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INTERNATIONAL POLICY COORDINATION: THE CASE OF THE DEVELOPING COUNTRY DEBT CRISIS

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ABSTRACT

This paper reviews the management of the debt crisis to date, and considers several possible alternative approaches for international cooperation in the future. The first part of the paper briefly reviews the scope of the crisis, and some of the reasons for its onset. Then, the paper describe the internationally coordinated policy responses to the crisis, as well as the conceptual underpinnings of this coordinated response. In the latter part of the paper, some of the reasons for the incomplete success of the policy response are described, and several alternative measures for the future are discussed. The discussion emphasizes the possible merits of debt forgiveness in addition to debt reschedulings as an instrument for the future management of the debt crisis.

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I. 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 which 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 has 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 a 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 U.K., 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 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 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 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,

Table 1

U.S. Bank Assets in the Debtor Countries
Nine Major Banks

	End-1982	Mid-1984	March 1986
Total Exposure ($b)			
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 from statistical release of October 15, 1984; March 1986 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).

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 II of the paper briefly reviews the scope of the crisis, and some of the reasons for its onset. Section III describes the internationally coordinated policy responses to the crisis. Section IV describes the conceptual underpinnings of this coordinated response, and Section V then describes some of the reasons for the incomplete success of the policy response. Section VI discusses several alternative measures for the future. Conclusions from the paper are summarized in Section VII.

II. The Scope and Origins of the LDC Debt Crisis

The basic outlines of the LDC debt crisis are by now very well known, so that only a brief summary of the onset of the crisis will be needed here. (Detailed accounts of the crisis can be found in several recent books, including Cline (1984), Lever (1986), Lomax (1986), Makin (1984), and Nunnenkamp (1986)). 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 (for example 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.

A. 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 (see Sachs (1981), Eichengreen and Portes (1986), and Fishlow (1985) for descriptions of the ups and downs of international lending during the past century). 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 onlending 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 large 10 developing country debtors, as a group, were oil exporters.[1]

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 banks 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-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 2) actually fell between 1973 and 1980 despite the

Table 2
Trade, Interest Rate, and Debt Indicators for the Developing Countries

	1978	1979	1980	1981	1982	1983	1984	1985
(a) Interest Rates[1]								
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

1. 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.

Source: International Monetary Fund, World Economic Outlook, April 1986.

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 (another way to put the same thing is that real interest rates were consistently below the rate of growth of real export earnings). In 1979, for example, as shown in Table 2(a) and 2(b), nominal U.S. interest rates averaged 11.2 percent, while the export earings 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.[2]

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 (see Table 2), 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

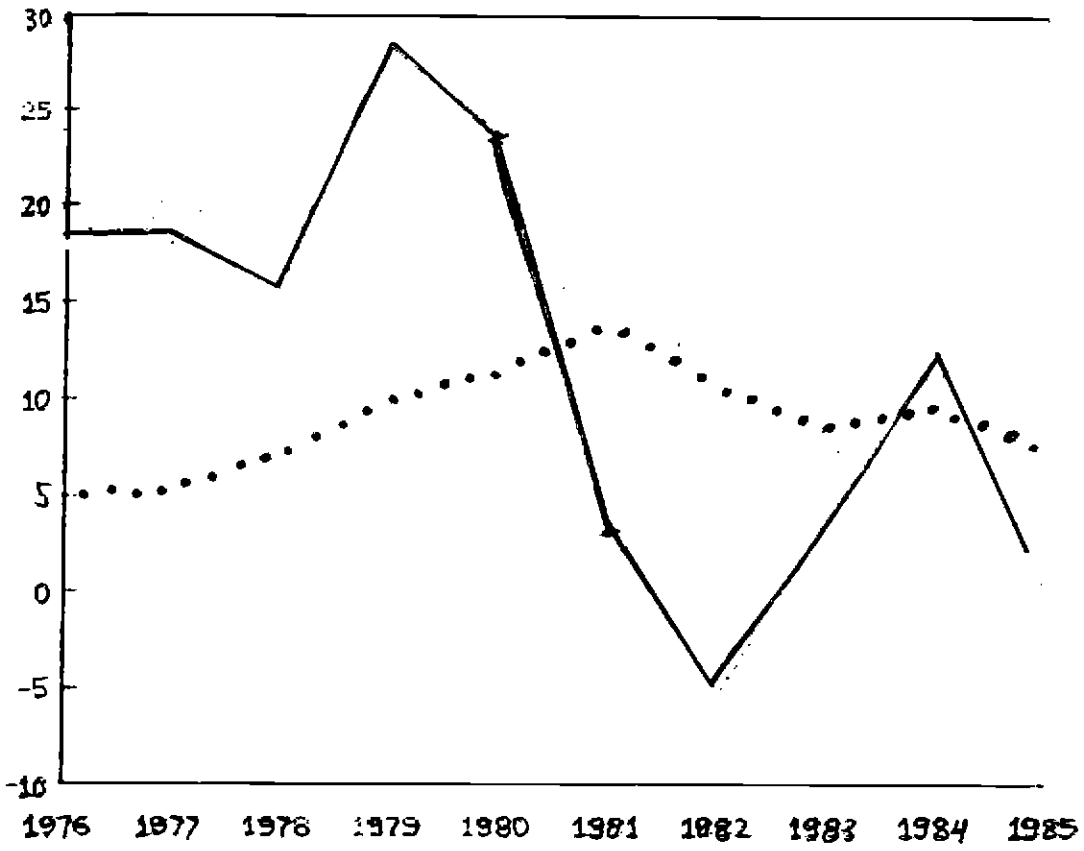
as the way to meet their debt-servicing needs.

