stone wall at the banks, who were particularly fearful of making the Mexican program a precedent for other countries.

Overall, the current method of involuntary lending is unsatisfactory for two reasons. First, the amounts involved appear to be insufficient to finance renewed growth in most of the debtor countries. Second, the amounts are unstable year to year. Whenever an economy looks like it can survive a year without new funds, the banks vociferously resist new lending. The lending resumes only in the context of a renewed balance of payments crisis. This kind of on-again, off-again lending greatly discourages investments in the debtor countries, since investors recognize that the debtor country will be prone to balance of payments crises for the foreseeable future.

4.5.4 Problem 4: Macroeconomic Oversimplifications in Conditionality

Even under the best of circumstances, the return of a debtor country from the financial brink is difficult. Lenders and investors are wary of an economy until a new and successful track record is established. New industries must be developed to replace the declining sectors that were previously fed by domestic demand or that have suffered from the collapse of international commodities prices. These difficulties usually require significant time and luck (a resource discovery, a terms of trade improvement, a rise in foreign demand), and any progress can come unhinged from domestic political unrest that follows in the wake of economic austerity. Moreover, the growth of new sectors often requires substantial public sector investment to provide the infrastructure (e.g., roads, energy, irrigation, etc.) to make the new industries viable.

One of the lesser recognized problems mentioned earlier is the fact that the bulk of the external debt is heavily concentrated in the public sector, so that the fiscal situation in many debtor countries has remained devastated even after the country's trade balance has improved. Thus, the debtor economies have remained the victims of very high interest rates (when the government deficit is bond financed), very high inflation (when money financed), or very inadequate public sector investments (when expenditures are cut to make room for debt servicing), or a combination of all of these afflictions. Higher tax revenues in many of the debtor countries will be a part of a realistic solution to the continuing fiscal crisis. Remarkably, however, the United States has recently opposed tax increases in the debtor countries as a matter of supply-side principle, almost regardless of the realities in the countries themselves. It is also true that, politically and economically, raising tax revenues during a recession is very hard, especially since the contractionary effects of a tax increase may intensify the recession.

The "official view" of the creditor community (with the United States, the IMF, and the World Bank in the lead) has simplified the macroeconomic picture by arguing that drastic liberalization of trade and domestic markets will solve the problem of economic recovery. These pronouncements ignore the problems just raised and are also ahistorical. The great successes of liberalization, such as in Japan or Korea, have been affairs over the course of decades, not months. Rapid liberalizations, as in the Southern Cone at the end of the 1970s, have more often than not failed. Moreover, strong government intervention in the Asian miracle economies of Japan, Korea, and Taiwan appears to have fostered, rather than hindered, economic growth.

4.5.5 Problem 5: Underemphasizing the Creditor Country Responsibilities

The creditors have made much of the policy mistakes of the debtor countries and have stressed that recovery from the debt crisis will require a change of behavior in those countries. This emphasis has some merit, we have seen, since most of the debtor countries made serious policy mistakes in the past decade. But the focus is also seriously misleading, since it reduces the much-needed scrutiny of the behavior of creditor countries as well. As noted earlier, forty countries did not simultaneously fall into crisis because of a virulent epidemic of bad behavior; rather, the shocks of macroeconomic policies of the creditor governments also played a key role. Similarly, the worsening of the debtor situation since 1985 is not a result of debtor country behavior but rather the collapse of commodities prices, which is a global macroeconomic phenomenon.

The leading governments have only recently begun to coordinate macroeconomic policies in ways conducive to recovery from the debt crisis. The Reagan Administration spent its first five years denying any responsibility for high world interest rates and renouncing any intention of coordinating macroeconomic policies. That is beginning to change, though the enormous U.S. fiscal deficit, which continues to hold world interest rates at unusually high levels (to the debtor country detriment), is only fitfully being brought under control.

Moreover, the United States and other creditor governments have successfully divorced discussions about the debt strategy from discussions about their own trade policies. It is an elementary proposition that rising LDC exports are a key to a successful resolution of the debt crisis, and yet with increasing frequency, trade actions by the United States and the Europeans work directly against this imperative. As an example, the United States recently (January 2, 1987) cut the benefits under the generalized system of preferences for eight developing countries, including the debtor countries Brazil, Mexico, South Korea, and Yugoslavia. Similarly, voluntary restraints on steel exports into the United States instituted in 1984 resulted in a restriction on steel exports from many debtor countries, most importantly Brazil and South Korea. In general, with worldwide trade in agriculture, textiles, steel, and increasingly electronics subject to extensive protectionism and controls, it is extremely difficult and risky for a debtor country to embark on an aggressive export push as a way to climb out of a debt crisis.

4.5.6 Problem 6: The Failure of Diplomacy

The final problem that I shall raise is one of political style rather than economic substance: the diplomatic manner in which the debtor countries have been dealt with in recent years, and the role of these countries in the formulation of their debt management strategies. My point of reference is the Marshall Plan, which had as one of its major ambitions the development of political, as well as economic, stability in Europe after World War II. One of the key aspects of the Marshall Plan was that the European nations were required to work out a recovery plan on their own and then to submit that plan to the United States for review and financing. After much debate, the Senate rejected imposing strict conditionality in the program, arguing that it would not be conducive to developing European support for and dedication to their own recovery program. In fact, the only specific condition imposed in the program was the establishment of a joint and continuous European organization to oversee the recovery effort (Wexler 1983, 48–49).

In the case of the debt crisis, the developing countries have not been treated with such dignity, but rather as if they needed constant scolding from superior developed country brothers. This has been an extremely harmful aspect of the recovery process, with much time spent on fights between the debtor countries and the IMF, which has rather autocratically attempted to impose its views on stabilization programs. The bad will also spilled over into the Baker Plan, which dictates a radical free market solution as the remedy for all of the debtor countries' problems.

This attitude of the creditor countries is particularly hard to understand in view of the fact that the debt crisis arose in most cases in South America under autocratic military dictatorships that have since been replaced by legitimate and responsible democratic governments. Democracies have replaced military dictatorships in Argentina, Bolivia, Brazil, Ecuador, Peru, and Uruguay, and in every one of those cases, the debt problem emerged under the previous military regime. In Asia, the same can be said about the Philippines. In other words, the most important step toward better government has already been taken.

4.6 Some New Steps in Managing the Debt Crisis

The earlier discussion in this paper suggests that the debt management has leaned too far in the direction of protecting the commercial banks and not far enough in promoting economic growth in the debtor countries. Several innovations in debt management could be effective in promoting debtor country growth, seemingly without posting major risks to the financial system. I will discuss three kinds of innovations, many of which have been debated in policy circles in the past couple of years. First, it has been suggested that there is a case for providing partial debt relief for countries in the most extreme difficulties. The present value of the country's obligations could be reduced through one of a number of mechanisms mentioned later. Second, for most other debtor countries, there may be a case for increasing and stabilizing the inflows of new capital, particularly in view of the fact that the concerted lending process seems to be functioning poorly. Third, some of the risks now faced by debtor countries could be shifted onto the international capital markets to allow the debtor governments a greater ability to meet the uncertainties of interest rates, the terms of trade, protectionism, and growth in the industrial countries.

These changes, which I will discuss at greater length in a moment, could be combined with other changes responsive to the problems identified in the previous section. Bank regulators might force a greater capitalization of U.S. banks, and more write-offs, to cushion them against losses on LDC debts in the future. International macroeconomic coordination could focus on the trade and interest rate linkages needed

to overcome the crisis. Diplomacy could enhance, rather than diminish, the stature of the new democracies of Latin America.

4.6.1 Partial and Selective Debt Relief

Twenty years ago, policymakers would have been much more enthusiastic about the case for selective debt forgiveness. In the generation after World War II, policymakers in the creditor governments knew that the failure to grant timely relief on international debt had severely weakened U.S. allies in the case of interallied war debts after World War I; had contributed to the rise of Hitler in the case of German reparations; and had contributed to the attractiveness of Perón's demagoguery in Argentina in the 1940s and 1950s. These considerations led the creditor governments to grant debt forgiveness to Indonesia as recently as 1970.

Policymakers today fear debt relief because of its potential impact on the commercial banks. However, relief could be granted *selectively* and *partially* to a restricted group of debtor countries in a way that would pose only minimal risks to the international financial system. One proposal, suggested in Sachs (1986), would grant relief according to a formula that gives relief to the countries that have experienced the largest declines in per capita income in recent years (other criteria could be applied, such as granting relief only to the poorest countries, or those that have experienced the greatest terms of trade shocks, etc.). In order to minimize moral hazard problems, it is recommended that the relief be granted only as part of an internationally supervised program of stabilization and reform.

In the specific illustration in Sachs (1986), relief is given in the form of five years of complete forgiveness of interest payments from debtor countries that have suffered a drop in per capita GDP of 15 percent or more since 1980. In Latin America, this criterion includes most of the debtor countries, but importantly *excludes* Brazil and Mexico, whose GDP decline has been less severe. The suspension is to apply to all debts currently subject to rescheduling by the commercial banks and by the official creditors in the Paris Club. It turns out that the overall relief provided by U.S. banks to five major Latin debtor countries (Argentina, Bolivia, Peru, Uruguay, Venezuela) would total $6.6 billion in present value, and by all BIS banks, $19.1 billion. The forgiveness by U.S. banks would represent approximately 6.2 percent of bank capital. This 6.2 percent of bank capital is much less than the market write-downs of bank stocks that have already occurred!

How could relief by the banks actually be effectuated? One way would be through moral suasion of the creditor governments and the IMF, or even through legislation. A different and interesting way, suggested by Kenen (1983) and others would be through the intermediation

of a financial institution (either an existing institution, such as the World Bank, or a new one created for this purpose). In the Kenen-Hatori plan, the international entity would issue a bond that is guaranteed by participating creditor governments and swap the bond with the commercial banks for their LDC claims. The new guaranteed bonds would have an interest rate somewhat *below* the market rate, and that lower rate would be passed along to the debtor countries. As in the previous example, the reduction in interest rates could be tied to the extent of deterioration of the debtor economy.

This plan has two key desirable features. First, the banks would be relinquishing a risky income stream with a positive spread over LIBOR for a safe asset with a negative spread. The improvement in the quality of the banks' portfolios would be enough to justify such a swap to bank shareholders, who might otherwise object to a straightforward write-down of debt. Shareholder objections would be moot, since it is clear that the market is already heavily discounting the value of LDC assets in the secondary market. Second, the plan would offer debt relief with no direct cost to the creditor governments (or their taxpayers). It would be self-financing, in the sense that the commercial bank shareholders would effectively be supplying the relief.

4.6.2 Increasing Net Capital Flows to the Debtor Countries

Many countries do not need explicit relief. Rather, they require increased and steadier inflows of public and private capital. The question here is how to generate the increased and steadier inflows in view of the fact that the commercial banks are *reducing*, rather than increasing, their exposures. Most proposals for vast amounts of new official lending are nonstarters, particularly in this period of budget austerity in the major industrial countries. There will have to be a continued reliance on private market lending to provide the needed capital, and the key to such lending is to make new private lending safer, in one way or another, than the existing stock of debt. There are several ways to do this. One common suggestion is for more cofinancing of projects between the World Bank and the private sector, thereby allowing the private lenders to piggyback on the seniority of World Bank loans (which by convention are never rescheduled). A related method would be to strengthen the insurance system for international investments (such as the MIGA).

A different way that leads to the same outcome, but without the need for any new official money, is proposed in Sachs (1986). In the proposal, an explicit agreement among the existing creditors would allow the debtor country to borrow a predetermined level of new funds that would be earmarked as senior to the existing debt. In other words, all creditors would agree that the specified new debt would be serviced

in entirety before any of the existing debt is serviced. The new lenders under this arrangement would not have to be banks. Senior lending could be made on the basis of marketable securities purchased by asset funds, corporations, or private wealthholders. As with the relief proposal, eligibility for seniority borrowing should be limited to countries with poor economic performance, but not so poor as to trigger debt relief. For example, eligibility might be given to countries that have suffered a decline in per capita GDP during the 1980s.

The multilateral institutions would have several functions in this proposal. First, the IMF would reach an agreement with the country on the amounts of incremental lending that will be raised on a senior basis. Unlimited new borrowing would not be allowed. Rather, the amount of senior debt would be linked to growth targets in the debtor country and the quality of investment opportunities. The IMF would record and monitor the new senior borrowing and help to verify the senior treatment of the new debt. The World Bank and the MDBs would continue to play their existing roles of defining and monitoring the investment programs of the country to support the effective utilization of the new borrowing.

The proposed arrangement would have the virtue that new capital could be provided to the debtor countries without having to make a judgment about the eventual fate of the existing debt. If the debtor country resumes its growth, both old and new debts will be serviced. If growth does not resume, the old debts will be written off, which presumably would have happened anyway under the current system of concerted lending. The proposal has both pluses and minuses for the existing creditors. By agreeing to such a program, the banks could suffer a reduction in value of their existing claims, but at the same time they would be freed from the obligation of involuntary lending, which now puts the burden for new lending precisely on those banks whose portfolios are already filled with the largest exposure in the debtor country. Additionally, the value of the existing debt would be raised by this plan, not lowered, to the extent that the new borrowing enhances the debt-servicing capacity of the country by more than the interest cost of the new loans.

