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THE EVOLUTION OF THE EXTERNAL DEBT PROBLEM IN LATIN AMERICA AND THE CARIBBEAN

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CONTENTS

I. THE INTERNATIONAL MANAGEMENT OF THE DEBT CRISIS. 1982-1987

When the debt crisis broke out in August 1982 there were objective conditions for an international financial collapse akin to those others in history which have marked the end of cyclical upswings in the flow of private capital from developed to developing areas.1/ The vulnerability of the international financial system in 1982 is well illustrated by the fragile condition of the U.S. banks: at the outset of the payments crisis they had loans outstanding in Latin America and the Caribbean equivalent to 124% of their primary capital. Moreover, the region's payments problems were led by three big debtors (Argentina, Brazil and Mexico) whose loans alone represented over 80% of the U.S. banking system's capital. The situation of the nine big money center banks --the heart of the U.S. financial system-- was even more critical as their loans to the region absorbed nearly 200% of primary capital (table 1).

Indeed, in some respects the stage was set for a crisis of potentially greater proportions than that witnessed earlier in history. To wit, the international lending that preceded the collapse of the 1930s was typically undertaken by individual investors who held bonds; hence, defaults directly affected the wealth of the risk takers themselves. With this, the financial collapse's effect in the spreading of depression to the real economy was largely limited to the loss of the investor's wealth and consequent reduced consumption.2/ In contrast, one or two major country defaults in 1982 would have severely eroded the capital base of a number of important international banks. Given the tightly intertwined national financial networks of the North, this could have been sufficient to destabilize world banking, with possible devastating consequences for the level of trade and output in the OECD economies.3/

In practice, however, the international financial system proved to be surprisingly resilient; notwithstanding a serious payments crisis in no less than 16 Latin American and Caribbean debtor countries, as well as problems in Africa (e.g., Nigeria, Togo, Senegal, Zaire, Zambia, Liberia and the Sudan), Asia (the Philippines) and Eastern Europe (Poland, Rumania and Yugoslavia) a classic financial collapse was avoided. Indeed, up through 1986 the private banks ironically experienced increased profitability even though they were in the midst of the worst financial crisis since the 1930s (table 2). Moreover, those healthy balance sheets helped the banks to dramatically reduce their exposure in the region relative to capital, thereby substantially assuaging the world financial system's vulnerability to default by the debtor countries. Again, the U.S. banks are illustrative; by March 1987 Latin American and Caribbean exposure relative to capital had been nearly halved with respect to 1982. The small and medium-sized institutions were especially well placed as Latin American and Caribbean loans fell to below 40% of capital (see again table 1).

Table 1

UNITED STATES BANKS EXPOSURE IN LATIN AMERICA AND THE CARIBBEAN (13 COUNTRIES) AS A PERCENTAGE OF THEIR PRIMARY CAPITAL

(Percentages)

	June 1982			March 1987		
	Total	Top 9	Rest	Total	Top 9	Rest
Latin America and the Caribbean (13 countries)	124.4	180.4	85.3	65.3	105.5	37.9
Argentina	13.3	20.7	8.2	7.7	13.4	3.7
Bolivia	0.5	0.9	0.4	0.1	0.1	0.1
Brazil	31.1	45.7	20.9	19.7	33.5	10.3
Colombia	4.6	7.7	2.5	1.7	3.1	0.8
Costa Rica	0.7	0.8	0.7	0.3	0.4	0.3
Chile	9.2	12.3	7.1	5.1	8.1	3.1
Ecuador	3.3	4.7	2.3	1.6	2.4	1.1
Mexico	38.2	50.4	29.7	19.4	27.6	13.7
Peru	3.6	4.9	2.6	1.0	1.3	0.7
Dominican Republic	0.7	1.3	0.3	0.3	0.6	0.1
Uruguay	1.1	1.6	0.7	0.7	1.4	0.3
Venezuela	16.3	26.5	9.2	7.2	12.6	3.5
Other	1.8	3.1	0.8	0.6	1.0	0.3

Source: Calculated from data of the U.S. Federal Financial Examinations Council, *Statistical Release*, various editions.

Table 2

EARNINGS OF LEADING U.S. BANKS

(As a percent of total assets)

	1980	1981	1982	1983	1984	1985	1986
Net interest revenue	0.76	0.67	0.67	0.67	0.67	0.67	0.67
Money Center Banks	2.4	2.4	2.9	2.9	3.2	3.2	3.2
Regional banks	3.4	3.3	3.4	3.6	3.9	4.0	4.0
Net income	0.62	0.59	0.58	0.65	0.63	0.64	0.65
Money Center Banks	0.51	0.52	0.54	0.63	0.60	0.68	0.71
Regional banks	0.76	0.67	0.63	0.66	0.66	0.59	0.58

Source: Salomon Brothers, A Review of Bank Performance: 1987 Edition, New York, April 1987.

The financial system has so far survived the challenge of systemic payment problems in the developing world due to an unprecedented co-ordinated international management of the debt crisis. The officially sanctioned formula for avoiding defaults and financial collapse is by now well known: On a case-by-case basis the IMF negotiated adjustment programmes in the problem debtor countries which acted as a "green light" for the banks to restructure debts on commercial repayment terms. Meanwhile, the OECD governments supported the process by encouraging negotiations between the debtors, and the banks and Fund, as well as by rescheduling government-to-government debt through the Paris Club and extending bilateral loans to complement commercial bank and IMF funding.4/ All told, since 1982 there have been four rounds of reschedulings of Latin America's bank debt which have involved restructurings totalling more than US$296 billion and new medium-term concerted lending of more than US$39 billion. This undoubtedly represents the most massive reorganization of international debt in financial history.5/

Notwithstanding the evident success in avoiding a collapse of the world financial system, the officially sanctioned management strategy has encountered increasing defections by creditors and debtors alike. This in turn has substantially altered the complexion of the management of the debt problem as well as the prospects for adjustment and economic restructuring in Latin America and the Caribbean.

1. 1982-1984: Converging interests and concerted international management

Creditors and debtors instinctively have different individual first preferences regarding the management of a severe debt service problem. On the one hand, prudential interests lead creditors to naturally prefer that the debtor fully adjust its current account so that debt can be serviced normally with the aid of little or no new net lending. Debtors, on the other hand, naturally want to protect their national income and output and thus prefer new financing to adjustment, at least in the near term. Clearly, if given the opportunity to negotiate there is, at least in principle, space for a mutually acceptable "second best" solution to emerge between the two parties that involves some combination of new finance by the creditors and adjustment by the debtors. However, historically, such solutions have only been reached after long, protracted negotiations. This has in turn given full play to the noted divergent primary reactions of the two parties, often leading to an explosive situation in which the former has cut off the flow of new loans and the latter has defaulted under the burdensome weight of unrefinanced payment obligations. Indeed, default has been a typical component of the "solution" which also includes a reduction of the market value of debt instruments that forces creditors to share the costs of an excessive build up of credit.6/

In 1982, however, three circumstantial factors helped to suspend the classic market solution. First, development in the postwar world economy had made international policy co-ordination and global management of a systemic financial crisis feasible. Second, that formidable institutional infrastructure could be effectively mobilized to stave off defaults, because at the time of the crisis perceptions of self interest on the part of the major actors --private banks, creditor governments, multilateral agencies and debtor countries-- caused all parties to converge on the same second best compromise solution to confront the crisis; third, debt was documented in forms difficult to market presenting, in the initial stage of the crisis, a reduction in the market prices of debt instruments.

a) International co-ordination

Central banks and finance ministries of the creditor governments had become accustomed to routinely co-operating on global economic issues both directly, as well as indirectly through multilateral agencies such as the IMF and the Bank for International Settlements. Thus, when the debt crisis broke out in 1982, international channels of communication were open and ready to deal with it. For their part, private banks --unlike the bondholders of the 1930s-- also had available to them an established institutional procedure for co-ordinating among themselves to negotiate en bloc with problem debtors to evade defaults. In effect, private banks, which have an oligopolistic market structure that permits them to easily identify each other and communicate, had learned to respond to isolated payment problems in developing countries during the 1970s by forming a Steering Committee to represent their interests in direct negotiations with the debtor country. By the late 1970s banks had worked out a standard procedure to avoid defaults: in return for the debtor country's acceptance of an IMF adjustment programme, the banks agreed to relieve debt service through a rescheduling of principal and partial refinancing of interest payments.

The availability of this international institutional infrastructure provided an unprecedented opportunity for debtors and creditors to negotiate an agreement. But to exploit that opportunity they had to first overcome a major additional hurdle. In effect, the Latin American and Caribbean payments problem that emerged in 1982-1983 was so severe that the finance derived from a rescheduling of principal alone was insufficient to maintain the debtors in a regular payments status. Yet private banks customarily refused to reschedule interest payments.7/ Meanwhile, multilateral financial agencies could not fill in the financing gap due to the erosion over the previous decade of their capacity to finance the world's balance-of-payments deficits.8/

A quick and innovative response to the financing dilemma appeared when the IMF boldly decided to directly position itself between debtors and creditors to ensure that a compromise was struck between the two parties regarding their respective concerns about adjustment and new finance. The IMF addressed the banks' preoccupation about adjustment and regular payment of the debt by i) agreeing to monitor the debtor countries' economic policies through stand-by agreements and ii) making a regular payments status with creditors a condition for the debtors' successful compliance with those agreements. However, in view of the scarcity of its own resources, the Fund insisted as part of the quid pro quo that the banks not only reschedule capital, but also commit new loans (termed involuntary lending) designed to help it finance the stand-by programmes. The banks disbursed their new credits pari passu with the Fund's, thus effectively linking the availability of their finance to the successful completion of the successive stages of that organization's rigorous conditionality.