The second and 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-growth relation after 1980, which is shown in Figure 1 (and in the data of Table 1).

The debt crisis followed relentlessly upon the rise in interest rates and 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 1). Bank lending itself dropped off, with gross BIS bank claims on the NOLDCs rising at 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 3 to 7 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

FIGURE 1. Interest Rates and Annual Change in Non-Oil LDC Export Earnings



····· U.S. Treasury Bill Rate

——— Export Earnings

Source: 1976-79, "non-oil" LDCs export value growth, from IMF World Economic Outlook, June 1981; 1980-85, "non-fuel exporter" LDCs export value growth, from the IMF World Economic Outlook, April 1986. Interest rates are U.S. Treasury bills, 3-month.

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 U.S. 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 Reaganomics tax cuts of 1981. As is now well understood, the especially high U.S. interest rates created a capital inflow into the U.S., and a sharp appreciation of the dollar.

B. 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 benefitted 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 <u>size</u> 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 (1982) among others, the orientation of trade and exchange rate policy was vital. Countries with export-promoting trade policies were far more successful in surmounting the external shocks. Third, 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 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 which 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 3 show the differences in real exchange rates of the two regions (vis-a-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:

Annual Changes in Export Volumes, 1980-84

	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

Source: International Monetary Fund, World Economic Outlook 1986, p. 205.

C. 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 was occurring in Argentina, Mexico, 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

Table 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	100	101	108	114	118	112
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: International Monetary Fund, International Financial Statistics. The real exchange rate is calculated as P/EP*, where P is the CPI, E is the exchange rate in units of currency per $U.S., and P* is the U.S. CPI. A rise in the index signifies a currency appreciation.

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.[3]

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 that the commercial banks were shovelling 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 defend the prevailing parity.

Thus, as shown in Table 4, the net claims of international banks on Mexico virtually doubled in the two years between end-'79 and end-'81, and the net claims more than doubled for Argentina. The combined claims on the three large debtors, Argentina, Brazil, and Mexico, almost exactly 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

Table 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	15.2

Source: BIS.

developing countries would rise rapidly in the near future unless these countries shifted towards a trade surplus, 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 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 ratios for 1980-83 for the two regions, we see the difference in Table 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 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

Table 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.

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.

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 of debt payments for 1982 and 1983. The list of reschedulers eventually ran up to more than forty countries.

III. 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, to which we turn first.

A. 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.

B. 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 banks' claims, only some of the rescheduling 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 of Table 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 of 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:

Table 6

Concerted Lending: Commitments and Disbursements, 1983 - Third Quarter, 1986[1]
(in Millions of U.S. dollars; classified by year of agreement in principle)

	1983		1984		1985		1st-3rd Qtr., 1986	
	Commit-ments	Disburse-ments	Commit-ments	Disburse-ments	Commit-ments	Disburse-ments	Commit-ments	Disburse-ments
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[2]	194	--	106
Colombia								
Medium-term loan	--	--	--	--	1,000	--	--	--
Costa Rica								
Revolving trade facilities	202	202	--	--	75	75	--	--
Cote d'Ivoire								
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[2]	--
Contingent investment support facility	--	--	--	--	--	--	1,200	--
Growth contingency co-financing with World Bank	--	--	--	--	--	--	500[2]	--

Table 6, Continued

	1983		1984		1985		1st-3rd Qtr., 1986	
	Commit-ments	Disburse-ments	Commit-ments	Disburse-ments	Commit-ments	Disburse-ments	Commit-ments	Disburse-ments
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: International Monetary Fund, International Capital Markets, December 1986, Table 45, p. 121.

1. These data exclude bridging loans.
2. These loans have an associated guarantee given by the World Bank in the later maturities equivalent to 50 percent of the nominal amount disbursed.