The amounts of new senior borrowing might represent 6 or 7 percent of the existing stock of debt each year for the next few years. This level would eliminate the net resource transfers currently made by the debtor countries to the creditors. At this rate, for example, Mexico would accumulate approximately $35 billion of new senior debt over the next five years, an amount that could readily be raised by new market borrowing, since $35 billion of debt could be easily serviced by Mexico in the future, as long as that $35 billion is serviced before any of the existing $100 billion of Mexican debt.

4.6.3 Shifting Risks to the International Capital Markets

So far, the international capital markets have done little to diversify the profound economic risks facing the debtor countries. Loan agreements have few contingencies, for example, linking the level of repayments to the state of the borrowing economy, its terms of trade, or any other indicators of the borrowing country's economic well-being. Commodity-linked bonds have never gotten off the ground for reasons that are not well understood by financial specialists. Interest rate risk is borne entirely by the borrower, since almost all debt is in the form of variable interest securities. The borrowers also face the risks of credit cutoffs, with little possibility of obtaining credit commitments for future borrowing.

It would seem that many of the risks facing the debtor countries could be more efficiently diversified through more complex loan agreements. An initial example is the Mexican accord reached in 1986, which contained two important innovations. First, there was a link of new financing (and of IMF performance criteria) to the price of oil: a drop in the price of oil raised the level of funds to be made available to Mexico, and a rise did the reverse. In either direction, the change in funding is gradually phased out over several quarters, so that eventually Mexico has to adjust to, and not simply finance, the changes in its terms of trade. The second special facility is a growth contingency loan, which allows Mexico to draw on more official and private funding for increased government spending if for any reason its growth does not meet the program targets during a fixed period. Given the complexity of the determinants of growth in the short term, negotiators felt that it was impossible to write an even more elaborate contract which linked the "growth" lending to changes in underlying conditions, even though the agreed terms suffer from the moral hazard problem that self-inflicted growth slowdowns are also rewarded by new lending.

There are several additional proposals that have been made in recent years of a similar nature. Interest rate capping was widely discussed in 1984 before being dropped, but it remains a promising way for shielding the debtor countries from some market risks. The debt-equity swap mechanism is also partly a way to shed risks (and also partly a hidden mechanism for partial debt forgiveness) by making the creditor take an equity position in the debtor economy. Finally, the mechanism of linking debt-servicing payments to the level of exports, as unilaterally adopted by Peru in its ceiling of debt servicing to 10 percent of exports, or to GNP (as proposed by Feldstein 1986) is yet another way for shedding some of the risks of debt servicing. Brazil, in a more consensual manner, is adopting the Peruvian position in its current debt negotiations by seeking to limit net resource transfers to its creditors to 2.5 percent of GNP. Such a rule would automatically alter the amounts

of debt servicing according to market interest rates and according to GNP growth in Brazil.

4.7 Conclusions

The management of the LDC debt crisis since 1982 has been an important example of successful international policy coordination. At the time of the outbreak of the Mexican debt crisis in the summer of 1982, many observers feared that the crisis would provoke an international banking crisis and a global depression. Those fears have not come to pass in large part because of the active involvement of policymakers from the creditor countries, the debtor countries, and the multilateral financial institutions.

The origins of the debt crisis can be found both in the shift in the global macroeconomic environment in the early 1980s and in major policy mistakes in many debtor countries. From a macroeconomic perspective, the fundamental change in the global economy was the rise in interest rates to levels exceeding the growth rate of exports of the debtor countries. Once this rise in interest rates occurred, the debt-export ratios of the debtor countries could be stabilized only by a shift to trade balance surpluses, a shift which required deep and often painful macroeconomic adjustments. Moreover, since most of the foreign borrowing had been undertaken by the public sectors of the debtor countries, the shift in interest rates also required sharp budget cuts in the public sector. For most debtor countries, the long-term debt-servicing prospects are not bleak, and it is realistic to expect over the long term that needed adjustments to the trade balance and the budgets can be made in most countries. The recent declines in global interest rates greatly enhance the long-term prospects for a successful resolution of the crisis. Nonetheless, short-term difficulties could still easily derail a successful resolution of the crisis.

Policymakers recognized three distinct roles for public intervention in managing the debt crisis. First, public authorities recognized that the marketplace itself could not provide adequate enforcement of the existing debt contracts. A complete hands-off attitude of the public authorities would likely have resulted in widespread defaults by the debtor governments with adverse consequences for all parties concerned. Second, the policymakers recognized that if left by itself, the loan market would likely provide insufficient levels of new funding for the debtor countries. There is an inherent gap between the self-interest of individual banks, who want to pull out willy-nilly from new lending, and the collective interest of all creditors, who are best served by continuing to make new loans to the problem debtor countries. Third, the policymakers recognized that there is a role for the IMF to impose conditionality on debtor countries in return for new lending, particularly

in cases where misguided policies contributed to the onset of the debt crisis.

The public role was conceived with these problems in mind. Led by the U.S. government, the creditor governments coalesced around a strategy that included: (1) pressure on the debtor countries to maintain debt servicing; (2) pressure on the commercial banks to continue lending in "involuntary" lending packages; and (3) IMF conditionality as the cornerstone of new lending agreements. To a significant extent, this package has forestalled widespread defaults and has prevented the worst fears of 1982 from coming to pass.

There continue to be serious problems, however, with the implementation of this strategy. First, the pressure to maintain debt-servicing payments has been carried to a point of absurdity, so that even countries in the midst of 50,000 percent hyperinflations, or free falls of income, have been pressed to maintain debt servicing. Second, the pressure on commercial banks to continue lending has waxed and waned. Involuntary lending has proved to be too little and too unstable a financial basis for economic recovery in most of the debtor countries. Third, the contents of conditionality have been oversimplified, with the IMF and the World Bank pressing for immediate liberalization as the key to recovery in the debtor countries, contrary to logic and historical experience. This has led to a backlash from the debtor countries that strongly resists such simple and politically dangerous prescriptions.

Several recommendations were discussed in this paper as possible remedies to these shortcomings. The recommendations revolved around three areas: partial debt relief; stabilized capital inflows; and a shifting of risks now borne by the debtor countries to the international capital markets. It was suggested that partial debt relief would not have to pose profound risks for the international system, and that such relief could be targeted to the countries most in need. With respect to new capital inflows, a proposal for new *senior* lending to the debtor countries was broached, with the aim of stabilizing and increasing the size of capital inflows into the debtor countries. Finally, various proposals were discussed that aim at shifting risks from the debtor countries to the international financial markets, such as interest rate capping and commodity-linked lending.

Notes

1. Detailed accounts of the crisis can be found in several recent books, including Cline (1984), Lever and Huhne (1986), Lomax (1986), Makin (1984), and Nunnenkamp (1986).

2. See Sachs (1982), Eichengreen and Portes (1986), and Fishlow (1985) for descriptions of the ups and downs of international lending during the past century.

3. The top ten debtor countries in 1983 ranked by gross external debt to BIS banks were Mexico, Brazil, Argentina, Korea, Venezuela, Philippines, Yugoslavia, Indonesia, Egypt, and Chile, of which Mexico, Venezuela, Indonesia, and Egypt are oil exporters, and Argentina is approximately self-sufficient. Oil exports exceed oil imports for this group of countries as a whole.

4. A country that borrows the money it needs to make its debt service payments will have its debt grow at the rate of interest (e.g., with interest rates at 10 percent, a country that borrows its debt-servicing bill will see its total debt grow by 10 percent per year). As long as that interest rate is equal to or less than the growth rate of export earnings, then the debt-export ratio will be stable or falling.

5. See M. P. Dooley, "Country-Specific Risk Premiums, Capital Flight and Net Investment Income Payments in Selected Developing Countries," IMF Research Department, DM/86/17, March 1986.

6. For a breakdown of the debt by creditor for different groups of borrowers, see IMF, *World Economic Outlook,* April 1986, table A48, pp. 244–46.

7. See IMF, *International Capital Markets,* December 1986, pp. 74–81.

8. The analytical oversimplifications tend to come in several places, as mentioned later in the text. First, in order to service the country's debts, GNP must be in an acceptable form—specifically, in the form of export earnings. However, as economies shift from domestic production to exports, measured GNP may well decline in the short run to intermediate run. Second, since the debts are generally owed by the public sectors of the debtor countries, debtor governments must raise taxes or cut spending in order to service the debts. Such fiscal actions will tend to exacerbate many macroeconomic problems, such as unemployment and recession. Third, private investors are likely to shun economies suffering from debt crises, thus undermining the economic growth that is counted on to facilitate future debt servicing.

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2. *Anthony M. Solomon*

Prospects for the LDC Debt Problem

A couple of weeks ago I was in San Francisco when Marty Feldstein and his European and Japanese colleagues in a study group presented

a very big paper on the debt question. I was struck by the careful analytic way in which they took all this myriad of debt management proposals, that we've been hearing for four and a half years, and categorized them, broke them down into three basic categories, and then did some evaluation of them.

I'm not going to do any of that today, because basically I think it's almost irrelevant to the process of dynamic action that is going on among the players. I believe that the banks—the creditor banks—are incapable of taking a concerted initiative to choose and push forward an alternative debt strategy. There are just too many differences among them—small banks versus large banks; European banks, Japanese banks, and American banks who have different regulatory, different supervisory, different accounting, and different tax policies. And even among the U.S. money-center banks there are some differences.

What I am going to try to do today is give you my feeling for what the new factors are and how this situation is likely to play out as a matter of reality. And believe me I have a lot of question marks in my mind because I have a cloudy crystal ball too.

But this is the way I like to approach it, because I just think it's too complicated to expect anything but the day-to-day evolving situation and the interplay among all these different players to determine the final outcome. Some people will say that, even though the banks may be incapable of a concerted initiative, you can have a forcing action by sovereign debtor governments, who will simply declare moratoria.

But I find myself very, very confused in this area. Look at the actual situation. Peru declared in effect a moratorium on commercial bank debt service, medium term and long term. Many of the bankers said they were going to get tough with Peru. Peru was small enough; their exposure to Peru was small enough to get tough and therefore teach a lesson. I have yet to see any retaliation against Peru by the banks.

Please don't misunderstand me. I'm not making any kind of judgments that they should or should not be retaliating. I'm trying to talk about the facts of this situation.

Mexico went for continuation of the existing conventional strategy, although in its Baker Plan form there is more emphasis on growth. Brazil has declared a moratorium, but I hear increasing talk that the Brazilian industrialists are bringing enormous pressure on the Brazilian president to dump his finance minister, to call off the moratorium, to make some conciliatory gestures, and to begin negotiating, because the industrialists are afraid that the financing for imports and exports will seriously hurt their businesses.

This is notwithstanding the freeze in short-term credits that the Brazilian government announced. I'm sure that Bill Ogden can enlighten us in greater detail, but I assume the reason why the freeze doesn't protect the Brazilian industrialists is that as particular letters of credit

expire, that money returns to the Brazilian government if its frozen, and they have no confidence in the Brazilian government that it will make those funds available again to the Brazilian industrialists. I don't know if that's correct or not, but I assume that's why the freeze is not calming the fears of the Brazilian industrialists.

Argentina is talking about settling, if it can get Mexican terms. Now can you imagine that two-eighths of a point difference above LIBOR is going to make this kind of difference between confrontation and no confrontation? I find myself very confused by this, because so far the facts are that there has been no retaliation. There are certain countries that could probably continue a substantial part of their foreign trade (although in a much more inconvenient form) without the credit extended by the banks, but they are still reluctant to go down that road.

I also hear reports that what the Brazilians are really afraid of is a trade boycott by the U.S. government if they were to default. Again, I find that hard to believe. If they were to formally repudiate the debt, possibly. But that's not likely. They're not going to do it that way. They'll simply have a moratorium and, while they're negotiating, not pay interest for debt service, and this will drag on and on. But I cannot see the U.S. Congress imposing a trade boycott on Brazil. In fact, on the contrary, any consensus that may exist is to promote more U.S. exports to Latin America, and certainly a trade boycott on imports would not lead in that direction.

So I find myself thoroughly confused by the play and the players. I don't see that there is any clear trend yet whereby the sovereign governments are going to force moratoria. But I'll come back to this toward the close of my remarks.

I think there have been some changing factors in the last year or two that are important enough to comment on. One is that there is a much greater intellectual consensus and concern for growth in the LDCs than there was before. I think there is very little sympathy for what are called, I think erroneously so, IMF austerity programs. There is very little sympathy for LDCs being pressured to pay full interest by compressing their imports in order to have a large enough trade surplus. This is important because it changed the tone of the debate; it changed the bargaining power of the different players.

Another factor that is important, I think, is that there has been much more erosion of the ability of banks to get together to put up money. The smaller banks are falling by the wayside more and more, and the big banks are getting very desperate about this problem. Also, as more and more big banks write off or write down part of their loans (it's not entirely a rational action), it makes them more resistant than ever to putting up their share of new money. So you have a lot of fatigue, an erosion developing on the side of the banks' willingness to put up new money.