In its new role the Fund effectively became a "catalyst" for private financing of problem debtor countries. During the first round of reschedulings in 1982/1983 the official ex ante formula called for creditor banks to expand their exposure by 7% per annum on a pro rata basis to those countries subscribing to Fund programmes. The involuntary loans --in matter of fact a disguised rescheduling of interest-- were designed to cover roughly half of the interest burden. During the first round of reschedulings the banks committed US$14 billion of new medium-term money to finance nine Latin American countries (table 3). The ex-post increase of the exposure of the banks, however, was somewhat less than 7%, in part due to the erosion of short-term credit lines and reduction of other types of lending.

b) Convergence of interests

The arrangement of such a complex package of rescheduling and new involuntary loan packages was facilitated by circumstances that induced the major actors in the debt crisis to suppress their primary reactions and converge on a second best compromise solution.

Table 3

LATIN AMERICA: PRIVATE BANKS' INVOLUNTARY MEDIUM-TERM LOAN COMMITMENTS a/

(Millions of dollars)

	Rescheduling exercises			
	1st Round 1982/1983	2nd Round 1983/1984	3rd Round 1984/1985	4th Round 1986/1987
Argentina	1 500	...	4 200	1 950
Brazil	4 400	6 500	...	...
Costa Rica	225	...	75	...
Chile	1 300	780	1 085 b/	...
Ecuador	430	...	200	350
Mexico	5 000	3 800	...	6 000
Panama	100	...	...	...
Peru	450	...	...	...
Uruguay	240	...	45	...
Total	13 645	11 080	5 665	8 300

Source: ECLAC, Economic Development Division.

a/ Gross loans organized in conjunction with rescheduling exercises. Some commitments remained undisbursed because of problems in completing IMF targets.

b/ US$150 million of which was covered by a World Bank guarantee.

Once a changed perception of risk in Latin America and the Caribbean pushed the private banks to their points of credit rationing, individual rationality dictated against new lending. Yet, as mentioned, many banks --especially the bigger ones-- were extremely vulnerable to any defaults that might occur. Thus when presented with a collective proposal for lending that promised to assuage the so-called "free-rider" problem,9/ it was in the interests of most private lenders to co-operate with new involuntary lending.

As for creditor governments, in the beginning of the 1980s many of them disavowed public intervention in markets and active support of multilateral lenders. However, when the crisis broke out the urgent need to rescue domestic and international financial systems from collapse induced them to quickly rescind their resistance to increased quotas for the IMF and to give emergency public bridge loans to problem debtors to support their reserve levels until the banks disbursed new loans. Moreover, behind the scenes, the OECD governments cajoled banks --especially the smaller ones with less incentive to lend-- and borrowers to co-operate in debt restructurings.

Meanwhile, the IMF had traditionally eschewed direct interference in the marketplace. Its decision to play the role of quasi-referee in the debt restructurings undoubtedly was influenced by the urgency of crisis. But also of importance was the opportunity to reassert the position of the Fund in balance-of-payments financing after that institution had been marginalized by the great banking expansion of the 1970s.

As for the Latin American and Caribbean debtor countries, they all initially co-operated with the official management strategy even though it suspended the classic risk sharing mechanism of default and thereby effectively shifted to them a greater share of the costs of resolving the crisis. The debtors' co-operation was elicited by at least two factors.

First, creditors promised that a quick adjustment of the debtors' economies would restore creditworthiness and access to credit markets. There also existed the implicit threat that default would ostracize debtors from those credit markets and bring costly sanctions.10/ Thus conventional wisdom based on a narrow rational economic calculation justified co-operation: assuming markets are efficient, it was entirely plausible that the present value of future flows of private credit, less that actual cost of short-term adjustment, would be greater than the present value of debt service saved by default less the lost income derived from sanctions.

Second, broader criteria than narrow self-interest motivated the cooperation of the borrowing countries. Throughout the 1970s --partly due to an abundant access to foreign credit-- the Latin American and Caribbean countries broadened their integration into the world economy. At the outset of the 1980s Latin America also initiated a period of political integration as manifested by the process of democratization in the region. These developments reinforced the region's shared values with the North, making debtor governments disposed to shared solutions through international co-operation.

Finally, an important global factor that contributed to a convergence of interests for a co-operative solution was the widely-accepted diagnosis that the debtor economies suffered from illiquidity --as opposed to insolvency-- and would therefore be quickly pulled out of trouble by the then expected sustained recovery of the world economy.11/ In these circumstances it became more rational for the creditors to attempt "to lend" themselves out of trouble and for the debtors to accept the short-term costs of adjustment.

2. 1985-1987: Diverging interests and a break up of the compromise

The first round of reschedulings was followed almost immediately by a second and third round carried out between late 1983 and early 1985. Private banks rescheduled US$130 billion of debts and committed new money totalling US$17 billion. These reorganizations were not without their difficulties, however, as some of the less exposed banks displayed growing resistance to further new lending and debtors complained about the increasing burden of recessionary adjustment as well as the high financial costs of the restructuring exercises. Debtors also began to express doubts about whether the communication among the creditors constituted co-operative management of the crisis, or the operation of a creditor cartel which colluded to avoid bearing a fair share of the costs of a solution. Indeed in early 1984 the debtor countries responded to their problems with the initiation of communication among themselves.12/ By mid-1984 communication had gelled into a formal debtors' forum: the eleven country Cartagena Consensus which facilitated ministerial-level discussion of issues of mutual interest concerning debt. While the Cartagena Consensus explicitly disavowed intentions of becoming a "debtors' cartel", fears nevertheless arose in creditor circles that this might be the eventual outcome of the co-operative efforts.

The creditors contained the centrifugal forces emerging in the debt crisis by making concessions to the debtors: at the urging of their home governments, the banks lowered commercial spreads and fees on the debt restructurings as well as granted much extended maturities and consolidation periods on those operations.13/ By the third round of reschedulings, the negotiated cost of credit had fallen well below the extraordinary high levels registered in the first round of negotiations; indeed in most cases that cost was below levels recorded in the normal credit market that preceded the crisis (table 4). The official management strategy also received help in late 1984 from declining international interest rates and the strong recovery of the world economy. Since world growth was led by a vigorous expansion in the U.S. economy, Latin American and Caribbean exports gained a special stimulus which dynamically boosted trade surpluses and allowed the region's economy to grow, albeit modestly, for the first time since 1980. All this calmed tensions in the debtor countries. With only Bolivia, Peru and Nicaragua in protracted arrears at the outset of 1985, some observers felt that the international debt management strategy had successfully defused the crisis.14/

Table 4

LATIN AMERICA AND THE CARIBBEAN (13 COUNTRIES): THE CONDITIONS OF THE INDEBTEDNESS WITH PRIVATE BANKS a/ b/

(Index: 1980-June 1981 = 100)

Country	Reschedulings: First round 1982/1983	Second round 1983/1984	Third round 1984/1985	Fourth round 1985/1986
Argentina	317	-	116	42
Brazil	144	108	43	...
Costa Rica	133	-	84	...
Cuba	148	93	65	...
Chile	250	151	89	50
Dominican Republic	235	-	61	...
Ecuador	342	191	109	49
Honduras	153	-	63	...
Mexico	281	160	83	44
Panama	274	-	79	...
Peru	197	133	-	-
Uruguay	349	-	97	44
Venezuela	-	-	68	43

Source: Calculated on the basis of data provided by the Economic Development Division of ECLAC.

a/ Based on an index of elements of the cost of credit which are subject to negotiation.
The formula is:

$$\left(\frac{\frac{C_1}{A_1} + M_1}{A_1} \right) / \left(\frac{\frac{C_0}{A_0} + M_0}{A_0} \right) \times 100$$

where: C = commissions; A = amortization period; M = margin over LIBOR and the subscript 1 refers to conditions during the respective reschedulings, while 0 refers to the conditions of the normal credit market of 1980-June 1981.

b/ During the reschedulings the banks often forced the State to assume responsibility for unguaranteed private sector obligations. This deterioration of terms is not captured in the index.

However, 1985 did not mark the triumph of the international debt management strategy. Instead, objective conditions contributed to a partial unraveling of the second best compromise which had been struck among practically all the participants during the first three rounds of the restructuring exercises. This in turn considerably changed the complexion of the debt problem and the way the major participants choose to deal with it.

a) The creditor banks

The banks' key contribution to the official strategy consisted of new involuntary general balance-of-payments loans. Their involvement in the new money packages was predicated upon: i) their severe vulnerability to default; ii) the expectation that the world economy would undergo a strong and sustained recovery; iii) the notion that the debtors suffered from illiquidity, not insolvency and iv) the expectation that the IMF would enforce adjustment. All these variables, however, evolved in such a way as to undermine the continued willingness of the banks to participate in involuntary lending packages.

i) Vulnerability to default. The debt crisis arose because most Latin American and Caribbean countries became unable to normally service their foreign debt. Yet the mechanics of the international debt management strategy successfully kept most of the region's loans very profitable for the banks, albeit through creative accounting involving the extension of new loans to facilitate payment of interest on old loans.15/ Keeping Latin American and Caribbean loans current bought time for the banks to bolster primary capital (equity and loan loss reserves) and thereby reduce their vulnerability to exposure in the region. Less vulnerability, however, objectively damped the incentive to grant involuntary loans.16/ Moreover, the creative accounting of the banks (extending new loans to maintain old ones current) did not impress the market. On the one hand, banks with significant loans outstanding in Latin America and the Caribbean suffered erosion of their stock share prices.17/ On the other, the more involuntary loans a country received, the greater the discount tended to be on the secondary market price of that debt.18/

Another repercussion of the strengthened balance sheets was that they progressively drove a wedge into the banking community and made it much more difficult for the banks to maintain a co-ordinated position to confront problem debtors. As illustrated in table 1, small and medium-sized U.S. banks had made considerably more progress than their bigger brethren in bringing down their relative exposure in the region. For them new lending became technically unnecessary and even perceived as a threat to their ability to compete with the big banks in the increasingly deregulated home market. Large lenders therefore found it much more difficult to corral the less committed banks into involuntary loan packages. Moreover, even when they did participate, the small and medium-sized lenders often partially neutralized the effect by withdrawing short-term lines of credit.