-- 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.[4] 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

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 U.S. since 1985. The World Bank has recently increased its lending to the heavily indebted countries, with many loans now coming as part 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 1986-1988, 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 multilateral development banks has 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 (see IMF International Capital Markets, December 1986, pp. 74-81).

IV. 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 the 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 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 economy. 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- 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 were 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 the 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 to 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.[5] 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 that 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 U.S. 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.

A. Enforcement of International Loan Agreements

The creditor governments have played a major role in recent years in raising the costs to default by the debtor countries. The leading governments have steadfastly opposed all forms of debt forgiveness or moratoria 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 is the penalty of default, the safer will be international lending in general, and the easier will it be for debtor governments to obtain loans. On the other hand, when debtor get 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 to far: the absence of the safety valve has forced some countries into situations of extreme economic misery and social instability.

B. 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 decisionmaking 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 <u>other banks</u> 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 that 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 <u>long-term</u> capacity to repay their loans, and are just stuck in a short-term credit squeeze. The Fund also recognized correctly that even if each bank agreed with such reasoning, there is no guarantee that the loan

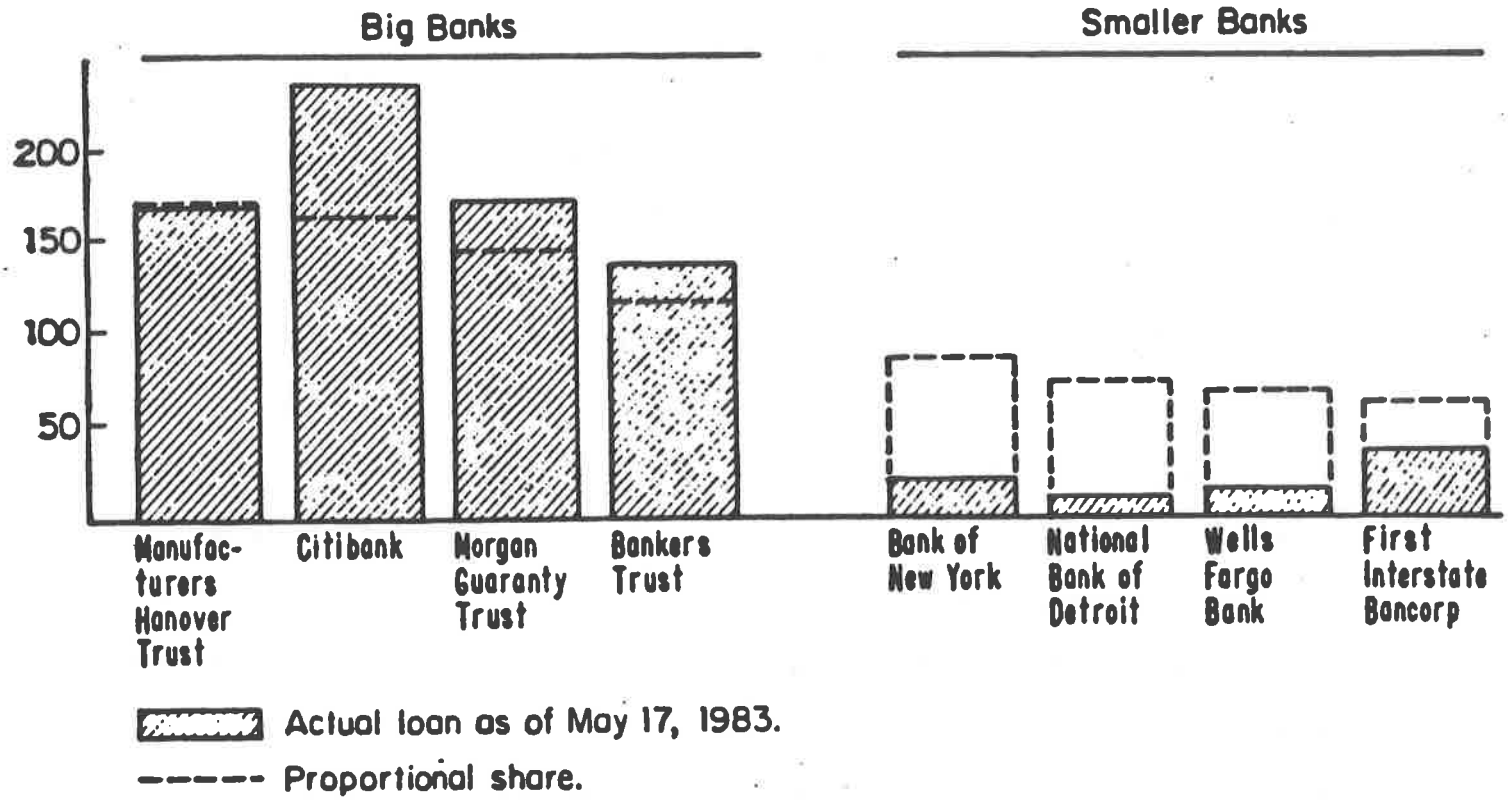
market on its own would spontaneously provide sufficient capital to the debtor countries.