Another factor of course is that there is fatigue on the part of the LDC debtor countries willingness to do these austerity-type programs. There is this intellectual consensus on growth that's been made respectable by the Baker Plan, and all the talk goes in that direction.

So it seems pretty clear that the priorities are going to be such that any debt strategy has to be consistent with more adequate growth for the LDCs. This leaves everybody in confusion. What is really being looked at by the key players? I think it's fair to say, as I see the situation, that a lot of attention is on developing an exit vehicle for the smaller banks. There's not only a Reserve Bankers' Committee, but there are also certain high echelons in the World Bank that are studying this. It's not obviously a World Bank proposal by any means, and it would take the consent of creditor governments who are powerful in the Bank. But the proposal goes along the lines of a partial guarantee to a sovereign debtor government putting out a ten-to-fifteen-year bond issue, the money to be used to buy debt paper from the smaller banks, or up to a certain amount from all the banks, at the discount in the secondary market. That would have a double advantage. First, it would reduce the debt service of the debtor countries, because now when the paper is sold in the secondary market, that's no help to the debtor country. And second, of course, it would help clean up this problem of eliminating the nuisance of the small banks' refusal to put up their share of the new money.

There are different forms in which this can be done, and there's been talk—not in the World Bank, but outside the World Bank—by bankers about setting up another institution, a subsidiary to the World Bank which would be an intermediary in buying up debt paper at the secondary market discount. This is less practical politically.

Parenthetically, I'm not so sure that under any of these arrangements the small banks will rush to sell their paper at the discount of the secondary market. I can see the discount of the secondary market shrinking the minute they see anything really being done in this area.

It's an enormously complicated problem. The trouble with all of these debt proposals is that they sound nice sometimes, but they are incredibly complicated to implement in a way that would achieve the results intended.

I think it is worth saying that what we are seeing is that the public-sector component of these support packages for the debt-ridden LDCs is creeping up. In the Mexican package, the public sector has gotten up to 50 percent when you include the World Bank, the IMF, the official export credits, et cetera.

Now even if this exit vehicle instrument is devised, where does that leave us? Stepping back and looking at the whole picture . . . even if this proposal is successfully implemented . . . where does it leave us?

It seems to me it doesn't really affect the bottom line that much, even though it would be a help. The bottom line is still going to be that, in my opinion, without adequate economic growth in the industrialized countries, I see no way for the heavily indebted LDC countries to begin to get the adequate growth that there is now a consensus they must have. How else can they develop the resource flow they must have to get that growth while also, incidentally, although an important factor of course, methodically servicing their debt in an orderly and conventional way?

I think that all these debt strategy proposals basically boil down to ways of alleviating or mitigating the situation somewhat and buying time for the banks. There's talk now among the banks about developing what's called a menu of options, whereby each bank can choose the particular form of support that it wants to give. That's easier said, again, than put into practice. To develop equivalencies of sacrifice or of support or of whatever you want to call it is very, very difficult. The most obvious one support option has been talked about for many years: the capitalization of interest to an amount equivalent to the new money that other banks are putting up. In practice, capitalization is difficult because the banks fear that if the debtor governments see that 40 percent of the interest can be capitalized and stretched out, then they might unilaterally push for 60 percent or 80 percent or ultimately 100 percent.

So I feel that the problems are enormous without adequate OECD growth. That brings us back to the discussion this morning about policy coordination, and I won't go into that.

What happens if we don't have adequate growth and sufficient resource flow? I think that's by far the most likely scenario over the next couple of years. What's going to happen in the debt situation?

It seems to me, even if the Brazil moratorium gets cleared up, that we will see a recurrence of more random moratoria from time to time, and some of these will then get patched up in new agreements after a while. For example, I cannot see the next president of Mexico coming in and calmly continuing the conventional strategy that has been followed. I think both the political and economic situation in Mexico make that almost impossible. We will see confrontations from time to time. I doubt that the banks will be able to come up with a concerted bank compromise strategy package that could be successfully negotiated with the sovereign debtor governments. I think that there will be individual deals struck and many deals not struck. There will be confusion. I would assume that at some point the situation will force governments, particularly the U.S. government, to take the initiative and try to hammer out some compromise packages. That will probably involve more public support as a component, although I don't see a

full bailout for the banks. It seems to me that the difficulty we will be getting into as the situation becomes more confused will be one where the U.S. government ultimately will have no alternative. Over the years as this process goes on, the banks will build significant reserves (or write-downs) against their exposure. My guess is that the history books will finally say that the larger part of the sovereign country commercial bank debt was never repaid (nor did they return to good-credit standing with the commercial banks), but the process of absorbing some substantial part of this debt as loss was successfully and gradually stretched out by all the parties.

3. William S. Ogden

The Need for Change in Managing LDC Debt

This August will mark the fifth anniversary of Finance Minister Silva-Herzog's visit to New York and Washington to inform governments and banks that Mexico could not service its external debt. His announcement, and the subsequent realization that many other countries were in similar circumstances, led to an abrupt halt in commercial bank lending to developing countries. At the peak of this truly worldwide crisis, over forty countries were affected.

I gave a talk on this subject in the fall of 1982 in New York. At that time, many observers perceived the causes of the crisis, and research has helped us understand them better today. I identified four principal players in the debt crisis: debtor countries, creditor country governments, multinational institutions, and commercial banks. Each shared responsibility for the onset of the problem and each currently has a critical role to play in its resolution. Within this context, I would like to comment briefly upon the policies pursued over the last five years, and then turn to the future.

Let me begin my saying that, with hindsight, it is easy enough to be critical of the initial responses of these players. We should remind ourselves, however, that in spite of their mistakes, the response to date has been largely successful. In this regard, I have special praise for Jacques De la Rosier and the role he played throughout this period. While designing an active role for the IMF, he managed to remind others that the IMF was actually filling a gap left by its member governments.

These players helped us avoid the threat to the economic system the debt crisis posed. Indeed, over the last five years some countries have seen major improvements. Many countries now enjoy access to international financial markets that they either did not have five years ago, or were in real danger of losing in 1982. The global economy has grown. World trade did not continue to decline. Protectionism, or at least protectionsim with a vengeance, has been held at bay. Even the banks are stronger, as their capital has grown and their income stream has become more diversified. Let us, therefore, not lose sight of our achievements as we examine the need for change in the process. Let us also remember that in 1982 we rejected many of the more radical solutions so easily set forth by others. Let us also continue to look with great skepticism on proposals for easy solutions which claim to make the problem go away.

Having said this, the need for change in the process has become increasingly apparent. It is more than a liquidity crisis arising from a sudden loss of confidence in almost all debtor countries. True enough, in some countries such as Korea, Columbia, and Thailand, it was an issue of confidence and they have regained market access. We have even forgotten now that Korea was affected in those early months of the crisis. But for a number of LDCs, the problem turned out to be more intractable, truly a debt problem. Unfortunately, some of the countries with the very largest external indebtedness fall into this group. For example, the five largest Latin American debtor countries have seen their foreign debt grow steadily, from $276 billion at the end of 1982, to $319 billion at the end of last year. As a result, the debt burden of this group, relative to its economic size, has remained substantially unchanged.

There were three events over the last year which represented both a greater recognition of the need for change in the process, and the beginning of a new chapter. The Baker initiative was one of them. It recognized the long-term nature of the problem. It also acknowledged the political impossibility and economic undesirability of strategies that are perceived as calling only for further sacrifice and slow growth well beyond the time horizon of a few years. Such policies are unpalatable in any context, but particularly in countries with rapid population growth and in those struggling to legitimate new democratic institutions. A third, but to my mind no less important, element of the Baker initiative was its explicit recognition that some countries are so deeply mired in underdevelopment, poverty, precious misallocation of resources, and social ills, that their problems cannot be solved through the coordinated efforts of the four principal players. Instead, these countries must work directly with creditor governments and multinational institutions. Nevertheless, the Baker initiative had important flaws. It was not a

policy response with much in the way of specificity behind it. Nor did it provide leadership behind which the major players could rally, or even debate. Charitably, it was more than a speech, but not a policy.

The second event signalling a clear need for change occurred in the efforts this year to provide refinancing for Mexico. Concerns arose about the way it was done. Concerns over the system of allocating fair shares among the participants and the unwillingness of smaller creditor banks to participate at all. The coyness with which governments of major creditor countries attempted to position themselves in their dual role as both regulators and interested parties, and the different treatment of banks within each of the creditor countries was not helpful. All in all a host of frustrations made it extremely difficult to put the financing together.

Some of the difficulties, as Tony Solomon has already pointed out, just represented weariness on the part of the players. The fatigue was compounded by the slowness of mulitnational institutions to formulate a program that was consistent with the spirit of the Baker initiative. Even more fundamentally, there were doubts that Mexico, even with the best of intentions, could carry out its end of the program.

The third and complete turning of the page that made it clear the strategies of the last five years had finally become unworkable was the confrontational negotiating tactic adopted by Brazil in their most recent rescheduling. Such a strategy might be explained and even justified by some, while it would be condemned by many others. But, regardless of one's position, such behavior signals the close of the chapter on debt which began in 1982, and crystallizes the need for change. In my opinion, however, the need for change does not mean radical change or radical solutions. As weary as we are, and as desirous as we are to make the problem go away, instant gratification for all four players is just not feasible. It is also not desirable in terms of future access to international financial markets, or growth in the debtor countries, world trade and the world economy.

Now, I would like to turn to the kind of changes that I believe are necessary. First and foremost, it seems to me that we must stop dealing with debtor countries as though they are a homogenous group. Each country is unique, with a unique set of financial and development problems. Each should be encouraged to work out its own programs, recognizing both that growth must be a priority and that creditor concessions made to particularly troubled countries cannot automatically become the common denominator to be applied in all cases. For example, it is just as ridiculous to say to the Bolivians that they should look to Argentina for proof that the process is working rather than at their own suffocating economy, as it is to insist that concessions made to Bolivia must be applied to all countries across the board. Indeed,

as a high Brazilian official pointed out to me recently, it certainly was not lost on finance ministers in debtor countries that a finance minister in Mexico was replaced ostensibly for not being tough enough on the banks.

A second element of needed change lies in that sore subject of conditionality. No country likes conditionality applied to it. Years ago I saw a number of countries in Europe take offense at the idea of conditionality being applied to them. Nevertheless, I firmly believe that cooperative efforts tied to highly questionable economic programs and short-sighted political windfalls not only cannot be part of such a process, but are self-destructive. Such efforts not only fail, their failure undermines the viability of cooperative solutions.

While it might sound naive, my own experience leads me to believe that if we can agree on a vision for growth with some mutual sacrifice and resistance to protectionism, a responsible conditionality, tailored to each individual country, could be achieved. To reach such an understanding, the creditor and debtor country governments would have to take the lead. They will need, however, to negotiate a lot less coyly than they have in the past. Put simply, we need leadership. Conditionality is too important a subject to be left to the IMF and other multinational institutions without strong political leadership from the major creditor countries.

The third area in which change is badly needed is in achieving growth in trade and income. Naturally, I refer to the frequently mentioned need for resistance to further protectionism in the creditor countries and for economic growth in the debtor countries. But I also believe that economic growth in the creditor countries and resistance to protectionism in the debtor countries are equally important. As far as creditor-country growth is concerned, I refer most particularly to creditor countries other than the United States. From 1982 to 1985, *all* of the net increase in Latin American exports to the industrial countries was accounted for by the United States. Over that time the share of that troubled region's exports bound for the U.S. rose from 33 to 41 percent. By contrast, Japan's imports from Latin America remained unchanged and Germany's registered only a modest gain.

Continued protectionism practiced by the debtor countries should also be questioned. This issue should be raised particularly with the emerging industrial countries that never lost market access. In general, creditor countries ought not condone highly discriminatory practices by debtor governments, regardless of whether or not the debtors have access to international financial markets or are members of the GATT.

I would like to put forward three other elements of change that focus on the role of the commercial banks. First, we must expect that adverse shocks to debtor countries, such as a precipitous drop in export prices

or an earthquake, will require additional financing. I recognize that this goes against traditional precepts in that it implies increased lending when circumstances worsen. But there is both a precedent and a need for this. I think, however, that creditor governments should play a bigger role in reacting to the vagaries of external forces, both in terms of the financial commitments they are willing to make and in terms of their willingness to exert leadership roles.

Second, I believe that the private sector can play a more helpful role in developing both debt-for-equity swaps and the so-called secondary market for sovereign debt. These market-related responses are not a panacea and cannot solve the whole problem. They can be an important element, however, not only by helping to share and transform the risk, but by signalling that debtors prefer investment to debt. This signal becomes particularly clear when combined with sensible economic policies that encourage investment in the first place. In addition, such policies make possible the return of flight capital, which has made external financing much more difficult in many of the countries. It is appalling that some debtor countries have such tight restrictions on debt-for-equity swaps and yet complain of their inability to service foreign debt and of their need for growth.

Third, it is sometimes said that banks have not yet taken any losses in sovereign risk-lending. The truth is that many have, and that all will over time. This does not imply, however, that the debt should be forgiven, nor that any rote formula should be applied across the board. Debt-for-equity swaps, for example, may lead to greater risk and frequently will involve write-down of the debt swapped.