A further rift developed between the big U.S. banks and European and Japanese institutions. The latter, often more conservative in their accounting practices, had quickly built up relatively larger reserves against their Latin American and Caribbean loans.19/ Moreover, bank regulatory authorities of some countries found the aforementioned creative accounting unacceptable, forcing affected banks to reserve one dollar for every dollar they contributed to new involuntary loan packages. This made new lending extremely unattractive.

These conditions contributed to ever-greater delays in the organizing of new involuntary loan agreements, and, as can be observed in table 5, a dramatic decline in new net credit flows to the region. Indeed, by 1986 that net loan flow had turned negative.20/ Furthermore, the prospects for involuntary lending received a major blow in the second quarter of 1987. Faced with the growing dissension in the banking community, as well as other problems to be described below, the big U.S. banks decided to dramatically raise their reserves against loan losses.21/ That strategy damaged quite severely the technical foundation of the involuntary lending programme.

Table 5

PRIVATE BANK NET LENDING TO LATIN AMERICA a/

	1979	1980	1981	1982	1983	1984	1985	1986
Latin America	23.2	27.4	30.5	12.1	8.3	5.3	1.7	-1.6

Source: Bank for International Settlements, Fifty-Seventh Annual Report, Basle, March 1987, p.101.

a/ Change in assets adjusted for exchange rate movements. This may slightly underestimate loan flows because data on assets incorporate the effects of write offs and debt conversions. Note that in contrast to table 3 which contains partial commitments, these figures represent total net lending.

ii) The sluggish world economy. The creditors' co-operation partly rested on the expectation that a strong recovery in the industrialized countries would pull most debtor countries out of their servicing problems. The OECD economies did in fact recover from the 1982 recession. However, growth quickly peaked at 5% in 1984 and slipped sharply thereafter. By 1986 the industrialized economies rates of expansion had fallen below the 3% rate which some had established as the minimum necessary to bring considerable improvement in the debtors' capacity to pay.22/ Moreover, the outlook for 1987 and 1988 involved continued mediocre economic performances in the OECD area.23/

The environment of slow growth, along with structural changes in international production functions, also kept commodity prices generally depressed. The sharp fall in oil prices in early 1986 proved extremely damaging since the region is a net exporter of petroleum products. In any event, Latin America and the Caribbean --where commodities account for 80% of exports-- suffered further sharp terms-of-trade reversals in 1985 and 1986, leaving the overall index 20% below the level recorded in 1980.24/

Meanwhile, although in the latter half of 1984 nominal international interest rates began to drift downward, during 1985-1987 those rates remained high and burdensome in real terms (4.5%). A considerably more dire picture appeared when nominal interest rates were deflated by the debtor countries' export price indices; in that case real interest rates ranged between 15 and 20% (table 6).

iii) Illiquidity vs. insolvency. The faltering world economy contributed to a worsening of the debtor countries' economic situation and therefore made more banks reassess their original assumption that the debt crisis represented a short-term problem of illiquidity that would be quickly overcome.25/ Indeed, by the end of 1986 most conventional indicators of debt burdens (debt/exports, etc.) in Latin America and the Caribbean had become as bad as, or worse, than they were at the outset of the crisis.26/ Consequently, the bankers' foresaw a protracted payments problem in the region.27/

iv) The monitoring of adjustment. Viewed from the narrow perspective of current account balances, Latin America and the Caribbean adjusted in spectacular fashion: a deficit of US$41 billion in 1982 fell to nearly zero by 1985. However, the adjustment was achieved at the expense of growth in the debtor countries, causing adjustment fatigue to set in. For many debtor countries the IMF became a serious political liability.

By mid-1985 the Fund's grip on the Latin American and Caribbean adjustment process had clearly began to weaken. Only a handful of problem debtors had been able to consistently comply with its targets. Indeed, some countries had made it a matter of public policy to eschew the IMF entirely, or accept only partial and indirect contact through Article IV consultations. Thus, the role of the Fund as a referee in the negotiations between debtor and creditor faltered. Moreover, with a growing number of stand-by programmes paralysed, the IMF's net transfer of resources to the region declined and turned negative in 1986. Ironically from the banks' perspective the Fund had become a free rider, which provided them with additional disincentive to participate in new money packages.28/

Table 6

NOMINAL AND REAL INTERNATIONAL INTEREST RATES

(Percentages)

	Nominal LIBOR rate[a]	Nominal Prime rate[b]	CPI, indus- trialized countries	Variation in the unit value of Latin American exports of goods	Real LIBOR rate		Real Prime rate	
					[c] (1)/(3)	[d] (1)/(4)	[c] (2)/(3)	[d] (2)/(4)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1974	11.20	10.81	13.3	65.7	-1.9	-32.9	-2.2	-33.1
1975	7.61	7.86	11.1	2.6	-3.1	4.9	-2.9	5.1
1976	6.12	6.84	8.3	7.5	-2.0	-1.3	-1.3	-0.6
1977	6.42	6.83	8.4	17.2	-1.8	-9.2	-1.4	-8.8
1978	8.33	9.06	7.2	0.3	1.1	8.0	1.7	8.7
1979	11.99	12.67	9.2	22.7	2.6	-8.7	3.2	-8.2
1980	14.15	15.27	11.9	26.6	2.0	-9.8	3.0	-8.9
1981	16.52	18.85	9.9	-0.9	6.0	17.6	8.1	19.9
1982	13.25	14.77	7.5	-9.9	5.3	25.7	6.8	27.4
1983	9.79	10.81	5.0	-7.1	4.6	18.2	5.5	19.3
1984	11.20	12.04	4.8	2.6	6.1	8.4	6.9	9.2
1985	8.64	9.93	4.2	-6.0	4.3	15.6	5.5	16.9
1986	6.82	7.99	2.3	-12.7	4.4	22.4	5.9	23.7
1987[e]	7.29	8.14	3.1	...	4.2	...	5.0	...
1984								
I	11.10	11.68	5.1	...	5.7	...	6.3	...
II	11.30	12.40	4.5	...	6.5	...	7.6	...
1985								
I	9.05	10.37	4.4	...	4.5	...	5.6	...
II	8.23	9.50	4.0	...	4.1	...	5.3	...
1986								
I	7.43	8.98	2.8	...	4.5	...	6.0	...
II	6.20	7.70	1.9	...	4.2	...	5.7	...
1987								
I	6.86	7.64	2.6	...	4.2	...	4.9	...
II[f]	7.72	8.64	3.5	...	4.1	...	5.0	...

Source: ECLAC, on the basis of information from Morgan Guaranty Trust, *World Financial Markets*, and International Monetary Fund, *International Financial Statistics*.

[a]Corresponds to the interest rate for 180-day eurodollar deposits in London. [b]Preferential rate which United States banks grant to their best clients. [c]Nominal rate deflated by the consumer price index of the industrialized countries. [d]LIBOR rate deflated by the unit value of Latin American exports of goods. [e]January-November. [f]July-November

b) The IMF

The IMF's main contribution to the official debt management strategy was to insert itself directly between creditor and debtor in the restructuring negotiations. However, as already suggested, with time the Fund's relationship with both parties became increasingly awkward and this undermined its effectiveness in the adjustment process.

The recessionary nature of the IMF's programmes --which alienated many debtor countries-- had some of its origins in the design of the agreements and conditionality.29/ However, the decisive factor has been shown to be a severe short fall of finance vis-à-vis the requirements of socially efficient adjustment.30/ The scarcity of finance in turn highlighted the structural weakness of the Fund and its shortcomings as a catalyst for the mobilization of private finance.

Ostensibly the IMF designed its adjustment programmes flexibly on the much touted "case-by-case" principle, which should have allowed accommodation for the different economic and social conditions of the debtor countries. Yet in practice the IMF's reliance on the private banks for the finance of its adjustment programmes led to the application of a fairly rigid across-the-board formula for the management of debt service. First, countries wanting to co-operate with the Fund also had to reach a parallel agreement with the private banks since the former made the existence of debt arrears sufficient grounds for violation of a stand-by arrangement. Second, to arrive at an agreement with the banks the debtors had to accept the creditors' demand that debt reorganization packages bear commercial interest rates. Third, since forced lending by the banks was conventionally viewed as "bad" for a country's image of creditworthiness, de minimus criteria governed the volume of loans. Thus, in practice, a sufficient flow of credit emerged to keep the countries current on their debt payments, but not enough could be raised to support socially efficient adjustment. In sum, the new relationship with the banks created an anomaly in which a public macro-economic adjustment programme hinged on the narrow variable of debt service to private banks on commercial terms. All other variables --in particular growth in the debtor countries-- effectively became residuals in the adjustment process.

The debtor countries criticism of the recessionary adjustment process, coupled with the creditors declining response to its exhortations for new loans, eventually brought forth in late 1987 some rethinking in the Fund about its role in the adjustment process. This reflected itself in the September 1987 IMF/World Bank meeting in Washington, D.C., in which the new Managing Director, announced that the Fund would in the future consider: i) a longer time path for adjustment; ii) the introduction of more comprehensive contingency financing and iii) reduction of the number of variables employed in the application of conditionality.31/ Later, in October, the IMF announced a new US$65 million stand-by agreement with Costa Rica in which there was no requirement that the government reach prior agreement with the private banks concerning its arrears with them.32/ The new accord represented an important sign that the Fund might be formally delinking its adjustment programmes from the crisis management of the banks' assets.

c) <u>The creditor governments</u>

Being clearly reluctant interventors in the marketplace, industrialized country governments began as quiet behind-the-scenes players who encouraged negotiations between the banks and the borrowers and provided emergency bridge financing when necessary. However, as the initial state of converging interests among the major players began to evolve into a more divergent pattern, creditor governments, in behalf of their lender of last resort function, had to progressively step forward to directly corral all major parties into an agreement.