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 the 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 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, and 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

FIGURE 2
RESCHEDULING PACKAGE OF INTERBANK LOANS TO BRAZIL

(in millions of dollars)



with the other creditors (and perhaps on a "first come, first serve" basis). Unless the creditors find some consensual way to reduce the value of the debt, or 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, 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 jointly 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.

C. 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, and 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 to 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.

V. 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 much more than they have received in new loans. For Latin America, the negative net resource transfer between 1982 and 1985 totalled 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 7. Also worrisome is the fact that investment in the debtor countries has declined sharply, so that the underpinnings for renewed growth in the coming years are not now being put in place. Table 8 shows the large decline in national investment as a percent of GNP. Private savings in the debtor countries is today spilling over into capital flight rather than new domestic investments.

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 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, and 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.

Table 7

Changes in Per Capita GDP in Latin America

Country	Cumulative Change in Per Capita GDP, 1981-1985
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
Venezuala	-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 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: International Monetary Fund, World Economic Outlook (April 1986), Table A7, p. 186.

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 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, and 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

Table 9

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

Exposure in	9 Money-Center Banks			All Other U.S. Banks		
	$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 1.

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 50,000 percent annual rate.

During mid-'85 to mid-'86, 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 Fund staff, with the IMF 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 of one percent of U.S. bank capital.

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 which 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 U.S., bank regulators have required writedowns 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 writedowns for 32 developing countries. In Europe, writedowns 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-a-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 10, U.S. money center banks chair the bank negotiating committees for <u>all</u> 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 Rumania. No doubt the European and Japanese banks find the hardline position of the U.S. banks a convenient one, since it has produced years of complete debt servicing by the largest debtors. But it

Table 10

Composition of Bank Advisory Committees

	Total	USA	Canada	Europe	UK	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 Rep.	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 Sud-americkanische/ 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 Tokyo)
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

*Co-chairman.

Source: David F. Lomas, The Developing Country Debt Crisis, MacMilan Press Ltd., London, 1986.

able to absorb 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 greater writedowns of LDC debt, and all plans involving debt forgiveness, the market value of these banks has already declined in anticipation of future debt writeoffs. 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 in a secondary market. Recent quotations (Salomon Brothers, December 1986) on LDC debt show the following bid prices (per $100 of face value):

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

Thus, in a sense, a market writedown of LDC claims has already occurred. However, the debtor countries have enjoyed no benefit from this writedown (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.

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 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 the 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, 12/15/86) Among the 15 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, is shown in Table 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 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 into 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 crisis for the foreseeable future.

Table 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: International Monetary Fund, International Capital Markets, December 1986, Table 7, p. 46.

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 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 U.S. 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 U.S., 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.

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 U.S. 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 U.S. and the Europeans work directly against this imperative. As an example, the U.S. recently (1/2/87) 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 U.S. 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.

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 the debt management strategy. 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 U.S. 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 and dedication for 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.[6]

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 in 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 responsive 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 towards better government has already been taken.

VI. 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 posing 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 for countries in the most extreme difficulties, there is a case for providing partial debt relief. The present value of the country's obligations would 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 are discussed 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 writeoffs, 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.

A. 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 Peron'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 <u>selectively</u> and <u>partially</u> 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 5 years of complete forgiveness of interest payments from debtor countries that have suffered a drop in per capita GDP of 15 per cent 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, Venezuala) 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% of bank capital. This 6.2% of bank capital is much less than the market writedowns of banks 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 Hatori (1985), 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 would 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 feature. 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' portfolio would be enough to justify such a swap to bank shareholders, who might otherwise object to a straightforward writedown 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.

B. 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

non-starters, 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 Fund would record and monitor the new senior borrowing, and help to verify the senior treatment of the new debt. The World Bank and the multilateral development banks 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 judgement 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 5 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.

C. 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 wellbeing. 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 drop 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.

VII. 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 country. 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 in the debtor countries, 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. These 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, that 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 resist 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 <u>senior</u> 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.

Footnotes

1. 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.

2. 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.

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

4. For a breakdown of the debt by creditor for different groups of borrowers, see IMF World Economic Outlook, Table A48, pp. 244-46.

5. 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 upon to facilitate future debt servicing.

6. See Wexler, Immanuel, The Marshall Plan Revisited, Westport Connecticut: Greenwood Press, 1983, pp. 48-49.

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