As far as the secondary market for sovereign debt is concerned, it is developing. I think this is a healthy sign, and I can see considerable growth for it in the future. Nevertheless, it is important to remember that these secondary market transactions cannot by themselves solve either the problem of the current debt "overhang" or the problem of future lending. I also think that the accounting profession ought to stop quibbling over whether this so-called market establishes a price for debt instruments of a particular country. In additon, I think finance ministers in the debtor countries should not use the secondary market discount as a vehicle for clubbing the banks by arguing that, since the market has already written off a percentage of this debt, only a smaller amount needs to be serviced.

Next, let me come to two even thornier issues, as far as the banks are concerned. The first has to do with the negotiating process, which by its very nature requires that leadership be provided by a committee representing all bank creditors. This is a problem specific to the American banks, simply because there are so many of us involved. I believe that communications have flowed smoothly from these creditor bank

committees to creditor banks in other countries, where there are fewer syndicated banks and where confidentiality is more easily maintained. Frankly, there is also more confidence that the interests of all of the banks in countries other than the United States are being represented. It is not for lack of trying, and to be completely fair, also not for a lack of good will. This communication issue among the American banks is, nevertheless, a very nettlesome one. I applaud the efforts among the American banks, or at least some of them, to address this problem. It is critically important as we go forward.

The second issue that applies to all banks, but particularly to the American banks by virtue of the sheer number involved, is that some banks have a considerably smaller commitment to international banking. They not only wish the problem would go away, but have lost any willingness to participate. This is very understandable, particularly if a bank never had any genuine interest in international business, got into it in a burst of enthusiasm in the 1970s, and now has gotten burned. Such banks have little knowledge of how negotiations are proceeding and learn more from newspapers than they hear from the negotiating banks. They are constantly trying to explain their involvement to their boards of directors who share the view that the bank should never have gotten into the international business in the first place. Combine that with opportunities for profitable domestic business and with regulators who must already carry water on both shoulders, but view it as essential to continue reinforcing bank directors' responsibilities in the management of their banks, and you have an enormous amount of pressure to drop out of refinancing. We must find a solution to this problem. There have been many proposals made, ranging from the idea that no bank should be allowed to drop out to the idea that if a bank drops out it cannot have a free ride on everyone else. The central issue is, of course, who will make up the difference if some are permitted to drop out.

A further complication is that a number of banks have sold or swapped loans to other parties. In these instances, the problem of defining the size of a fair share becomes even more complicated. The purchaser of debt in the secondary market, or the holder of equity from a swap often does not intend to put up any new money for additional debt accumulation. As a result, in some cases a bank that has sold or swapped the debt of a particular country has been asked to put up a share of new money based on what it held formerly. This has already become a problem. As the market for loan sales and swaps increases, it will become an even bigger problem.

I think we have to find a way to address the issue of the smaller banks, especially those smaller American banks that want out. Tony Solomon has already alluded to some of the proposals that are being discussed. I would suggest we begin to develop a mechanism to en-

courage their participation rather than continue to ignore the dropout problem. One such approach might be a government program to guarantee partially the first x-million dollars or its equivalent of developing country debt held by each of the commercial banks. Because this would be an absolute amount, invariant to the amount of a bank's capital or the size of a bank's portfolio, it would represent a much larger percentage of the total amount held by any of the smaller banks. To qualify, the bank would have to set aside reserves of, say, a third of the guaranteed amount, or a fourth of the program amount. The same percentage would apply to any new funds that would have to be provided in the future. This scheme would recognize that, in voluntarily accepting the guarantee, a bank would also have to be willing to establish such a reserve. This would mean a reduction in defined primary capital by that amount, but would not be a write-off of the debt.

As an illustration, let me give you a sense of how this might have worked in the recent Mexican financing. If we assume that the government through some mechanism would provide a 75 percent guarantee for the first $25 million from each bank, we estimated that approximately 50 of the 101 U.S. banks that had committed by the end of March would have been fully covered by such a program. These banks, however, would be required to participate in future refinancing and would have to write down the 25 percent of the debt not insured. The U.S. government would therefore be guaranteeing about $1.3 billion of debt if all 101 U.S. banks chose to participate. For their part, the banks would have to increase reserves by about $435 million. These calculations exclude about 50 American banks which did not participate in the 1984 rescheduling negotiations. In other words, last time a third dropped out.

I would also like to suggest that the commercial banks, the accounting profession, and the Securities and Exchange Commission begin to explore a possible change in accounting conventions. One positive change would permit banks to set up allocated reserves of narrowly defined exposure in such a way that the charges could flow directly to their capital accounts, rather than through their income statements and then into their capital accounts. Before we all throw up our hands at this heresy, let me say that there are ample precedents in the way that we have treated some of the problems of the savings and loan industry, in the way that the country debt restructurings have not automatically meant loans were reclassified as nonperforming, and in the way that all corporations have been permitted to take exchange rate fluctuations, under certain carefully defined rules, directly to their capital accounts, rather than through their income statements.

It was not that long ago when every chief executive officer of a major multinational corporation in America was explaining how his earnings in any particular quarter were affected by foreign exchange fluctuations.

I would guess that a lot of chief executive officers are not even aware how this affected their capital accounts in this last quarter. I have not been asked by a bank-stock analyst in years about the impact of exchange rate fluctuations on our capital accounts, whereas I used to be quizzed regularly on the income statement.

I know there are problems with suggesting that loan write-offs be passed through to capital. But I think the idea should be explored, as it would allow increased flexibility and make it easier to take a longer view. This emphasis on quarter-to-quarter performance is a criticism of American corporate management we have all heard. Perhaps it is true, but it is partly a result of the unnecessary emphasis in our financial markets on short-term earnings.

In summary, the developing country negotiations seem to be well into a new stage. It seems likely, however, that current negotiations will require even more coordination than the substantial amount that has been seen in the last five years. I think a change in the process is urgently needed.

But it is also becoming increasingly apparent that the major players—the debtor countries, creditor-country governments, multinational institutions, and commercial banks—will have to begin to play significantly different roles, and that the political leadership has to come from government.

4. *Eduardo Wiesner*

Latin America's Policy Response to the Debt Crisis: Learning from Adversity

> It is notable that many advances in economic analysis have arisen from efforts to understand and cope with adversity. (Stanley W. Black, 1985)

I am most grateful to Dr. Martin Feldstein for having honored me with his invitation to participate in this Conference on International Cooperation. As we enter into the fifth year of dealing with the debt problem, this conference offers an excellent opportunity to take stock of what has been achieved and to reflect on the issues that still remain unsettled. More generally, this is a good occasion, I think, to look at Latin America's broad policy response to the debt crisis. I deeply believe that an examination of that response is the best way to determine the long-term significance of the debt crisis. What really matters

is policies. So one must look at events and developments but always in terms of their relationship with policy change. I have organized my presentation in four parts. First, I will provide a brief background on the origins of the debt crisis. Second, I will review developments in the period 1983–86 and comment on what appears to be the major policy accomplishments of the region to date. Third, I will examine the current situation and the pending issues at this juncture. Finally, I will try to outline the directions that Latin America's policy response may take in the years ahead.

At the outset, let me underline that for reasons of brevity I will have to summarize and simplify very complex matters.

Origins of Latin America's Debt Crisis

The debt crisis was the combined result of three sets of interdependent causes: (a) inadequate economic policies followed by a large number of countries; (b) imprudent lending policies on the part of the commercial banks; and (c) adverse global economic conditions at the time.

On their part, the debtor countries incurred large fiscal deficits[1] which led to growing current account deficits and to excessive external indebtedness. The high absorption of external resources was not accompanied by a corresponding increase in investment but by increased consumption and by lower ratios of domestic savings. In brief, the accumulation of external liabilities was not accompanied by a significant increase in assets within the debtor country. In these circumstances a debt crisis became a question of time, which proved to be very short as external disturbances arose in 1982.

On the part of the creditors, there were imprudent lending policies, particularly by the large international commercial banks which offered ample and easy credit especially to the public sectors of the borrowing countries. They engaged in what Hirschman (1987) has called "vigorous loan pushing." These loans were made on the—mistaken—assumption that sovereign lending involved little if any risk.

Global international economic conditions changed abruptly in the early 1980s when real interest rates rose from about 0.6 percent in 1979 to more than 7 percent in 1982. An aggravating factor at the time was the deterioration of the terms of trade for most of the Latin American countries. Finally, when in 1982 the world economy, and with it world trade, entered into a severe recession, the debt crisis erupted.

In brief, the debt crisis came about because there was overborrowing and overlending. Without the imprudent policies of lenders and borrowers it is not certain that the adverse world economic conditions would have created, by themselves alone, a debt crisis.[2] These disturbances simply precipitated the crisis; they did not create it. The debt crisis came because both lenders and borrowers made mistakes.

One can then conclude that they both share the responsibility for the debt crisis.

Of course, one cannot assign proportions to this responsibility. Perhaps an implicit distribution can be found in the choices that were made at the outbreak of the crisis. The banks had to choose between (a) large and immediate losses if they were to turn their backs on their debtors, or (b) to provide some additional new money to protect their existing claims. The debtor countries had to choose between (a) abrupt and probably inefficient adjustment, if they were to declare formal moratoria; or (b) to make a serious effort to service their obligations in exchange for a relatively less onerous adjustment. As we know, both the banks and the countries chose negotiation over confrontation. They both saw a net gain in such a strategy.

Developments and Accomplishments, 1983–86

The strategy that was put into place in late 1982 and early 1983 worked well. Indebted countries adopted strong adjustment programs, commercial banks provided new money, and both official and multilateral creditors also substantially increased their disbursements. The results were prompt and positive. Between 1982 and 1984, Argentina, Brazil, Mexico, and other countries more than halved their nonfinancial public-sector deficit in relation to GDP. This strengthening of the fiscal position contributed to a very substantial improvement in the current account of the balance of payments of the region. For Latin America as a whole, the current account deficit was reduced from an average of $43 billion a year in 1981–82 to less than $3 billion a year in 1984.[3] Although this adjustment was achieved mainly through a sharp reduction in imports, it is worth noting that import volumes did increase in 1984 and 1985.

The policy corrections adopted by the debtor countries, besides being supported by additional concerted money from the banks, were helped by a more auspicious world economic climate in 1983 and 1984. During those years, growth resumed in the industrial countries and real interest rates declined. These factors contributed to a return of growth in Latin America, and the region as a whole grew by 3.2 percent in 1984 and by 3.7 percent in 1985 (see table 4.12).

The gains in adjustment made in 1983 and 1984 were not sustained in their entirety in 1985. Several factors contributed to that situation. There were slippages in economic policies in the debtor countries and inflation accelerated. Also, growth in the industrialized countries returned to a more moderate level of 3 percent. Lastly, oil prices began to come down at the end of 1985. These factors, together with the virtual cessation of commercial bank lending, resulted in renewed pressures on Latin American countries.

Table 4.12 Real GDP Growth in Selected Latin American Countries, 1981–86

Country	1981	1982	1983	1984	1985	1986
Argentina	−6.8	−4.6	2.8	2.6	−4.5	5.7
Brazil	−3.4	0.9	−2.5	5.7	8.3	8.2
Chile	5.5	−14.1	−0.7	6.4	2.4	5.7
Colombia	2.3	0.9	1.6	3.4	2.4	5.0
Ecuador	3.9	1.2	−2.8	4.0	3.8	1.7
Mexico	7.9	−0.5	−5.3	3.7	2.8	−3.8
Venezuela	−0.3	0.7	−5.6	−1.3	0.3	3.0

Source: International Monetary Fund.

The policy response was uneven. In some instances a frontal attack on inflation was launched, which was the case of Argentina with its Austral plan (June 14, 1985) and of Bolivia with its stabilization program (August 1985). In the case of Brazil, while the external sector remained strong, inflation accelerated to 235 percent in the twelve months ended in December 1985. Finally, in early 1986, the authorities adopted the Cruzado plan as a comprehensive monetary reform to eliminate inflation. In the case of Mexico policy, slippages led to higher inflation and to a real effective appreciation of the peso through the first half of 1985. Nevertheless, it can be said that, on the whole, the region continued to show relatively good performance in the external sector. Chile made considerable progress in reducing its current account deficit, and Venezuela, in spite of the drop in oil prices, maintained a current account surplus and reduced its overall public sector deficit.

This generally positive policy response contrasted sharply with the reluctance of the commercial banks to continue to bear their share of the costs. Although it was desirable for the banks to lower their exposure from the unsustainable rates of 1980 and 1981, the extent to which their lending contracted after 1984 created a very serious problem (table 4.13). Also, it was not clear how such a policy could have been in the best interests of the banks themselves.

With this setting, at the Annual Meetings of the International Monetary Fund and the World Bank in Seoul, Korea, in late 1985, the U.S. Secretary of the Treasury announced what became known as the Baker initiative. His proposal was aimed at revitalizing the debt strategy. It rightly stressed the three basic ingredients of the debt strategy: (a) a strengthening of policies on the part of the debtor countries; (b) additional financing from commercial banks; and (c) a greater technical and financial role by official creditors and by the multilateral institutions.