That process reached full maturity in September 1985 with the announcement of the "Program for Sustained Growth", more commonly known as the Baker Plan. The Plan promised to introduce renewed vigour to a strategy which had begun to sag on all fronts. In effect, the Baker Plan dramatically shifted the official management focus from austerity to growth, from balance-of-payments adjustment to economic reform and structural adjustment. To support growth the initiative promised to raise US$29 billion of new money over three years for 15 problem country borrowers, most of which were in Latin America. The contribution of the banks was announced as US$20 billion, which represented a modest 2 1/2% per annum expansion of bank exposure. The rest of the money would come from public lenders. Importantly, the Plan assigned a much greater role for the World Bank, which heretofore had been overshadowed by the IMF's daily short-term management of the debt crisis.

The Plan largely represented an initiative of the United States Government; the banks and debtor countries literally were "informed" of their respective participations in the programme.33/ However, the banks responded cooly to the new money commitment, while the borrowers displayed open skepticism of the Plan's ability to improve their plight.34/ This contributed to a difficult take-off for the new strategy. Indeed, it took nearly a year for the Plan's pilot case to emerge and even then it grew out of an emergency: a threat in late 1986 of a unilateral moratorium in Mexico if the official adjustment programme failed to attend to the growth aspirations of that country. On this occasion the banks --again "informed" of their new money commitment of US$7.7 billion (including contingency funds) to support a growth-oriented adjustment programme for Mexico-- reportedly were infuriated by public intervention which they interpreted as a forced abdication of control over their own loan portfolio.35/ As an indication of dissension, it took more than six months to finalize the participation of the banks in a new money package that marked the formal initiation of the Baker Plan (and the fourth round of reschedulings).

The diverging interests of the private banks and their creditor governments reflected changing conditions. By 1986 a critical mass of banks had improved their capital positions to a degree that they could become much more selective about the amounts and terms of the debt restructuring packages. Yet not all institutions were equally well protected. Thus from the public perspective of industrialized country governments, at the margin there still remained a risk of systemic bank failure and hence a role for concerted lending programmes.

However, in early 1987 signs appeared that the creditor government authorities also began to sense that the systemic threat had subsided. They began to actively support the incorporation of non-lending options in the restructuring exercises, such as debt-equity swaps and exit bonds. Also, authorities did not intervene to stave off the declaration of a moratorium in Brazil, the Third World's largest debtor. As if to confirm that the international financial system was stronger, the Brazilian moratorium provoked no panic in creditor bank circles either. Indeed, the big U.S. banks responded to the Brazilian declaration not by offering new loans to refinance interest payments, but rather by sharply raising loan loss reserves. This, of course, made them less vulnerable to official pressures to lend new money, whether from creditor or debtor governments. With incentives for new lending diminishing, and a growing number of countries functioning outside the framework of the international debt management strategy, the Baker Plan lost some of its original definition.

However, the U.S. stock market collapse in October 1987 gave renewed impulse to public intervention in the Latin American and Caribbean debt problem. In effect, U.S. banking authorities must declare loans with overdue interest in excess of six months "Value Impaired" unless there is a reasonable prospect of a settlement of those arrears. A reclassification to Value Impaired brings with it the requirement that the banks cover the problem loan with a specific reserve equivalent to 10% of its nominal value. Each year thereafter an additional specific reserve allocation of at least 15% is required against the questionable credit until it is fully written down.36/ The 6-month limit on arrears in Brazil coincidently arrived in the middle of a period of extreme fragility in world equity markets. The need to avoid more bad news contributed to the creditor governments application of direct pressure on the banks to reach an agreement with that country.37/ This led to an interim accord in which Brazil's major bank creditors promised to provide US$3 billion to refinance roughly two-thirds of 1987s interest arrears; the remaining third would be covered by a direct payment from Brazil.

d) The debtor countries

Even while preferring a global debt relief plan that would minimize their loss of income and output, the debtor countries immediate perception of self interest caused them to converge on the second best compromise arrangement that emerged out of international debt management strategy. However, with time perceptions changed about that management and about the options available to the debtors to reduce the burden of payments.

First, the debtor countries began to question the distribution of the costs of the crisis management. This had generated a large outward transfer from Latin American and Caribbean debtors to creditor countries equivalent to more than 4% of GDP, a figure that exceeded even the famous burden of German war reparations after WWI.38/ The official strategy also validated the private banks' claim to high commercial interest margins and fees on the restructuring exercises. The marked contrast between the lenders' profitability and the borrowers' depressed economies was too striking to be overlooked by the latter. This created resentment in the debtor countries and induced them to press very aggressively for lower interest margins and the elimination of fees.

As mentioned, the banks did come forth with concessions, but these tended to lag behind the deteriorating condition of most of the borrowers. Thus the pressure on the banks' lending terms intensified; indeed margins and fees gained a life of their own and became symbolic test of burden sharing in the debt restructurings. Moreover, by 1987 many Latin American and Caribbean debtors had begun to demand non-commercial rates in the form of zero or negative interest margins. There also emerged wide support in debtor circles for formal limits on payments.

Second, the debtor countries initial perception of a transitory crisis changed when it became evident in 1985 that the medium-term outlook involved sluggish world economic growth, depressed commodity prices, and high real international interest rates.

Third, private credit markets failed to fulfill their promise to respond to successful adjustment with renewed lending. In effect, most Latin American and Caribbean countries had made Herculean efforts to adjust and generate large trade surpluses. Moreover, some, like Brazil, Mexico and Venezuela, had by 1984 generated large enough trade surpluses to integrally finance interest payments without the help of involuntary loans from the banks. In late 1984 Venezuela even agreed to begin amortizing the debt. However, the debtors found that renouncing involuntary loans did not bring forth voluntary lending; rather it only became an excuse to accelerate the banks' retreat from the region. The problem has been recognized by the IMF. As Managing Director Camdessus recently remarked:

> "... it takes too long to have recognition of strengthened creditworthiness after implementation of adjustment policies. We have learned in this process that even if countries make impressive efforts and obtain results in the balance-of-payments field, in reducing their fiscal deficits, in embarking on structural adjustment change and better exchange rate policies; even if the reflow of flight capital begins to occur, the creditor community remains cautious and the delays in putting together the financing packages then are taken badly, and sometimes they tend to become somewhat destructive of the process itself."39/

The market's failure to respond with new lending clearly represented a degenerative influence on the international debt management strategy. As mentioned earlier, illiquid borrowers will naturally be inclined to accept the relatively high short-term costs of adjustment and commercially-priced restructuring packages. This is because underlying internal rates of return on capital are high; after a relatively brief period of adjustment the borrowing country expects to gain access to foreign loans which could be deployed to exploit that high rate of return. Thus, the net of foregone income today and the present value of future income from new loans is positive. This co-operative spirit, however, can change when markets fail to respond to positive developments. The illiquid borrower can gradually perceive that it is in his interest to behave like an insolvent borrower, even though it may not be one. The insolvent borrower, of course, calculates the net of foregone income today and the present value of future income generated from new loans as negative. Thus the best way for an insolvent borrower to maximize the present value of future resource flows from private markets is to negotiate debt forgiveness, or enter into full or partial moratorium.

This latter conclusion became reinforced by a fourth factor. With experience, the debtor countries realized that the creditors' threats of dramatic sanctions for non-co-operative behaviour were greatly exaggerated.40/ In practice, the major cost of de facto default was rather subtle: more difficult access to short-term credit lines. While the loss of short-term credit is undoubtedly troublesome, its negative impact can be controlled by countervailing strategies in the debtor countries.

Lastly, the debtor countries gradually realized that co-operation among themselves could enhance their individual negotiations with the Steering Committee. As mentioned, a regional approach to the debt problem began to emerge in early 1984. It has taken diverse forms such as regional governmental meetings, the formation of the Cartagena Consensus, the establishment of a formal "G-3" consultation group (Mexico, Argentina and Brazil), a G-8 Presidential Summit as well as ad hoc bilateral talks between governments on debt strategies.

These changing circumstances and perceptions in Latin America and the Caribbean led the countries to gradually reposition themselves vis-à-vis the international debt management strategy. A snapshot picture of the year 1987 summarizes well the diversity of the situation in Latin America. Argentina, Chile, Uruguay, Mexico, Venezuela and Colombia were --as they have largely been throughout the crisis--41/ current on the interest payments to the banks. However, Brazil, Bolivia, Ecuador, Costa Rica, Honduras, Cuba, Nicaragua and the Dominican Republic had been explicitly or implicitly in a state of conciliatory moratoria with these institutions throughout most of the year. Meanwhile, Peru continued to unilaterally limit the service on its pre-July 1985 debt to 10% of export earnings.42/

3. The future course of the international debt strategy: the market menu approach

The diverging interests of all the participants in the debt crisis contributed to a loss of definition in the international debt management strategy. One of the strategy's main pillars in particular --new involuntary loan packages to finance growth and economic reforms in the debtor countries-- suffered structural damage due to aggressive loan loss provisioning by the banks, coupled with their more negative perception about the region's future payments capacity. Indeed, with the banks actively exploring the alternatives to expanded exposure in Latin America and the Caribbean, even the modest --and according to many analysts inadequate--43/ lending targets of the Baker Plan remained unfulfilled in 1986-1987. Furthermore, the lending that did materialize generally represented a last minute patch work response to a threat of unilateral moratorium by a big Latin American borrower, or a scheme to erase arrears in interest payments.44/ All this contributed to a sensation that the international strategy had in fact degenerated into little more than "muddling through".

Notwithstanding the above, authorities in the creditor governments, multilateral agencies, and many major commercial banks have steadfastly supported the notion of a well defined international debt strategy. The basic principles set forth by Secretary Baker in September 1985 were reaffirmed in September 1987 as: i) promotion of economic growth in the debtor countries; ii) market-oriented policy reforms in those same countries; iii) additional capital —in the form of equity, debt, and repatriation of flight capital— to support the reforms and iv) respect of the case-by-case approach.45/ There was, however, at the same time tacit admission that the centrifugal forces at play in the arena of debt could not be entirely dominated. Thus, the involuntary loan packages —a centerpiece of the Baker Plan's "Program for Sustained Growth"— drifted into the background and became absorbed by the newest component of the international debt management strategy: the emerging "Market Menu Approach".

a) The market menu approach

The menu approach simply legitimizes the different alternatives to involuntary lending that the banks began to develop on their own to sanitize their loan portfolios in Latin America and the Caribbean. The two philosophical pillars of the menu approach are that the options contained therein be: i) market-based and ii) voluntarily negotiated between creditor and debtor.46/ As for the basic options themselves, they have been officially denoted as the following:47/

- Trade and project loans. Loans which are tied to specific commercial or investment activities. Banks are attracted to this option because returns are more identifiable than general purpose loans and therefore perceived to be more secure.

- On lending. Provisions which give the banks an opportunity to rechannel part of their loan payments to the local market.

- New money bonds. The replacement of all or part of the involuntary loan package with an emission of bonds by the debtor country. The bonds would likely enjoy seniority over old debt.

- Convertible notes. Debtors emit notes to the banks which they can convert into local equity.

- Exit bonds. A portion of outstanding debt is converted into fixed interest rate bonds. This will allow selected banks to "exit" from the rescheduling/new money packages.

- Debt-equity swaps. The transformation of outstanding debt into local equity. This can be done directly by the bank, or indirectly through secondary market transactions.

- Debt-charity swaps. Non-profit organizations purchase Latin American and Caribbean debt at a discount in secondary markets and exchange it for local currency that is deployed in a philanthropic fashion.

- Interest capitalization. These schemes, however, must be voluntary and limited in scope.

- General balance-of-payments loans. Traditional involuntary loan packages are also part of the menu.

b) What is not in the menu

The menu explicitly excludes all options which the market will not sanction. In particular, mechanisms such as general capitalization, debt forgiveness, moratorium, partial arrears, unilateral limits on payments (e.g., debt service as a percentage of exports) are excluded. This is because so-called non-market options are considered harmful to the debtor countries' creditworthiness and therefore foreclose the possibility of inherently strong economies gaining access to voluntary credit markets. In the official view, the debtor countries' "course into the Twenty-First Century must be built upon increasing their trade and financial linkages with the rest of the world, not undermining them".48/

II. EVALUATION OF THE MENU OF OPTIONS

Almost everyone agrees that a solution to the Latin American and Caribbean crisis must rest on economic restructuring in the debtor countries to promote more open and internationally competitive economies, coupled with the availability of adequate external finance to support that process. However, the international debt management strategy's market menu unfortunately does not adequately address the question of reform and its financing.

1. The market menu: basically a creditors' menu

As mentioned, the menu of options is an outgrowth of the banks' efforts to break out of the international debt management strategy's new lending packages. The banks developed the approach for their own commercial objectives.49/ Not surprisingly, it serves their immediate interests reasonably well. However, the same does not hold true for the interests of the debtor countries.

The international debt management strategy initially put the hundreds of creditor banks into one homogeneous vehicle: rescheduling cum involuntary loans. The approach did not accommodate the fact that the banks are a very heterogeneous group; banks compete with each other, express different business objectives, have different exposures in Latin America and the Caribbean and are subject to different banking regulatory environments. The banks could therefore be voluntarily contained in the official vehicle only for a very limited amount of time. In this sense it must be recognized that the menu approach is a healthy development because the creditor banks can more freely pursue the options that most suit their commercial preferences for portfolio development. In effect, each bank can better choose its own mix of instruments and establish the most convenient time path to exploit them. The menu is therefore a good vehicle for portfolio adjustment.

Nor is the menu devoid of attractions for the debtors. When presented with the menu the Latin American and Caribbean countries have always found something of interest to select. Different forms of debt-equity swaps have interested governments in the region as almost every commercially indebted country has introduced or is introducing some type of programme.50/

However, with regard to the central macroeconomic issue of financial support for economic growth and restructuring in Latin America and the Caribbean, the market menu is less helpful. Indeed, the menu repeats the basic flaw of the earlier stages of the debt crisis: the day-to-day mechanics of an international multilateral debt management programme remain very biased towards the objective of an orderly adjustment of private financial portfolios. The initial phase was overly characterized by a "holding action" to avoid accounting losses —via commercially priced reschedulings and new money packages— in the international financial system. The latest phase is now primarily oriented to the gradual adjustment of the banks' asset values and enhanced risk diversification through schemes involving debt swaps and securitization. The macroeconomic issue of improvement of the debtor countries' capacity to pay remains largely a passive residual to this process. It is in this sense that the market menu is basically a private creditors' menu.

2. The shortcoming of the market menu

To restore their payments capacity, Latin American and Caribbean economies must undergo serious socio-economic reform. However, successful market-oriented structural reform is linked to predictable access to adequate amounts of external finance through conventional channels. Sustained levels of finance are required for both political and economic reasons. On the one hand, the costs of reforms are politically easier to absorb if they are diluted by the effects of economic growth. On the other, serious reform involves considerable investment in human and physical capital that will raise productivity to internationally competitive levels. Sustained levels of finance also are important to contain uncertainties and encourage the participation of the private sector (including the repatriation of flight capital). Without adequate financial support the most heroic efforts of structural reform risk being frustrated by the outward transfer of national resources to service foreign debts.

The classic free market solution to a debt crisis can release a large amount of resources through its risk sharing device of default. Historically this has helped debtor countries sustain GDP levels even in the midst of a debt crisis; indeed, available evidence suggests that after 1929 Latin America suffered relatively little in terms of real output levels.51/ However, the effects of systemic defaults on world output, trade and finance also considerably narrowed the debtor countries' channels to the outside world, inducing them to pursue aggressive inward looking development, often with considerable loss of economic efficiency. In contrast, a properly designed international debt management strategy affords the opportunity to support a style of growth in the debtor countries that will improve economic efficiency and hence the capacity to service debts. The menu approach unfortunately does not promise to release sufficient resources to promote either adequate growth or sustained structural reforms in the region.

The menu is based on "voluntary" market responses. However, the international credit market is on the downside of a portfolio adjustment. That adjustment to the debt overhang in Latin America and the Caribbean promises to be painfully slow, especially since the international debt management strategy is primarily geared to artificially insulating portfolios from market valuations. Consequently, the amount of finance that the menu can release over the near term will likely fall short of what is required to support growth and restructuring in the region. This conclusion is derived from an examination of the different instruments contained in the market menu.

a) <u>New bank loans</u>

Significant amounts of voluntary lending for Latin America are clearly not on the horizon. Small as well as many regional banks have shifted their portfolio strategy to safer home markets. The big money center banks have as well, although to a much lesser degree due to a long-term commitment to the international market. Even so, these latter institutions have established an agenda to sharply reduce their asset/capital ratios in the problem debtor countries.52/ Under favourable assumptions for the banks concerning their annual capital buildups (12%) and absolute reductions in claims in the problem Baker Plan countries (5%) those ratios would still remain high (63%) at the end of 1990. Therefore, unless there were an improvement in the overall economic outlook, pressure would continue into the 1990s to lower those ratios still further.53/ As one banker recently observed "in present circumstances, there is very little prospect in any case of future voluntary medium term lending from commercial banks on a significant scale".54/

This conclusion, moreover, is independent of the efforts of the debtors to improve their creditworthiness. It was noted earlier that credit markets have not responded well to objective advances of the debtor countries regarding the adjustment process. However, this is entirely consistent with the historical experience of private financial markets. In effect, when a systemic payments problem arises, markets tend to experience "revulsion". Thus, credit volume becomes paralysed generally by a "neighbourhood problem"; i.e., "good and bad" debtors in the vicinity of the crisis are lumped together.55/ For example, Argentina was the only country in South America to service debts in the 1930s,56/ yet its access to credit was equally limited as other countries. Likewise, Colombia has not had a debt problem as such in the 1980s, but its efforts to secure truly voluntary syndicated loans has nevertheless been severely frustrated.57/ It also is important to point out that defaults have typically been followed by a 30-year drought in access to private credit.58/ Latin America and the Caribbean, although not in <u>de jure</u> default, has been largely in <u>de facto</u> default since 1982.

There are better prospects for voluntary lending in the areas of trade and project finance. Trade credit is relatively secure and highly profitable for the banks, making it available even for countries in default. But trade credit is very short termed. As for medium-term project finance, banks could be attracted by foreign exchange earning ventures in which they are permitted to take a direct or indirect lien on the investment's cash flow. However, such arrangements are awkward and in many cases may be politically unacceptable to governments. Also, many countries would have technical difficulties in quickly formulating a large number of profitable projects, especially since public sectors are under severe fiscal restriction. Thus, project finance cannot guarantee a critical mass of sustained financial flows, at least until countries are in a sustained process of economic growth.

As far as involuntary medium-term bank loans are concerned, it has already been pointed out that the inducement for the banks to voluntarily participate in that type of credit package is rapidly exhausting itself. Only a few very big borrowing countries still have the technical strength to force new lending from the banks. But time is running out even for them as the banks build up their reserve cushion against loan losses.

b) Debt-equity conversions

Debt-equity conversions have received enormous attention in the last two years; they certainly represent one of the highlights of the market menu. The conversions have their origin in the region's protracted crisis and the consequent interest of banks to swap their loans for other assets, including cash.

Swapping activity has increased markedly over the last few years. Trading is confidential and very personalized, making it difficult to quantify the volume of transactions. Nevertheless, informal estimates of trading in this emerging secondary market go as high as US$10-12 billion for 1987, although there is a very large amount of double counting.59/ Demand, however, has not kept up with the supply of circulating paper, giving rise to considerable discounts. By late 1987 most Latin American loans traded at 50% or less of their nominal value (table 7).