A key contribution of the Baker proposal was the emphasis it placed on the need for internal structural adjustment as a condition for sustainable growth. Underlying this initiative is the realization that a country

Table 4.13 **Total Cross-Border Lending to Western Hemisphere Countries (in billions of U.S. dollars: change in period)[a]**

Year	U.S. billions
1981 (est.)	40.0
1982 (est.)	20.0
1983	14.9
1984	5.6
1985	1.0
1986 (Jan-Sept.)	−4.0

Source: IMF, *International Financial Statistics;* Bank for International Settlements, data reported to the Fund on currency distribution of banks' external accounts; and Fund staff estimates.

[a]As measured by differences in the outstanding liabilities of borrowing countries, defined as cross-border interbank accounts by residence of borrowing banks plus cross-border bank credits to nonbanks by residence of borrower. Adjusted for changes attributed to exchange rate movements.

can register a large degree of external adjustment and still maintain large internal imbalances (Wiesner 1986). In fact, we have seen that many Latin American countries were able to improve substantially their trade and current account positions but were unable to really suppress inflation or to restore growth on a permanent basis.

This emphasis on structural change is correct, especially if it is seen as the way to reconcile the constraints imposed by the other two possible alternatives to pursue growth. Since these countries already have a heavy debt burden, they must minimize their external borrowings, and since they cannot run the risk of higher inflation—or more depreciation—if they were to adopt expansionary fiscal and monetary policies to foster growth, they must look for the additional resources they need in higher productivity and efficiency in the use of the *existing* stock of capital.[4] This is the essence of structural change: extracting additional resources from a more efficient resource use of existing assets. It does not involve more indebtedness or the risk of higher inflation or exchange rate depreciation.

I would like now to turn to the central theme of this paper, namely, the policy response of Latin America to the debt crisis. In particular, I will refer to the policy response in the area of external adjustment.

External Adjustment in Latin America

The long-term significance of Latin America's debt crisis will depend on the effect it will have on the quality of the economic policies of the region. If no basic improvement in policies were to emerge, then the crisis would have been very costly indeed; but if some basic policy lessons were to be distilled and were adopted as a permanent element

of economic management, then the debt crisis would not have been in vain and it could even prove to have had beneficial effects in the long term. Although it is still too soon to reach a final judgment on this matter, I believe it can already be said that in the process of adjustment one very basic lesson has been learned: Countries should not let their exchange rates become overvalued. This is what Fischer (1987, 32) has called "the most important commandment" of economic policy.

Before the debt crisis, Latin American countries had tended to allow their exchange rates to become overvalued and in some cases kept them in parity with the U.S. dollar in the face of rapidly declining international reserves and high rates of domestic inflation. As Cuddington (1986, 24) has pointed out, the consequences of this policy were capital flight, exchange rate instability, and stagnation of nontraditional exports. Well, it would seem that this is no longer the general case. It now appears as if Latin America's policymakers are determined not to be caught up again in a situation in which they do not have a minimum of international reserves to protect their trade and to meet their external obligations (table 4.14). Most policymakers seem committed not to let the history of 1982–83 repeat itself.

The results of this change are encouraging in terms of the growth on nontraditional exports. In the case of Mexico, nonpetroleum exports rose by close to 40 percent during 1986; agricultural exports in particular grew by almost 60 percent to $2.1 billion. In the case of Chile, noncopper exports have been growing at close to 10 percent a year since 1984. Nontraditional exports in Ecuador grew by 25 percent on average in 1985 and 1986, mostly on the strength of increased produc-

Table 4.14 Real Effective Exchange Rate Changes in Selected Latin American Countries, 1980–86 (percentage change)

Country	Dec. '86 / Dec. '80	Dec. '86 / Dec. '84	Dec. '86 / Sept. '85
Argentina	−60.2	−6.1	15.7
Brazil	−14.4	−9.9	−2.5
Mexico	−48.2	−39.3	−30.8
Chile	−47.3	−25.3	−9.7
Colombia	−35.4	−37.4	−23.3
Costa Rica	−39.8	−20.8	−17.3
Ecuador	−34.9	−22.1	−24.3
Guatemala	−23.5	−28.9	5.1
Uruguay	−31.8	−2.3	1.6
Venezuela	−49.2	−44.7	−39.0

Source: IMF Information Notice System.
Note: Based on indexes 1980 = 100.

tion in agricultural, shrimp, and fish products. In general terms, one can see substantial gains in exports of nontraditional products in Colombia, Costa Rica, Venezuela, and others.

Behind these developments there is a remarkable degree of real effective exchange rate depreciation. From 1980 to 1986, Argentina has depreciated its currency by a little more than 60 percent, Venezuela, Mexico, and Chile by close to 50 percent, and Colombia by 35 percent.

In some cases, such as Mexico, Colombia, Ecuador, and Venezuela, there has been a very large real effective depreciation in the last two years. The particular situation of Mexico deserves to be underlined as the authorities have courageously maintained a realistic exchange rate policy even when there were calls to slow the pace of depreciation to, allegedly, moderate an already high rate of inflation. By following this policy, Mexico has been able to avoid a major crisis, even in the face of the sharp drop of the price of oil and the absence of the external financing expected from the commercial banks.

This more realistic and flexible exchange rate policy does not mean, of course, that the major problems of adjustment have been solved in Latin America. After all, current account deficits (tables 4.15 and 4.16) are still high, and it could be argued that the countries are just validating in the exchange rate the still high rates of domestic inflation (Fishlow 1986, 6). This may be true. Depreciating a currency in line with domestic inflation, or even with a differential with the rest of the world, does little to correct the internal imbalances that give rise to that inflation. It could also be argued that, under the so-called "real exchange rule, the authorities no longer control the price level and that inflation might become unstable" (Adams and Gros 1986, 439). This may be so but not in all cases. If the move toward a more realistic exchange rate does not result in a gain of international reserves, there is no reason to expect that the authorities will necessarily lose control of their domestic credit policy. But, even beyond this, my point is that it is better

Table 4.15 **BOP Current Account Surplus or Deficit (−) in Selected Latin American Countries, 1980–86 (as a percentage of GDP)**

Country	1980	1981	1982	1983	1984	1985	1986
Argentina	−8.5	−8.3	−4.1	−4.0	−3.7	−1.5	−3.5
Brazil[1]	−5.0	−4.3	−5.8	−3.3	—	—	−1.2
Chile	−7.1	−14.5	−9.5	5.4	−10.7	−8.2	−6.5
Colombia	0.4	−6.1	−10.1	−9.8	−6.8	−3.9	1.6
Ecuador	−7.0	−10.0	−11.5	−1.2	−2.4	1.1	−6.3
Mexico	−5.8	−6.7	−3.3	3.7	2.2	0.4	−1.0
Venezuela	4.1	3.2	−4.8	5.7	9.4	5.9	−4.9

Source: International Monetary Fund.

Table 4.16 Current Account Surplus or Deficit (−) in Selected Latin American Countries, 1981–86 (in billions of U.S. dollars)

Country	1980	1981	1982	1983	1984	1985	1986
Argentina	−4.8	−4.7	−2.4	−2.5	−2.4	−1.0	−2.6
Brazil	−12.8	−11.7	−16.3	−6.8	—	−0.2	−3.0
Chile	−2.0	−4.7	−2.3	−1.1	−2.1	−1.3	−1.1
Colombia	0.1	−1.7	−2.9	−2.8	−2.1	−1.2	0.5
Ecuador	−0.6	−1.0	−1.2	−0.1	−0.2	0.1	−0.6
Mexico	−10.7	−16.1	−6.2	5.3	3.8	0.7	−1.3
Venezuela	2.4	2.1	−3.2	3.3	5.0	2.9	−2.3

to adjust the nominal exchange rate when there is domestic inflation than to try to maintain an overvalued domestic currency.

Now, some authors argue that what really matters is external adjustment and balance of payments viability, and that as long as a country is able to meet its external obligations one should not be overly concerned about domestic inflation. But the question then arises about the fragility or precariousness of the external adjustment if internal imbalances are left uncorrected. And we have seen some examples of this.

Although one must be careful in drawing conclusions from changes in exchange rates, and there are many caveats that should be kept in mind,[5] I think it can be reasonably argued that what the numbers show is that policymakers in Latin America have learned a lot about the significance of this key price in their economies. Maybe more will need to be done to really set these countries on a long-term export growth strategy, but in any case what they have done so far is encouraging.

Current Situation and Pending Issues

Currently two major issues are pending in Latin America. The first one has to do with the difficulties of a number of countries to achieve more internal adjustment in terms of greater success in controling inflation and laying the basis for durable growth. The second one has to do with external financing, particularly the role to be played by the commercial banks which seem to have become increasingly reluctant to continue to provide financing.

The first issue is basic. In essence, it is the old question of how to eradicate high rates of inflation without having to go through a recession.[6] The two major monetary reforms adopted by Argentina and Brazil, the Austral and the Cruzado plans, ran into serious difficulties after some initial success. These two experiences suggest that transitional income policies and direct price interventions cannot substitute for correcting the underlying fundamental imbalances. This would

involve a balanced government budget and a sustainable position of the current account balance of payments. Some authors argue that in the long run not only a balanced budget is required but also "a reduction in the size of the public sector" is necessary (Blejer and Liviatan 1987, 20).

Let me now move on to the related topic of structural adjustment, which in its most concise definition refers to the strengthening of growth through a more efficient use of existing resources. The basic question about structural change is not whether it is needed but how to implement it. We know the theory and we know the objectives, but that is not enough. We know that most public sectors should not continue to grow in relative terms, and yet fiscal deficits often are reduced not by cutting expenditures but by increasing taxes. We know that expenditure cuts should not take place in the investment budgets, and yet that happens with disturbing frequency. We know that trade liberalization will generally make economies more efficient, and yet we see that countries are reluctant to open up their economies. We know that overregulation is deleterious to growth, and yet governments end up unable to rid themselves of such restraints.

Why is the implementation of structural change so difficult? A large part of the answer lies in what Helen Hughes (1985, 19) calls "political obstacles" and in that power of vested interests.[7] The answer in my personal view lies in the strong political power of those who gain from large, inefficient, interventionist public sectors. There are strong political reasons that make it very difficult for policymakers to cut public spending, lay off workers, or lower barriers to imports. I place a lot of emphasis on the deliberate aspect of this type of measure to highlight the contrast between internal structural adjustment measures, on the one hand, and external adjustment policies, on the other.

In the first case, the policymakers cannot resort to the political protection offered by the argument that their policies are dictated by exogenous factors such as the fact that they have run out of foreign exchange. Here, policymakers are more vulnerable to political obstacles as they seem to be adopting policies that are their own creation and arising from convictions about some abstract theoretical model.[8] Ultimately, policymakers do choose implicitly or explicitly the level of domestic inflation that they have, while in the area of external adjustment countries cannot really choose between adjusting or not adjusting. In other words, internal adjustment is to some extent avoidable or at least postponable, while external adjustment is inevitable.

This argument takes me directly to the Baker initiative and its emphasis on structural adjustment. Is there not a contradiction here? I have said that the Baker initiative is right in focusing on structural

change, and now I say that it is extremely difficult, for political reasons, for countries to implement comprehensive structural adjustment measures. I do not believe that is a contradiction. What I want to do is to add a word of caution about how much can reasonably be expected in the area of domestic structural change. It is important to avoid high expectations of quick results in the correction of internal imbalances through policy-based lending to remedy supply-side rigidities. Care must be taken to avoid the possibility of incurring a mistake similar to the one made in the years preceding the crisis, when bank commercial lending seemed a risk-free source of financing. The risk now is that some countries may give the appearance of adopting major structural adjustment measures in exchange for policy-based financing, when in fact they can deliver relatively little in this area in the short run.

Does this mean that policy-based lending for the correction of internal imbalances should not be increased by multilateral institutions and by official governments? Certainly not. But it should be done with full awareness that its conditionality will be more difficult to implement and to monitor than more traditional external adjustment performance criteria. What we must try to avoid is that, say, in 1990 and onwards we discover that the countries have become heavily indebted to, say, the World Bank and the IDB, but that commensurate progress has still not been achieved in structural areas.

The second unresolved issue at this juncture is the role expected of the commercial banks. The Chairman of Citicorp has stated that "capital will not be provided in any significant amounts unless the conditions of the financial markets are met" (Reed 1987, 27). On the other hand, the indebted countries argue that without additional financing they cannot service their obligations and maintain a modicum of growth (Funaro 1986, 4). Behind these positions is the issue of how to distribute the gap between the contractual value of the debt and the lower market value of those claims. For the commercial banks it is difficult to lend more money when the market discount is telling them that the new debt "will immediately fall to the same discount as the existing debt" (Dooley 1986, 3). For the debtors it is very difficult to service the obligations at their full contractual value when some of the corresponding assets are not performing for them either, at least not performing for their public sectors. Since the market has already established a discount, some believe that full service at the contractual value would mean a windfall profit to the banks.

Since all possible strategies[9] to manage the debt problem must involve some additional financing, this market discount is seen by many as a potential source of financing. The discount would provide debt relief to indebted countries and would cause the banks to realize the

losses which the markets already have registered. All that is needed, some argue, is a mechanism or an institution to purchase the debt at the discounted market price.