The appearance of discounts has stimulated schemes to convert debt into local investments in the debtor country. A typical transaction involves a multinational firm which purchases a loan in the secondary market at a discount and then converts it into the debtor country's local currency at par, or at least at a value higher than that recorded at the time of purchase. Thus if a country's loans circulated at a 50% discount, a firm could make a US$1 investment there for as little as 50 cents. Banks are not only sellers of paper, but also buyers and thus also can participate in debt-equity transactions. However, they tend to prefer to bypass the secondary market and directly convert their own loans into equity. That way they can avoid the costly discount.

As mentioned earlier, almost all countries with significant amounts of commercial debt have sponsored formal schemes to convert their debt into equity (see table 8). It has been estimated that up through mid-1987 Latin America has transformed US$6 billion of foreign debt into local currency.60/ A significant part of that has found its way into equity investments. Some resources even have filtered into charitable schemes to protect the environment in the debtor country; these are so-called debt for charity swaps.61/

There has been considerable debate about the utility of debt for equity swaps. Commercial bankers, investment bankers and creditor governments are generally very enthusiastic on the grounds that there are benefits for everyone. Bankers get to reduce their loan exposure. Investment bankers make attractive commissions on the deals they organize. Creditor governments have to monitor a smaller debt overhang in their financial systems. Debtor countries reduce their foreign debt, save on interest payments, and supposedly also are recipients of a dynamic foreign investment. All this in turn

Table 7

MARKET VALUE OF FOREIGN DEBT NOTES, BY COUNTRY

(100 = nominal value)

Country	1985	1986			1987				
	June	January	June	December	February	March	May	August	October
Argentina	60-65	62-66	63-67	62-66	62-65	63	58	43	35
Bolivia	...	...	7	...	...	55-10	11-13	14	8
Brazil	75-81	75-81	73-76	74-77	73-75	69	62	40	40
Costa Rica	...	...	...	40	...	45	...	...	21
Chile	65-69	65-69	64-67	65-68	68	68	71-72	61	51
Colombia	81-83	82-84	80-82	90	...	...	...	...	74
Ecuador	65-70	68-71	63-66	63-65	...	62	50	36	30
Mexico	80-82	69-73	55-59	54-57	56-58	58	58	50	50
Peru	45-50	25-30	17-23	16-19	16-19	...	14	12	5
Uruguay	...	...	64	...	...	...	...	67	63
Venezuela	81-83	80-82	75-78	72-74	72-74	72	72-75	63	50

Source: Eugenio Lahera, "La conversión de la deuda externa: antecedentes, evolución y perspectivas", Joint UNDP/ECLAC project on development financing, Santiago, Chile, ECLAC, September 1987, and "The conversion of foreign debt viewed from Latin America", *CEPAL Review*, No. 32, August 1987; and Salomon Brothers, "International Loan Trading" *High Yield Department*, October 19, 1987.

Table 8

CHARACTERISTICS OF PROGRAMMES FOR THE CONVERSION OF FOREIGN DEBT INTO EQUITY IN SELECTED COUNTRIES

	Argentina	Brazil	Costa Rica	Chile	Ecuador	Philippines	Mexico	Venezuela
GENERAL ASPECTS								
Date of programme start-up	May 1987	December 1982-June 1984	August 1986	May 1985	December 1986	August 1986	April 1986	April 1987
Type of debt to be converted	Public	Public and Private	Public and Private	Public and Private	Private	Public and Private	Public	Public and Private
	Principal	Principal	Principal	Principal	Principal	Principal and interest	Principal	Principal
Acceptable uses of local currency funds	Investment, possible payment of local debts	Investment	Investment	Investment, payment, of local debts, others	Investment	Investment	Investment, payment of local debts	Investment, payment of local debts
Authorized operators	Banks, TNCs, firms	Banks, TNCs	Banks, TNCs, firms, individuals	Banks, TNCs, firms, legal and natural persons. Chilean nationals under Ch. XVIII	Banks, TNCs, firms, individuals	Banks, TNCs, firms national and foreign individuals	Banks, TNCs, individuals	Banks, TNCs, firms
Programme ceiling	US$2 000 million in 5 years	None	None	US$2 000-US$4 000 million	US$1 346 million	US$6 000 million	US$1 600 million	None
OPERATIONAL ASPECTS								
Time limits	Yes	None	None	Yes	None	None	Yes	None
Possibilities of laundering capital	None	None	Not specified	Yes	Yes	Not specified	None	Yes
Exchange rate to be used	Central Bank buyers' closing rate	Official	Official	Dollar	Official	Official	Official	Bs. 14.5
Central Bank means of payment	Australes	Cruzados	Bonds	Pesos or bonds	n.a.	...	Pesos	Bolívares or bonds
Exchange price	100%	100%	Up to 70%	100%	100%	100%	70% - 100%	100%
CONDITIONS								
Priority investment sectors	Yes	No	Yes	No	No	Yes	Yes	Yes
Possibility of purchasing existing assets	No	Yes	Yes	Yes	No	Yes	Yes	Yes
Applicability of foreign investment rules	Yes	Yes	...	No	Yes	...	No	Yes
Need to bring in new funds	Yes	No	No	No	No	Limited	No	No
Special conditions for remittance of profits	Not for 4 years	No limit	No limit	Not for 4 years	Not for 4 years	No limit in priority sectors. Not for 4 years in others	For 5 years must be less than interest	Not more than 10% for 3 years
Conditions for repatriation of capital	Not for 10 years	Period not less than original debt	Period not less than original debt	Not for 10 years	Not for 12 years	Not for 3 years in priority sectors and 5 years in others	Not for 12 years	Not for 5 years. Not more than 12.5% in next 8 years
Possibility of operating in stock market	No	No	No	Yes	No	Yes	No	Yes

Source: Eugenio Lahera, *La conversión de la deuda externa: antecedentes, evolución y perspectivas*, Joint UNDP/ECLAC Project on development financing, ECLAC, september 1987, and "The conversion of foreign debt veiwed from Latin America", *CEPAL Review*, No. 32, August 1987.

enhances creditworthiness and brings forward the day when countries will have renewed access to private credit markets.

Debtor countries obviously perceive some advantages in the debt equity swaps because otherwise they would not formally sponsor programmes. Nevertheless, in development circles concern has been raised about the swap programmes because of their side effects on such factors as monetary control, exchange rate management, local interest rates, domestic industrial structure, the long-term balance of payments and national sovereignty.62/

In any event, what is of interest here is the usefulness of the debt conversion schemes as a macroeconomic tool to finance growth and restructuring in Latin America and the Caribbean. In this respect it appears that in the immediate future its contribution clearly will not be decisive. The problem lies in the limits on absolute volume that are derived from both supply and demand factors.

As mentioned, the upside estimates of LDC loans traded in the secondary market is about US$10 billion annually. This figure will surely expand in the years to come. But it would have to expand quickly and dramatically to release significant amounts of new finance. For example, if one were to introduce the exaggerated assumption that the US$10 billion contains no double counting and is all converted Latin American and Caribbean debt, that alone does not provide new net finance since the region is currently not amortizing its obligations.63/ The savings on a cash flow basis therefore only comes from reduced interest payments.64/ With an interest rate of 10%, the retired debt would generate relief of US$1 billion. That is less than 1/20 of estimated annual finance requirements of the region.65/ The result may be more significant for some individual countries, as the bulk of debt conversion operations is concentrated in a few countries.

Moreover, the loans available for conversion can rise only gradually. On the one hand, the banks' reserves for loan losses in problem debtor countries are considerably less than the discounts in secondary markets.66/ Thus, these institutions are not in a financial condition to shed more than a modest part of their loan portfolio.67/ On the other hand, investment opportunities are hard to identify, especially when countries are suffering from low economic growth and possible external insolvency. Another consideration is that banks will probably resist a big liquidation of their problem loans in the anticipation that the longer they wait, the more likely they will be able to draw in taxpayers to share the losses with them.68/

Furthermore, the country's ability to absorb equity conversions has its annual limits if only due to technical questions of monetary control, exchange rate stability, etc. Chile, which has undoubtedly the most liberal conversion programme in the region, has been able to retire US$2.6 billion of debt over roughly 30 months. At an interest rate of 10%, that saves US$260 million, neutralized, in part, by a future stream of profit remittances. Important as that is, it palls against an annual interest bill on bank debt of some US$1.4 billion (again assuming an interest rate of 10%). Moreover, if a country prefers to take a more active role in guiding investments into specific sectors, the relative impact of the conversion programme over the near term would be proportionately less.

In sum, there are numerous pros and cons to the debt equity swaps. Nevertheless, this item in the menu should be viewed basically as a mechanism to stimulate new foreign investments. Its macroeconomic contribution to the finance of the balance of payments is certainly the lesser dimension. As the recent Group of Thirty investigation concluded, the debt-equity markets' "inherent limitations...imply that it is unlikely to reach sufficient size to replace the need for other financing sources. And as the market grows, the negative side effects [of the conversion process] may increase even more rapidly".69/

c) Securitization

After an ebullient beginning, most bankers now recognize that debt-equity swaps are not the panacea for the debt crisis that they once thought they were. Even as expectations for debt-equity swaps shrink to more realistic proportions, a new grand market solution has emerged for the debt crisis: securitization. This, of course, also has a prominent place in the market menu.

There moreover is manifest interest in the debtor countries regarding securitization of the debt. In early 1987 Argentina offered some of its creditors exit bonds as a substitute for participation in rescheduling and new money packages. Meanwhile, later in the year Brazil proposed that a substantial part of its foreign debt be converted into bonds.70/ This, again, was the basis of an innovative debt for securities swap announced by Mexico at the end of 1987, the securities being guaranteed by United States Treasury zero coupon bonds.