On the surface this proposal looks appealing, but things are more complicated than that. In reality, there are no simple solutions to the debt problem (Mulford 1987), and there are a number of questions that need to be answered. First, from a distributional point of view, the question is: Who should gain the most from such debt relief, the countries that have the largest discount or the ones with the lowest discount? Is there not a "moral hazard" problem here? Granting more relief to those who have adjusted less may induce others to loosen their policies. A second question, from an efficiency point of view, is: Will this form of debt relief impair future international capital flows? Last and very important: Could debt relief be provided outside a policy framework of adjustment and structural change?

To this last question, the most realistic answer is that countries should continue to adjust and to improve the quality of their economic policies in spite of the tensions that exist in the system, including uncertainty about how this issue of debt relief will be settled. It would seem that countries have no better alternative than to continue their efforts to reduce their imbalances. After all, this is the only thing that they can really control. If the international economic environment were to turn inauspicious to the efforts of the indebted countries, even if the flows of external finance were to shrink, those countries that adopted the better economic policies would still be the ones able to avoid the most onerous forms of adjustment and would be the ones with better prospects for long-term growth.

If what the debtor countries want is more independence from the commercial banks or from external uncertainties that are beyond their control, such as changes in international real rates of interest or declining terms of trade or increasing protectionism, the best response lies in prudent economic policies. In spite of all the limitations and restrictions, this is what ultimately remains in their hands to a larger degree than anything else.

Possible Evolution of Latin America's Policy Response

Although it is difficult to say in which direction Latin America's policy response will evolve in the future, it may be interesting to look at some possible future policies somewhat apart from any particular solution of the debt problem. The idea is to focus on avenues of policy response that seem highly probable under most circumstances.

One area where policy response is not very difficult to visualize is that dealing with domestic savings. It would appear that debtor countries have little choice but to increase their domestic savings as the

magnitudes of external savings that will be available to them will not grow very much over the next few years. This will not be an easy policy to follow, but it seems one that can hardly be avoided as countries will find that they must finance with a larger proportion of their own resources the investment necessary to achieve higher rates of growth over the medium term.

Since it would be difficult to finance large fiscal deficits without exacerbating inflationary pressures or without crowding out an already weakened private sector, it can be expected that, on the whole, the current fiscal effort to strengthen public finances will be maintained. While smaller fiscal deficits will contribute to a strengthening of domestic savings, it is not certain that this will also mean a reduction in the relative size of public sectors. That is, countries may be more inclined to reduce fiscal deficits by increasing revenues rather than by reducing expenditures. However, efforts can be expected to be made to increase the efficiency of public sectors, particularly of large public enterprises; how effective those efforts will be is very difficult to say.

Under most possible outcomes of the present problems faced in the debt strategy, it can be assumed that most Latin American countries will continue to pursue efforts to strengthen their external sectors. Policymakers are likely to continue to seek more competitiveness through their exchange rate policies and will seek to avoid overvaluations of their exchange rates. They will certainly work hard to strengthen their international reserve positions. Whether this will also mean a more liberal trade policy is not clear. This is a very sensitive political area. It could be assumed that with more depreciated exchange rates in real effective terms most countries would be more receptive to trade liberalization. And yet it may well be that policymakers will remain cautious on this front, as they seem concerned about the difficulty of managing a liberalization scheme at the same time they are trying to implement a stabilization program.

In terms of the sequence of liberalization, I have no doubt that the capital account will hardly be liberalized. The experience with capital flows has been rather negative in Latin America (Edwards 1984, 91), and there is also the question of whose risk would the possible new debt turn out to be. The debt crisis has sent Latin American policymakers the message that it is dangerous to open up the capital account. The experience of the last five years indicates that, at the end of the road, private risks tend to become public risks (Wiesner 1985). This is one area where many years will have to go by before liberal policymakers will be able to persuade public opinion about the alleged advantages of freely flowing capital resources. Those countries who in good faith followed that policy now find their public sectors and their fiscal positions burdened with those liabilities (French-Davis 1983, 25).

Given the recent experience with the emergence of the debt crisis, where external disturbances turned out to be so important, it can be expected that policymakers in Latin America will pay more attention to the international conditions in which they conduct their own policymaking. In other words, economic policymaking in Latin America will tend to improve as the authorities realize that they must look through the global interdependencies[10] to arrive at forecasts on, for instance, international interest rates or protectionist trends. Although these may be processes over which they have little control, or precisely because they do not control them, they will have to incorporate some assumptions about their possible behavior in their own policymaking exercises. This will be a salutary consequence of the debt crisis.

In brief, an overview of the possible policy responses of Latin America over the next years suggests that there will be, in global terms, an improvement in the quality of the economic policies. There will still be many flaws and setbacks but, on the whole, there will be more discipline in the public finances, better exchange rate policies, and some gradual advancement in structural change, but not much. This will be a positive balance. Although history is full of forgotten lessons, I believe that some of the ones learned from the debt crisis will long be remembered by Latin America.

Concluding Observations

Looking back on the past four years, the debt strategy that was put in place was effective in achieving its immediate objectives. Major individual country and systemic crises were averted and, most notably, a framework was established to coordinate the efforts of debtor countries, official and bank creditors, and international institutions. Nevertheless, it cannot be said that normal relations between debtors and creditors have been reestablished.

The policy response of Latin America to the debt crisis has been more effective in dealing with external imbalances than in controling domestic inflation or in laying the foundation for economic growth on a sustainable basis. It is a common experience that the reduction of external imbalances precedes that of reducing internal imbalances, perhaps because the former is viewed as inevitable and beyond the control of the authorities. Internal adjustment—namely, reducing inflation or the size of public sectors or making them more efficient—requires measures and policies that often are vigorously resisted politically, in part because they are not necessarily perceived as actions that are truly indispensable.

Structural change is certainly the long-term correct strategy to establish the conditions for durable growth, particularly when countries face the constraints of the need to (a) reduce fiscal deficits and (b) avoid

incurring substantial additional external indebtedness. Although structural change is the right approach, it must be recognized that there will be strong political resistance to measures aimed at reducing the relative size of the public sectors or at opening trade or the capital accounts of the balance of payments.

The present debt strategy is under strain because one of its important components, namely additional commercial bank financing, has become increasingly difficult to obtain; it is noteworthy that in 1986 commercial bank flows to Latin America were negative (see table 4.13). Compounding this situation is the weakening of the adjustment effort in some of the debtor countries. In these circumstances, calls have been made again for some form of debt relief. The discount that the markets have established between the contractual value of the debt and its price in the secondary market is seen by some as the way both to provide debt relief and to allow the banks to present their situation in more realistic terms. However, there are difficult distributional and efficiency issues that need to be settled first. Beyond that there is also the key question of where the financing is going to come from for any institution to buy country debt, even at a discount.

Finally, it should be said that achieving economic growth on a sustainable basis is a very elusive and complex goal. Durable economic growth does not come about without a major effort of savings, investment, and technological and educational changes within a society. Sustainable growth does not follow automatically from the mere availability of additional financing, nor does it necessarily stop in response to a reduction in financing; it is the result of the quality of the policy mix put in place for a long period of time (Camdessus 1987). It is with this perspective in mind that the interrelationships between the debt strategy and economic growth should be contemplated.

Notes

The views presented here are those of the author and do not necessarily represent the position of the International Monetary Fund.

1. In only four years, from 1978 to 1982, the three largest countries—Argentina, Brazil, and Mexico—more than doubled the size of their nonfinancial public-sector deficits, which rose from the already high levels of around 6 percent of GDP to well over 15 percent.

2. For a different view, see Fischer (1986, 3). Fischer thinks that the rise in the ex ante real rate of interest was one of the major causes of the debt crisis.

3. IMF, *World Economic Outlook*, February 1987, p. 37.

4. For a discussion on the importance of resource efficiency see Guitián (1987), especially p. 15.

5. For a discussion of the major conceptual and methodological problems, see Maciejewski (1983, 491).

6. See Sourrouille (1987) for a discussion of the need to fight inflation without lowering real wages.

7. For a discussion of the power of interest groups, see Mueller (1986).

8. "Policymaking by conviction vis-à-vis policymaking by the inevitability of it all." This is the way Adolfo Diz, in a personal conversation, characterized this situation.

9. For an excellent discussion of options for new debt initiatives, see Feldstein et al. (1987).

10. For a discussion of this topic, see Dornbusch (1986).

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5. R. T. McNamar

Evolution of the International Debt Challenge

> This is no time to mince words. What today, at the inception of our work, have we found? Well, in the first place, we see an impenetrable and colossal fogbank of economic opinions, based upon premises of fact which have changed so rapidly as to make the bulk of them seem worthless, even if they were in agreement. With all due respect to the great ability of those experts who have wandered through this gloomy labyrinth, they could not have failed to come out in the opposite direction. They were confronted with the necessity of finding stable conditions where no conditions were stable.
>
> In general, we have failed to find much value in economic arguments based on what ought to be instead of what is.

These are the words of Charles Dawes in Paris on January 14, 1924, when he opened the meeting of the Committee of Experts that became known as the Dawes Committee. At the time, Germany had defaulted on its World War I reparation payments, and France and Belgium had sent troops into the Ruhr. The British had taken exception to the French and Belgian action, while the Germans threw up their hands and simply asserted they could not pay.

And so Dawes was called to head a nongovernmental Committee of Experts to solve an apparently intractable situation. Well, by agreeing to stabilize the German economy (making what today the IMF would call structural adjustments), extending the time for reparations, and relating it to the German economy's ability to service the debt, Dawes developed a policy consensus that was implemented.

Today the question of repayments and debt service in each heavily indebted country involves both economic and political problems. And a permanent resolution necessitates a compromise between the economics and the politics, along the lines of expediency, which recognizes the real essentials of both. Again, Dawes's words summarizing his view of the situation after World War I may strike you as appropriate for today's challenges in resolving the overhang of international debt:

> In negotiating settlements of such a nature, men of official position, endeavoring to avoid offense to public opinion, tend to advocate proposals sacrificing economic principles for temporary political objectives, while economists, on the other hand, in applying economic principles tend to disregard existing public sentiments, which however prejudiced, ignorant, or temporary at first, must eventually determine the fate of the settlement.

These strike me as rather statesman-like words from a man who only a few years before had actually been the Comptroller of the Currency of the United States. Many people have forgotten that.

Let me talk about the evolution of the debt challenge. In August 1982, the international financial community was virtually paralyzed with fear. Mexico, Brazil, Argentina, and indeed Yugoslavia appeared on the brink of economic collapse. Although our European friends might not believe it, we in the United States were quite concerned about Yugoslavia.

In Toronto in September 1982, the mood of the meeting of the International Monetary Fund and World Bank was almost universally morose. Fear was widespread that the world's banking system would collapse, bringing an implosion of credit, then trade, and ultimately an inevitable worldwide depression.

Today we find ourselves in a different, rather improved world. Consensus has been reached on many points, yet the long-term solution is not evident, as real growth in the industrial countries appears fragile.

I shall ignore the origins of the problem, as they are well understood and chronicled. Indeed, I think Jeff Sach's paper (see above) was excellent on that point. Rather, I would like to review what I believe are the four phases of the debt problem's resolution and analyze some potential ideas that, with additional work, may have merit.

The four phases of the debt challenge that I have observed begins with Phase I, which was characterized by a crisis mentality and concern

over liquidity. This was late 1982–83. Phase II was the period in which industrialized and developing countries alike came to grips with what had to be done to stabilize and strengthen the world financial system. That began sometime in 1983 and continued into the beginning of 1984 perhaps. Phase III, the period when orthodoxy and conventional solutions were applied with limited success and new approaches began to emerge, is where I would suggest we are today. Phase IV is, quite frankly, the next twenty-five years, when the problem will be resolved and be only of historical interest.

As Wilfred Gutt, the former chief executive of Deutsche Bank observed, in the life of every banker there is one event that leaves a permanent mark. For this generation of bankers that event appears to be the international debt crisis. Let's examine the management of that crisis, or challenge, as I prefer to call it.

Phase I: liquidity squeeze and crisis mentality. Throughout the spring and summer of 1982, the U.S. Treasury and the Federal Reserve had been concerned about the international debt situation. In the spring of 1982, the U.S. Treasury held a series of meetings with Mexican officials and repeatedly requested, but never received, an in-depth analysis of their economic and reserve situation or at least consultations with the then Lopez-Portillo Administration. In addition to Mexico, a very close watch was kept on Yugoslavia where the situation was deteriorating. And the Argentine debt situation was becoming critical as events led to the Malvinas conflict.

The debt crisis is usually considered to have begun on Thursday, August 12, 1982, when Mexico's newly appointed Finance Minister Silva-Herzog called the U.S. Treasury to say Mexico would completely exhaust its foreign exchange reserves by the following Monday. The next day, the Finance Minister flew to Washington. Over an intensive weekend (that I think might meet Mike Blumenthal's test of a period of exigency), the U.S. government arranged to prepay $1 billion in oil shipments for the strategic petroleum reserve, provide $1 billion to Mexico in CCC guarantees, and the Treasury, the Federal Reserve, and the BIS agreed to bridge loans totaling $1.85 billion, until Mexico could develop an approved economic adjustment IMF program.

Mexico squeezed by, but a crisis mentality among international bankers developed almost immediately. International confidence in the ability of the largest developing countries to service their debts had been dealt a staggering blow. With its vast oil reserves, Mexico had been considered among the most creditworthy of the developing nations. And I suspect that most people in this room would have shared the view that oil would go to $50 a barrel by now.

Within three weeks, the financial world was shaken again by similar problems in both Brazil and Yugoslavia. In Argentina the economic situation continued to deteriorate. By February 1983, some fifteen

countries had encountered severe debt-servicing problems involving moratoria, extraordinary financing, forced reschedulings, and the necessity for an IMF program.

I think Phase I can be characterized first by the fact that there was an extreme liquidity problem for the debtors. Although their long-term economic prospects may have been positive, the sudden constriction of international lending caused a major shortage of hard currency for many developing countries. The so-called rollover assumption was shattered.

A second characteristic was the atmosphere of impending crisis. Genuine fear of a collapse of the banking system and subsequent collapse of trade and worldwide depression permeated the financial community. These fears were overblown and exaggerated by a press that did not understand the implications of the problem at first. I cannot overstate the morose atmosphere at the Toronto Bank-Fund meetings in September 1982.

The third characteristic of this phase, frankly, was a lack of global experience in dealing with such problems. Financial institutions and government leaders simply had not dealt with problems of this magnitude and number. No one fully understood the nature and dimensions of the problem. There was simply no briefing book, collected judgment, or historical precedent.

Phase II: coming to terms with the challenge. By February 1983, the monetary system had reached the brink and was coming back. Phase II had begun. Substantial progress had been made in settling the financial problems of key debtor countries, and our knowledge and understanding of that problem had increased dramatically. Plus, confidence had been restored so that we knew the world's financial system would not immediately collapse.

At the same time, G-10 agreed to a U.S. proposal to modify and expand the IMF General Agreement to Borrow (GAB). This was designed to serve as a standby borrowing arrangement for the IMF in emergency situations, which might threaten the stability of the system. For the first time there would be a safety net for the international financial system.

I might stop here for a second and say that I think this is an often overlooked event by the historians and the economists. There was no authorization to use the GAB for anything other than developed or industrialized countries who had balance of payments problems prior to this change. That fund is now available to assist a developing or developed country who gets into trouble because of an inability to service debt. There was no safety net at the beginning, now there is. It may or may not ultimately be used or be adequate, but at least a net is there.

Also by February 1983, our knowledge and understanding of the debt problem had improved. A process for handling the debt problems involving the IMF, the BIS, creditor governments, bank regulators, bank advisory groups, and debtor governments was emerging. I would say a fair characterization of the process would be to say that it was ad hoc, disorderly, poorly articulated, and minimally adequate. Indeed, I think that Charles Schultze's comment this morning that it was "muddling through" was probably fairly accurate.

Nonetheless, confidence had been restored. Indeed, the IMF meetings in 1983 were virtually upbeat by comparison to those in Toronto.

I think Phase II can be further characterized by what I call "country-specific" crises, or "mini-crises." Every deadline on a loan in a country seemed to bring a new problem. More country-specific problems erupted around the quarterly performance reviews at the IMF. Each of these were country-specific problems, not systemic threats, as in Phase I. Each was solved. And, I suggest that in the years ahead it's safe to predict that there will be more country-specific challenges. And they, too, will be managed.

A third characterization of Phase II was the rise and fall of ideas, such as a debtor's cartel or calls for global solutions. Debtor countries have come to realize that each country's situation is unique and requires a unique, appropriate domestic solution. In addition, developing countries, especially the newly industrializing ones, realize that their prospects for future growth are enhanced by continued cooperation with industrialized countries and the banking community rather than by confrontation and acrimony.

Similarly, global bailout schemes also emerged and declined in Phase II. These schemes, like the so-called debtor's cartel, failed to recognize the uniqueness of each debtor's situation and the importance of continued involvement and cooperation by creditor banks and governments on an individual country basis.

Key concepts were developed in Phase II. In 1983 some of these concepts emerged with the announced five-point U.S. strategy for resolving the international debt problem. This program consisted of adoption of policies by industrialized governments to promote sustained, noninflationary growth, encouragement of sound economic policies within debtor countries to allow them to live within their resources, strengthening of international financial institutions, encouragement of continued commercial bank lending, and continued willingness to provide bridge financing where necessary.

Phase III: convention and orthodoxy. Phase III has lasted from mid-1984 to the present time. This has been characterized by the application of conventional approaches or orthodox solutions for the debt challenges by the indebted countries, the IMF, and the commercial banks.

Probably the apex of this phase was the 1985 announcement of the Program of Sustained Growth at the IMF meeting in Seoul. This was a more positive and better articulation of the earlier five-point U.S. program. While sound from a policy objective standpoint, the so-called Baker initiative has simply not been implemented to date.

Further, the required preconditions of sustained, noninflationary growth and open markets for LDC exports are now, I believe, drawn into serious question. The Reagan Administration's trade actions have been mixed at best. By my own standards the Reagan Administration has been basically protectionist and inconsistent with its LDC debt strategy.

In addition, during this phase, as Sachs correctly points out, the free-rider syndrome—which has been mentioned by both Tony Solomon and Bill Ogden (see above)—has become quite acute among the small and regional banks. For example, but for the recent Brazilian announcement of a moratoria, the bank steering committee system would have probably collapsed because of the free-rider process and its cumbersome nature. That system plus the syndication process are proving increasingly cumbersome, ineffective, and perhaps simply unsustainable in their present form.

For example, 90 percent of the banks in the Brazilian syndicate provide only 5 percent of the money. And as Eduardo Wiesner (see above) pointed out quite correctly, the time lags between political consensus and the actual funding are increasing rather than decreasing. And, of critical importance to the developing countries and their ability to effectively implement change, political resolution must be followed by action. The current Mexican case is a perfect example of this problem when you consider the lag between the time the IMF-endorsed policy change was agreed to and the time the bank funding will actually take place. As that time lag is increased, the ability to affect policy change is reduced.

Last, during Phase III there have been tentative signs that the World Bank and the Inter-American Development Bank may begin to play a more active and forceful role in promoting policy-oriented and structural adjustment loans. Again, while the increased role of the MDBs is welcomed and necessary, I think it's questionable whether they will move quickly enough or effectively enough. And while they are a promising source of new financing, their future role is unclear and their response very uncertain.

Indeed, the U.S. position in the Inter-American Development Bank (IDB) as to the voting rights question has raised serious questions among Latin American countries as to whether the United States is in fact committed to an increase in IDB resources for structural adjustment loans. Many compromises were possible that would have met the

basic U.S. policy objectives. All were rejected by Jim Baker. As a result of his actions, questions have been raised as to whether there is in fact a U.S. intention to push for the additional money in Congress or whether politically it's simply better to say "we couldn't reach a deal, so I didn't come up to Congress to ask for money." Indeed, the U.S. position was met with open cynicism in Miami. Read this week's *Economist* if you'd like a rather scathing review of the U.S. position on the IDB voting rights question. I think we are in an unfortunate situation.

As the recent Mexican loan package and the current Brazilian situation suggest, and as others have mentioned, debt fatigue is affecting all the parties. Capital flight and pessimism over economic policymaking are reinforced by the debt overhang. Few can see this current Phase III either as sustainable for many years to come or as solving the problem.

Indeed, can all the indebted middle-income countries always produce a trade surplus and continue net transfer of resources abroad indefinitely? Hardly not.

And on the horizon I suggest that the pending oil shock of the 1990s, while temporarily helping the oil-exporting LDCs, will in the current environment make the orthodox strategy ineffectual. International trade and world economic growth will suffer.

Let's consider some numbers so we have a background for the energy threat that is very near upon us. Every $1 increase in the price of a barrel of oil costs the oil-importing LDCs some $1.3 billion in foreign exchange. And there's a general assumption that you'll have higher interest rates with higher energy prices because of monetary policy responses. A 1 percent rise in interest rates is approximately $2.6 billion in additional foreign exchange to these countries.

So assume that oil were to rise from its current $15+ level back to about $30—a $15-a-barrel increase—but assume that interest rates only went up by 5 percent. The aggregate increase in LDC debt service would be $32.5 billion in addition to what they currently owe, on an annual basis. Let me suggest that this will certainly focus everyone's attention on the unsustainability of the present situation. The increase in interest rates would obviously offset any gains to the oil-exporting LDCs.

In short, new initiatives are needed to augment or supplement the case-by-case approach. To date we've only bought time, but we have no present solution.

Phase IV: the evolved process. The evolution of the debt challenge to date does offer some encouragement that new and more innovative approaches will ameliorate the difficulties of rescheduling and adjustment. However appealing, no global solution suggested to date appears

feasible, negotiable, or to command a political consensus. Still the variety of new proposals indicates that reform and ultimately progress will continue to be made.

I would submit that there are nine points of general consensus:

1. Sustainable, noninflationary growth in the industrialized countries is a prerequisite.

2. Liberalized trade in both industrialized and developing countries must take place.

3. Moderate interest rates and realistic exchange rates must prevail.

4. Developing countries must have a positive inflow of net new capital.

5. Net new capital flows to developing countries must be invested in productive investments, not used for consumption or transfer payments.

6. Maturities on debt must be restructured into a realistic debt-service burden for those indebted countries.

7. Direct investment, debt-equity swaps, mutual funds, and other devices can all contribute to easing the short-term payments burdens and to stimulating economic activity.

8. Repayment in local currencies, interest capitalization, and similar schemes should all be judged by whether they will increase net new capital flows into productive investments. That is, if in fact they ultimately result in a decrease of net new capital flows, then they are inadequate schemes.

9. Domestic debt considerations will in fact have great influence on the industrialized countries' policies. One need only think of the Japanese national railway debt or the Farm Credit System in the United States and the interplay in our respective parliaments and congresses to see that there will not be any type of massive public subsidy of the debt. Indeed, the one point I would most strongly disagree with in Jeff Sachs's paper would be on the question of so-called debt relief for even the most extreme countries.

If what I have proposed is an accepted consensus (and it may well not be), then some recent developments suggest the outline of some events for Phase IV, which, again, I believe will last for twenty-five years.

First is the growth of domestic political pressures within the indebted countries. The political reality of rescheduling is that each indebted country must be able to show that it received as good or better terms than the most recently rescheduled loan. For example, the Philippines can point to its new package as being better than Mexico's 1986 rescheduling. In time, in my judgment, Brazil will undoubtedly do better still. Banks will have lower margins and fewer incentives to lend new money. This domino or contagion effect of extended maturities, length-

ening grace periods, and local currency substitution on notes will all continue to rationalize the existing maturities and promote longer term syndicated loans or bond issues of ten, fifteen, even twenty-five years.

Second, the securitization of existing debt is beginning. A very thin secondary market is developing. Swapping of sovereign debt for project finance bonds is also beginning and offers good encouragement. The Philippine Investment Notes (PINs) provide a way for smaller banks to exit the syndication system and promote local investment. Mutual funds utilizing sovereign country debt to invest in local companies are being carefully studied and generally endorsed by debtor countries and investors alike. Indeed, those of you who have seen today's *Wall Street Journal* know that the Bank of Montreal has proposed a $100 million Brazilian mutual fund converting its debt.

Third, new options are being proposed that meet all the parties' needs. For example, one that I think deserves study (it's not new) is a split-currency interest rate to provide local capital. In this scheme, a rate of interest would be established that reflects a country's ability to pay, which conceivably could be below market rate; let's assume half of the market spread owed LIBOR. The difference between this rate and the market rate would be paid in local currency. This local currency interest rate payment would then be optionally relent to either the governments or the IDB, ADB, or World Bank to provide local counterpart funds for local projects. Again, recall that one reason for the decline in World Bank and IDB project lending is the lack of these funds.

The repayment terms on these local currency counterpart funds would coincide with the payment terms of the principle debt. These loans would be interest bearing. To avoid a foreign exchange loss to the commercial banks, these local currency loans, as well as the interest on the relent interest (that is, the part that is sent back for counterpart financing), could be indexed to the U.S. dollar or some other convertible currency and repaid by the debtor country in dollars at maturity, well into the future.

Let me say that I think people now realize that bank insolvency may not be substantially reduced from what it is today. The LDC debt problem for the banks is a funding or liquidity problem, not an accounting problem. So long as a bank can borrow profitably (that is, have an adequate spread either in the depositor market, the inner bank market, CDs, or international capital markets), it can tolerate the existence of loans that do not pay interest. Obviously, the higher a bank's asset quality, the better is its opportunity to manage its liabilities, that is, it can have longer term liabilities and be at the lowest rate over Treasuries or have an adequate spread to continue to make a profit.

So the term and spread over Treasuries can be better maintained, and the banks can fund themselves when they have higher asset quality.

By contrast, many analysts suggest that the money-center banks have already been discounted in the capital markets and that a further disposition of LDC debt will only injure their reported earnings, not further erode their bond ratings or funding costs. I'm sure there would be some erosion. I'm sure there would be some increase in funding cost or loss of ability to raise new capital.

But think about it. While the money-center banks in the United States today sell for about 40 percent of the price-earnings ratio of the Standard & Poor's 500, they're still able to raise capital and tolerate losses on LDC debt. I think this may, in some respects, suggest why you see a hardening of attitudes on the banks' parts. They're able to tolerate the losses and can increase their reserves. Remember, banks' reserves are counted as part of primary capital by a commercial bank.