The advantages of securitization for the debtors is that their obligations could be converted into a new instrument which: i) would not require yearly reschedulings and ii) would carry a fixed and predictable rate of interest. As for the creditors, they would receive an instrument that would allow them to take problem loans off their balance sheets; moreover, securities can be more marketable than a loan.71/ Securities also can potentially achieve seniority over old loans in terms of access to a debtors' cash flow. This in turn has raised expectations that bonds may be an effective instrument for the new money requirements of the debtors.72/

It certainly is useful to explore possibilities to securitize LDC finance and debt. Bonds have in fact been historically the main source of external finance for development; in this sense the great banking expansion into the periphery during the 1970s was a new phenomenon. Moreover, in recent years growth of international credit has been concentrated in bond markets (table 9). However, again after closer examination it is evident that there are serious limitations to capturing large amounts of voluntary finance for Latin America and the Caribbean via this instrument.

i) New money bonds. As shown in table 9, the market for international bonds is as big as the market for bank loans. If the bond market could be tapped for new money needs, the region would diversify its creditors, thereby making the severe restrictions in the banking market less disruptive to the economic restructuring process. The fact that new money bonds can enjoy

Table 9

INTERNATIONAL CREDIT MARKETS, 1981-1986

	1981	1982	1983	1984	1985	1986
Total international credit	197	154	143	173	230	316
Net international bank lending	165	95	85	90	105	160
Net international bond financing	32	59	58	31	25	156

Source: Bank for International Settlements, Fifty-Seventh Annual Report, Basle, June 1987, p.94.

seniority over loans also offers potential attractions to creditors, because the bearers of the former instruments would presumably be first on line for available foreign exchange to service the region's foreign debt. For example, assuming an interest rate of 10% on a country's foreign debt, and a 3-year refinancing of half of the upcoming interest payments through new bond issues, the stock of the new senior liabilities would be only slightly more than 15% of the original outstanding obligation. Such an issue could therefore conceivably be evaluated as a secure transaction by prospective creditors.

However, bond markets are not easily accessible to Latin America and the Caribbean because the bulk of their transactions are with borrowers carrying high credit ratings.73/ Indeed, even in the late 1970s when developing countries had their best image of creditworthiness, and hence easiest access to private credit markets, bondholders were not highly receptive to them. As can be seen in table 10, in the best of times those markets channeled most of their resources to first class borrowers in the OECD countries, with developing areas never capturing more than one-sixth of the total international transactions. Today, most countries of Latin America and the Caribbean are manifestly unable to service the stock of existing debt, generating deep discounts on traded loans. In these circumstances, the floating of bonds for new debt, without some kind of outside guarantee, represents a Herculean task, even with seniority for the creditors. Indeed, traditional purchasers of bonds such as insurance companies and pension funds have avoided the region's debt crisis and they are unlikely to become involved now and risk tarnishing their high credit standings.74/ Moreover, after the October 1987 crash of the world's stock markets, there has been a dramatic "flight to quality" issues in the bond markets.75/ Such a development further distances Latin America and the Caribbean from this type of creditor.

Table 10

FOREIGN AND INTERNATIONAL BOND ISSUES, 1976-1980

	1976	1977	1978	1979	1980
Total	34.3	36.1	37.4	37.8	38.3
Industrialized countries	23.1	22.8	22.6	24.6	26.3
Developing countries	2.3	4.8	6.1	4.0	2.9
Other	8.9	8.5	8.7	9.2	9.1

Source: Calculated from data in World Bank, Borrowing in International Capital Markets, Washington, D.C., October 1979 and May 1980.

There does exist, of course, the US$47 billion "Junk Bond" market in the United States, which specializes in lending to high risk borrowers.76/ However, an international junk bond market has yet to emerge, not to mention one for sovereign borrowers.77/ The obstacles to entering this market on a grand scale are formidable because the purchasers of junk bonds are accustomed to evaluating corporate risk in their well-known home market. Junk bondholders also in practice lend against attachable assets which give them a quasi-equity stake in the borrowing entity. Raising funds for problem sovereign governments in distant Latin America and the Caribbean would be an exotic undertaking even for the hardiest junk bond investors. Moreover, the crash of world stock markets has all but paralysed the junk bond market.78/ If that market re-emerges, initial preferences will likely be for corporate issues in the home market, not foreign sovereign developing country borrowers stricken by a debt crisis.

Aside from the above, junk bond issues are speculative and therefore very expensive for the borrower. With threshold interest rates of 25% for distressed corporate borrowers,79/ as well as a maximum maturity of 5-10 years, junk bond issues could in fact worsen rather than relieve the region's debt burden.

Another possibility is that the creditor banks themselves could be a market for security issues. But then one returns full circle to the original problem of the Baker Plan of forcing new money out of private banks that want to retreat from the region. Furthermore, any general issues by most Latin American and Caribbean sovereign borrowers would be subject to immediate discounts and therefore limited marketability. With a limited possibility to trade new issues, participating banks would clearly remain vulnerable to further new money demands from distressed borrowers.80/ This effectively dilutes the attractiveness of any potential seniority that might be conveyed by the purchase of a bond.

There also has been discussion of innovations which would allow developing countries to break into the bond markets for which they heretofore have been excluded. Two instruments which have gained attention are index linked bonds, which adjust payments flows to a general index of prices, or to the fluctuations of a specific commodity price. However, such ideas have not gained easy acceptance in capital markets and remain essentially exotic. Moreover, when private capital markets experiment with new instruments, they traditionally prefer borrowers with the highest standing in credit markets.81/

In sum, to the extent that Latin America can successfully issue securities for their new money needs, they will very likely be transaction specific and secured by escrow accounts or attachable sovereign assets such as gold reserves. There are, however, practical and political limits to such financing techniques. Therefore, without some type of outside guarantor, the potential to raise voluntary new money via securities will be very limited as long as the debt crisis persists.82/

ii) Securitization of old debt. The problems confronting securitization of old debt are partly manifested in the experiences of Argentina and Brazil. In early 1987, as part of the fourth round of rescheduling, Argentina offered banks an exit bond carrying a maturity of 25 years and an interest rate of 3%. The bond, which was directed to banks wishing to retire completely from multiple reschedulings and new money requests, had practically no takers. Meanwhile, as mentioned, later in the year Brazil proposed to convert roughly one-half of its medium-term debt into fixed interest long-term bonds. That particular proposal was harshly characterized as a "non-starter" by one of the creditors.83/

For a bank, the voluntary securitization of a big block of weak loans can present more problems than opportunities. Converting a loan into a security does not convert a weak obligation into a strong one. Moreover, since old debt is subject to pari passu clauses and negative pledges which demand equal treatment among banks, the securitized obligation does not enjoy seniority. Hence, that new bond would also be subject to big discounts. And, of course, the appearance of discounts forces the banks to encounter an "accounting event", which could provoke bank regulatory authorities to question the value of the remaining loans kept on the books at par.84/ In effect, as long as discounts on Latin American and Caribbean paper remain substantially higher than the loan loss reserves of banks, voluntary trading of big blocks of debt, whether in the form of securities or loans, has practical limits.85/ Those limits are even more severe if the debtor countries demand a below market interest rate and maturity on securitized debt; not only would that be open admission by the banks of a bad debt, but it also would constitute debt forgiveness, a precedent that banks will rarely accept voluntarily. If all this were not enough, securitization also runs into free rider problems: creditors know that any bank not participating in a conversion could realize windfall gains if the reduced debt burden raises the value of unsecuritized loans.

The market for securitized debt also is limited in size by the fact that discounts on Latin American and Caribbean obligations may not yet be big enough! Investors, especially when it is difficult to evaluate the quality of collateral, assess downside risk by looking to market valuations during previous periods of economic stress. During the Great Depression sovereign loans fell to values as low as 10-15% of par, which is still considerably less than quotations in contemporary secondary markets.86/ These downside risks restrict demand for the region's debt. Under normal market conditions low demand would bring forth the fall in prices that could create a market for securitized Latin American and Caribbean obligations; however, in banking markets this process is slowed by the fact that loan portfolios are artificially insulated from market valuations until a trade is actually effected.

There also has been much discussion about the possibility of repacking Latin American and Caribbean loans into high yield junk bonds once the secondary market discount is high enough to attract speculative investors.87/ Assuming most Latin American and Caribbean bank loans bear an interest rate of 9-10%, one needs a discount of the order of 70% to generate the 25% yield that often is cited as the threshold for attracting this type of investor.88/ However, all the problems set out earlier concerning the junk bond market apply equally to old debt. Moreover, the conversion of debt into junk bonds would offer only potential gains for the debtor. The investor's 25% rate of return will be realized only if interest on the original loan is paid in full, that is, if there is no debt forgiveness. The gains for the debtor can be realized only by locating the hard to identify bearers of those bonds and forcing them to renegotiate the terms of indebtedness. Moreover, such a renegotiation might require a prior default to "flush out" bondholders and put them into a disposition to restructure the terms of the obligation.89/

As far as exit bonds are concerned, the bankers' reception to them may improve if the terms are designed to give the income stream a present value in excess of the cash value of the debt in secondary markets. Exit bonds are directed at the small lenders which constitute a very tiny fraction of the region's bank debt. Hence, the amount of finance released by exit bonds will likely be modest even under the optimistic assumption that all small lenders purchase the instrument. However, exit bonds may facilitate agreement on debt reschedulings by reducing the number of creditor banks that are required to acquiece.90/ On the other hand, in lieu of accepting a below market return, small lenders may seek to collect a regular return by "free riding" on the loans granted by the big banks, and especially those of multilateral agencies. On the other hand, if the bank prefers to cut its losses and retire from the Latin American and Caribbean market, it may find a swap in the secondary market for cash more attractive than even a potentially higher yielding exit bond. This is because the former is a secure return and the latter, in addition to being uncertain, could be interpreted as a precedent for debt forgiveness, which is anathema to most banks.

In sum, the conversion of debt into securities can only be a very gradual process.91/ Today there is no market for such securities and such a market cannot be created overnight. The pioneering transactions will undoubtedly offer attractive profits for individual brokers and investors, which explains the financial community's intense interest in securitization. However, the volume of resources that can be mobilized by voluntary responses to securitize debt promise to fall far short of the macroeconomic requirements for new finance in Latin America and the Caribbean.