Interest rate spreads and commissions will continue to narrow whether the banks like it or not. Commissions in 1982 were running 1.0–1.5 percent. By Mexico's 1984 rescheduling, it was 0.63 percent. And I don't hear a lot of talk about commissions today. Spreads have gone little less than 2.0–2.5 percent in 1982 to Mexico's 1984 rescheduling of 1.5 percent. Now we're down to the famous 13/16 percent. And the Philippines asserts it's doing a little better than that. I'm not sure I quite understand that, but I'm sure that it can be packaged for domestic consumption in Manila as being better than 13/16 percent. And again, I'm willing to predict that Brazil will ultimately find one way or another to come in at better than 13/16 percent.

The bank earnings from rescheduled loans are therefore going down, lowering return on LDC assets. As this happens, alternatives to redeploy these assets look more and more attractive to the banks. This is why you see the mutual fund proposal from the Bank of Montreal, a willingness to underwrite and participate in PINs, growth of swaps in Chile, and so on.

Let me say that I agree with Tony Solomon's view that the banks are incapable of a proactive solution where they come up with a proposal. They are basically going to continue to be in a reactive mode. I think, though, that time has brought a certain maturity to the bankers, to the IMF's understanding, to the World Bank, and certainly to the United States and other creditor governments.

And I also think there is some maturity in the debtor governments. I think that we will see exit vehicles for the smaller banks. I would hope that the World Bank in its structural adjustment lending will try to work with the IMF. However, I'm not encouraged by the current Mexican program. I have to tell you I'm quite disappointed in it. I think that the World Bank structural adjustment loan that was put

together there can only be described as a pious hope, as opposed to a comprehensive program. That does not bode well.

One last comment: when people talk about U.S. government leadership, as Bill Ogden did, let me suggest that there is a background or set of criteria against which that leadership should be judged. It's very clear, or it should be very clear, that the IMF quota increase in 1983 was almost not passed by the U.S. Congress, despite the fact that it had been widely criticized internationally and by the banks as being inadequate in size. The United States has been too niggardly in terms of the access levels on the quota and other matters.

At the U.S. Treasury we found we were dealing with senators like the one who told us that the loan on his motel had been cancelled by his banker in a local small town because the banker told him he'd relent the money to big money-center banks, and they'd loaned it to Mexico, and he couldn't get it back. Well, I suggest there were probably other factors involved, but I don't know them. I do know I did not get his vote on the quota increase. And he's still there.

Let me suggest that you have to look at any of these global solutions, like an interest rate subsidy or an interest rate guarantee or anything else, in terms of the real politics of the United States. You have to look at it against the fact that we are currently having difficulty getting a replenishment of FISLC, our savings and loan guarantee fund. The analysis that I have personally participated in and have seen suggests that as of the third quarter last year, a minimal number for FISLC would require $35–$40 billion of new money—minimal. The Administration is pushing $15 billion, yet the Congress is talking $7.5 billion. We are not even addressing the problem. We can't even raise the money for a domestically supported program.

One must see debt release schemes for LDCs against the background of the current House Majority Leader's call for forbearance among the Texas savings and loans. You have to see it against the energy loans to the Texas, Louisiana, and Colorado banks, because I think the argument that there is a liquidity problem on these loans but that they're really good long term, because oil is going to be $30 or $40 a barrel, has a frightening parallel to the LDC situation. So I think it will be difficult, realistically, to expect the United States to continue to reduce its fiscal deficit, which we all agree it should, and at the same time to increase its subsidies, guarantees, or cash outlays on any type of global debt forgiveness scheme.

My conclusion is that it will take a variety of partial solutions acting in concert to "muddle through" Phase IV. Or we will need another Charles Dawes to provide a new consensus where neither economists nor politicians can currently forge one.

Summary of Discussion

Schmidt stated that progress can be made on the LDC debt problem only if the United States takes the initiative. He reiterated his belief that the Baker plan is a prophecy which the U.S. Treasury has yet to fulfill. Debtors will not be able to pay back the loans at face value; therefore, additional support must be forthcoming from either the IMF, the U.S. Congress, or a new international institution. In case this support is not forthcoming, banks should be setting aside reserves in anticipation of a substantial write-down.

Petty expressed the view that international financial cooperation between bankers, creditor governments, and international institutions occurs as the fear of failing grips them. To date, much more could have been done on the LDC debt issue. The Paris Club could have used reschedulings as an opportunity to offer more concessional terms, for example. *Anthony Solomon* agreed that the Paris Club has been niggardly, adding that it has offered no more leadership than the commercial banks themselves. Petty then suggested that guarantees on World Bank debt, which currently cover only principal, could be legally extended to cover interest instead. Asymmetric SDR allocations to the LDCs could be used to finance these countries and to encourage additional purchases from the developed countries. The debt problem will not be resolved in an international environment of slow growth.

Ogden concurred that leadership has been lacking and expressed disappointment that the U.S. government has not been more aggressive. The Bundesbank required West German banks to use the proceeds they earned on their rediscounts to supplement their loan-loss reserves. He thought it unlikely the Federal Reserve Board would mandate such a farsighted policy. Ogden found the inaction of the United States even more disappointing because a leadership role would not be very costly. For a time, the banks were close to setting a positive example with Brazil. A little bit of U.S. leadership would have gone a long way in helping to bring Brazil back into the international capital market and in persuading banks to resume voluntary lending. In view of Brazil's economic vitality, it is unfortunate that irresponsible Brazilian statements and policies were allowed to push the resumption of voluntary lending still further into the future. Ogden also expressed concern about the difficulty of keeping smaller banks involved in repeated refinancings. He felt this to be another area in which stronger government leadership would make a difference.

Carli argued that the huge U.S. capital account surpluses made finding additional financing for LDCs much more difficult. The $4 billion or $5 billion made available to LDCs pales in comparison with the U.S.

external borrowing requirements of $150 billion. As long as the United States absorbs so much of world savings, there is little opportunity for other countries.

Sachs pointed out that the discussion had focused on the financial implications of the debt for developed countries and had ignored the perspective of the debtor countries. From the point of view of the banks and creditor governments, the debt problem revolves around the question of whether the debts would be resolved without banks assuming large losses. But from the perspective of the LDCs, the debt problem has meant five years of misery: per capita income has fallen 20 percent, public services and infrastructures have deteriorated drastically, energy production is insufficient, and many public-sector corporations are bankrupt. Sachs argued that many proposals are simply financial band-aids and that the actors involved should be actively considering plans of selective debt relief. Bolivia had perhaps the most severe hyperinflation of the century: its terms of trade had fallen 20 percent with the collapse of tin and gas prices, and it was on the brink of complete financial collapse. Nevertheless, the IMF expected continued adherence to its program. This would have required Bolivia to funnel 60 percent of government revenues into debt service to banks. The IMF backed down, at last, but the incident indicates that bankers or IMF officials will continue to be surprised when defaults occur. The ultimate outcome could be a period of generalized debt moratoria. Sachs summarized empirical evidence that bank stocks were already discounted to reflect the price at which LDC loans are trading in secondary markets. A government-backed institution could purchase the debt from banks at current rates without a further loss to bank stockholders and give an enormous break to the debtors.

Feldstein held a different view from Sachs on the ability of the debtors to service the existing debts. He felt it was important to distinguish between larger countries, such as Mexico, Argentina, and Brazil, and some of the smaller ones, such as Bolivia and Peru. It is reasonable to be optimistic that these larger countries can maintain payments large enough to hold the nominal value of the debt constant, but small enough to allow for substantial increases in growth. He emphasized that political problems arise when different countries are treated differently. De facto, the Bolivias and the Perus will be allowed their conciliatory defaults. This kind of policy on the part of the banks is much less likely to be contagious to other debtor countries than a policy that officially condones such actions.

Wiesner disagreed with Sachs by saying that it was wrong to take the precrisis per capita level as the base for comparisons, since that particular base was not sustainable or realistic. Those high levels had been somewhat artificially raised by unsustainable external financial

flows and by unsustainable fiscal deficits. To put it simply, these countries had been living beyond their means. The worst thing that could happen to Latin America was to come out of the debt crisis believing that wrong domestic policies had not been the principal source of its tribulations.

Petty reacted to the idea of debt relief proposals by pointing out that it is difficult to forecast the reaction of markets to a write-down of the debt to the levels at which it is traded in the secondary markets. He did not agree with Sachs's contention that the discount in bank stocks is completely attributable to the banks' LDC portfolios. Real estate, oil, and energy-related loans also have not performed well and contribute substantially to the present discount in bank stocks. Petty was skeptical that the U.S. government would ever guarantee the bonds of an institution charged with the responsibility of buying up LDC bank debt.

Ogden responded to Sachs by observing that Brazil's growth rate of 8 percent in 1985 and 1986 qualified it to resume borrowing, but that the irresponsible actions of its finance minister did not. He emphasized that the cases of Brazil and Bolivia should not be lumped together. The IMF's persistence in Bolivia was absurd, he felt, and the banks will write off the Bolivian debt. Similarly, banks will take a loss in Peru. If we are to avoid a bad outcome, other small countries, such as Ecuador, will need help from both creditor governments and banks.

Sachs went on to say that missing in the discussion of the case-by-case approach is the point that the banks and the IMF may agree to write off the debt, but they seem unwilling to forgive it, even in the case of Bolivia. We sacrifice Bolivia because we are worried about Brazil. This goes against the case-by-case approach to debt relief. He emphasized that de facto forgiveness is not the same as de jure forgiveness. Only with the latter do the debtors have the chance to be discharged from bankruptcy.

Greenspan viewed the case-by-case approach as a poor way of planning for bad outcomes. If the Brazilian situation were to collapse, serious fiduciary questions would arise if bank stock became worthless. Insufficient attention has been paid to the question of what we would do if widespread default actually occurred.

Anthony Solomon agreed that some de facto forgiveness will be required, but could understand why the banks have not yet moved in this direction. The banks do not underestimate the political bandwagon effects of country-specific debt relief. He called Sachs's emphasis on granting de jure as well as de facto forgiveness almost ideological: even with complete de jure relief, Bolivia would not be cleansed of its reputation as a bad debtor.

Frenkel underscored Feldstein's earlier point that Brazil and Bolivia should not be mentioned in the same breath. He was skeptical about the likelihood of a doomsday scenario. When Brazil announced it would not pay, Argentina, Chile, and the Philippines were quick to complete their financing agreements: the domino effect may in fact go the other way. On the issue of de facto and de jure forgiveness, he stressed that the key issue is the degree to which capital markets have memory. Capital markets that function well are likely to have good memory.

Ruggiero agreed with Solomon that a radically different strategy is not really needed. Much of the necessary structural adjustment in LDCs has already been achieved. Further advances for the debtors will be contingent on three things. First, more growth in the industrialized countries is necessary if the debtors can hope to grow out of their debts. Second, in order for LDCs to take advantage of the higher growth, free trade must not be compromised. Third, the debtors will require further liquidity, and this must be made available. Currently, the banks and creditor governments have not found a way to guarantee the flow of credit. Each participant should not pretend that the responsibility of solving the problem lies elsewhere. The risks of failure go beyond narrow economic considerations: many LDC democracies may be lost if the problem is not properly resolved.

McNamar expressed uncertainty about the possibility of determining how much of the discount at which bank stocks trade is attributable purely to LDC debts. Whatever the discount, whether banks can continue to fund themselves, given their current asset structures, remains a good question. He noted that bond rating services seem to have discounted the bad debts accordingly. McNamar also stressed the need for greater foresight in dealing with reschedulings. Over the next two years, Brazil is scheduled to transfer $15–$20 billion to the banks. It is in the interest of all the major players to replace the bunching of payments with a smoother repayment flow.

Fischer remarked that several improvements in the debt situation had not been mentioned. First, real interest rates have come down from the onset of the crisis in 1982. Second, banks have made substantial adjustments by building up their balance sheets. Third, LDCs have dramatically improved their current accounts and balance of payments. The problem is that these changes may not be sustainable and do not constitute a long-term strategy for the debt overhang. He argued that a third party, such as the IMF or a creditor government, needs to take the initiative for a comprehensive restructuring. Looking ahead twenty-five years, we certainly don't want development to be financed primarily by short-term floating rate debt. This implies that any voluntary lending must be in the form of equity, direct investment, and long-term

bonds. Though debt-equity swaps are small flows, they will cumulate over time. But for many countries, these instruments will not be enough, and official flows must make up the difference. Such a change in the nature of LDC financing can be made only if better ways of monitoring LDC policies and imposing conditionality can be found, so that today's problems don't recur. Fischer also noted that the 20 percent reduction in per capita income of some of the debtors is measured since 1975, well before the debt crisis. In any case, a fall in real income should not be confused with the fall in absorption mentioned by Eduardo Wiesner.

Richardson suggested that we might use debt concessions to negotiate for trade consensus. The developed countries could insist on more restrictive rules governing the treatment of services, particularly intellectual property. The United States might ask for concessional treatment of U.S. multinationals in Mexico or Brazil in return for more generous debt relief.