3. Conclusions about the market menu approach

Viewed from the standpoint of the macroeconomic requirements for financing growth and economic restructuring in Latin America and the Caribbean, the market menu is very incomplete. The menu lists some interesting "appetizers" for the debtor countries, but the "main entrees" simply are not there.

The menu is a market-based approach which relies on the voluntary responses of the individual creditors. However, conventional market financing is procyclical in nature and therefore capital will unlikely flow spontaneously to Latin America and the Caribbean in any significant volume as long as potential creditors see discounts on old debt.92/ As for new more exotic instruments designed around the adjustment of private investment portfolios, their development will only be gradual. It must be remembered that private markets operate at the margin and each new instrument will necessarily start small.93/

In sum, when left to their own devices, private markets unwind from a crisis only very slowly. The menu approach therefore only chips away at the corners of the crisis. It clearly does not address the central macroeconomic problem: how to finance in a sustained and predictable way the economic reforms and new investments that Latin America and the Caribbean will need to initiate growth now and begin to restore its capacity to service foreign debts. Only when that capacity is restored will conventional private investors once again begin to put sizeable amounts of their capital in the problem debtor countries. The menu approach clearly is a poor substitute for a coherent multilateral initiative which would liquidate the debt overhang that is contributing to the vicious circle of stagnation in the region.

III. THE REAL OPTIONS FOR RELIEVING THE BURDEN OF THE OUTWARD TRANSFER OF RESOURCES

There is little disagreement that resolution of the region's crisis will require economic reforms in the debtor countries and adequate flows of finance to support that effort.94/ In fact, most Latin American and Caribbean economies have undergone spectacular adjustments. Moreover, there has been an overwhelming political disposition in the region to service debts and pursue economic reforms that would make the economies more competitive internationally and the State more functional to accumulation and equitable income distributions. The missing link over the last five years has clearly been a stable external economic environment which includes predictable and sustained flows of credit to the debtor countries.95/ Without finance, the countries have encountered an enormous outward transfer of resources which has destabilized local economies and restricted investment and growth. Moreover, the process may be reaching its political limits. Remedial action must be taken in one way or another.

1. The first-best solution: a comprehensive multilateral initiative

From the standpoint of world macroeconomic efficiency, the first best policies are quite obvious. On the one hand, debtors should persist with reforms and economic restructuring. However, more symmetry is needed in the adjustment process; i.e., the creditor countries must simultaneously correct the severe macroeconomic disequilibria in the North. Co-ordinated adjustment in the North would establish a basis for: i) higher rates of growth in the OECD area; ii) more normal international rates of interest and iii) higher commodity prices. The stimulus of a more dynamic performance of the OECD economies would in turn naturally relieve debt burdens in Latin America and the Caribbean and indirectly contribute to financing recovery and restructuring in the region.

Indeed, a sufficiently favourable external environment would undoubtedly help to pull many of the larger debtor countries out of crisis and give them the means to pursue reforms more or less autonomously through normal channels of trade and finance. The number of debtor countries in the region paralysed by crisis would be correspondingly less and probably made up of mostly smaller debtors. This in turn would open the prospect of the international community responding adequately to their problems through existing multilateral financial channels. It should be pointed out, however, that as time elapses without an improvement in external conditions, such improvement grows increasingly inefficient to produce the desired results.

In the absence of quick economic reform and renewal of dynamic growth in the OECD economies, the debt burden of most of the region's economies will be unbearable and represent an obstacle to growth and economic restructuring. In these circumstances, some form of direct or indirect generalized concessional (below market terms) debt relief becomes inevitable. So many formulas have been proposed since the outset of the crisis that it is virtually impossible to summarize them here.96/ However, one approach has repeatedly emerged in the debate about debt relief that has been going on since 1982: a multilateral facility which would help convert bank debt into long-term bonds with fixed interest rates.97/ Moreover, this particular approach has recently enjoyed support in the U.S. Congress.98/

The precise mechanics of the debt conversion facility differ according to whose proposal one examines. However, generically, the idea proposes that a new or existing multilateral agency purchase outstanding Latin American and Caribbean debt from the private banks. The purchase could be effected at a discount for cash; alternatively, the debt could be exchanged for bonds emitted by the multilateral agency. In some proposals the bond captures the discount from the banks directly, while in others it is realized indirectly by exchanging loans for bonds at par, but with the latter bearing below market interest rates. The banks, of course, would register a corresponding loss on their books,99/ but they receive compensation in the form of a solid off-balance sheet security that has no downside risk and is probably marketable.100/ Moreover, most proposals for a debt conversion facility suggest that the home country banking regulatory authorities change existing accounting rules in such a way as to make sales of debt attractive. One way to do this would be to follow a recent precedent and allow the banks to amortize their losses over a very long period of time.101/

With regard to the debtor countries, the new multilateral facility would, in exchange for a coherent, bilaterally organized programme of economic restructuring, agree to pass on the bulk of the discount realized on the purchase of debt. The co-operating countries' debt service would be correspondingly reduced to more manageable levels.

Various proposals exist to finance the new facility. Some suggest that its capital base be subscribed to by the creditor governments in proportion to their current participation in the World Bank and IMF. Others suggest that the major surplus countries contribute the capital, most of which would be callable, as opposed to paid-in, capital. One of the more recent proposals out of the United States Congress suggests that the IMF's US$40 billion of idle gold reserves be mobilized to establish a capital base for the new debt conversion facility.102/

The virtue of the multilateral debt conversion facility is that it could securitize a large block of debt much more quickly than one could expect through private market channels. It also could provide the banks with a guaranteed return as well as an organized and predictable way to amortize their losses.103/ Debtor countries furthermore would receive immediate gains from the securitization process in the form of a reduced debt service burden. Moreover, lower payments become automatically functional to economic restructuring because to become eligible for relief a debtor would presumably commit itself *ex ante* to an organized structural adjustment programme.

However, the establishment of a multilateral debt conversion facility in and of itself would unlikely be enough to turn around the debtors' economies. Countries would still require sustained new inflows of capital to support growth and economic restructuring. This initially would have to come from traditional multilateral financial agencies such as the IMF, World Bank, and IDB. The conditionality of these organizations also would have to become more flexible if it is to be successfully marketed in the developing countries themselves.104/

2. A second best solution: a debtors' menu of options

a) The poor prospects for a multilateral initiative

As ECLAC pointed out in its biannual ordinary conference held in Lima in early 1984, the debt crisis is a systemic public problem.105/ It has its origin in a complex interaction of policies pursued by the banks, the Latin American and Caribbean countries and OECD governments over the last decade. The negative effects of the crisis also impinge on all the parties involved and weigh heavily on the performances of the economies of both debtors and creditors.106/ Since private markets tend to behave procyclically, myopically overshooting on both the upside and downside of an economic cycle,107/ reliance on market forces to resolve a crisis can be a socially costly strategy. It is well known that confronting a public problem with a strategic deployment of public goods can minimize lost output and employment and hasten a solution to a crisis. Furthermore, effective public intervention can ensure that the inevitable costs of past mistakes are distributed equitably and paid for dynamically out of future income through growth. The postwar Marshall Plan is an elegant testimony to the mutual benefits derived from co-ordinated multilateral intervention in private markets to stimulate growth and restructuring.

In the current debt crisis public goods have been timidly deployed and those that have appeared have usually been excessively geared to the single purpose of smoothing the adjustment of private financial portfolios. More recently, one does observe some important progress to balance the framework of the international debt strategy. For instance, the creditor countries now openly recognize that there is co-responsibility in the crisis and that all parties must bear their fair share of the burden in resolving the problem. The need for renewed growth in Latin America and the Caribbean now is conventional wisdom. As mentioned, the IMF appears to be re-evaluating its conditionality and seems disposed to delink its stand-by programmes from the management of the banks' balance sheets. Furthermore a much needed increase in the capital of the World Bank now has the support of the creditor governments. There also is support for broader use of contingency financing in the IMF stand-by agreements. As positive as these events are, however, they fall short of a comprehensive multilateral initiative to tackle once-and-for-all the twin problems of a debt overhang and the underfinancing of restructuring in Latin America and the Caribbean. Moreover, the prospects do not seem good for the emergence of such an initiative in the near future.

The northern industrial countries are suffering from their own severe macroeconomic desequilibria. The OECD economic agenda has consequently given priority to questions relating to the value of the dollar, Japanese and German surpluses, U.S. deficits, etc. As judged by the communiqués of recent G-7 economic summits, the Latin American and Caribbean debt crisis is a secondary issue governed by considerable complacency.

Moreover, political conditions do not appear conducive to grand international initiatives. In the industrialized countries important political leadership regarding the production of international public goods has customarily come from the United States. However, that country has been economically weakened by large fiscal and balance-of-payments deficits that have converted it into the world's largest debtor nation. It is now being forced to retrench into greater austerity. Indeed, the recent decision of the U.S. administration to support a modest increase in the capital of the World Bank will considerably challenge the good will of a U.S. Congress concerned about deficit reduction. Grand initiatives such as a new multilateral debt facility, coupled with support of big increases in multilateral funding, seem to exceed the political realities of that country, at least for the moment.

Meanwhile, the stronger surplus economies of the North are not accustomed to leading bold multilateral initiatives. Japan, has, however, made an interesting commitment to recycle US$30 billion of its surplus to developing countries over the next three years (table 11). But it is not clear how much of those resources will be channeled to Latin America and the Caribbean and what the distribution among the countries will be. Nor is it clear how quickly the money will be disbursed, especially since an important part of the resources is being channeled indirectly to developing countries through the slowly disbursing international development banks and the IMF. Finally, Japanese banks, which are major participants in the recycling project, have publicly displayed ambivalence to a programme which will force them to raise exposure in problem debtor countries.108/

In sum, the picture remains clouded regarding the region's access to conventional channels of finance. In the face of these uncertainties, and the political requirements to reactivate their economies, new options must be developed by the debtor countries.

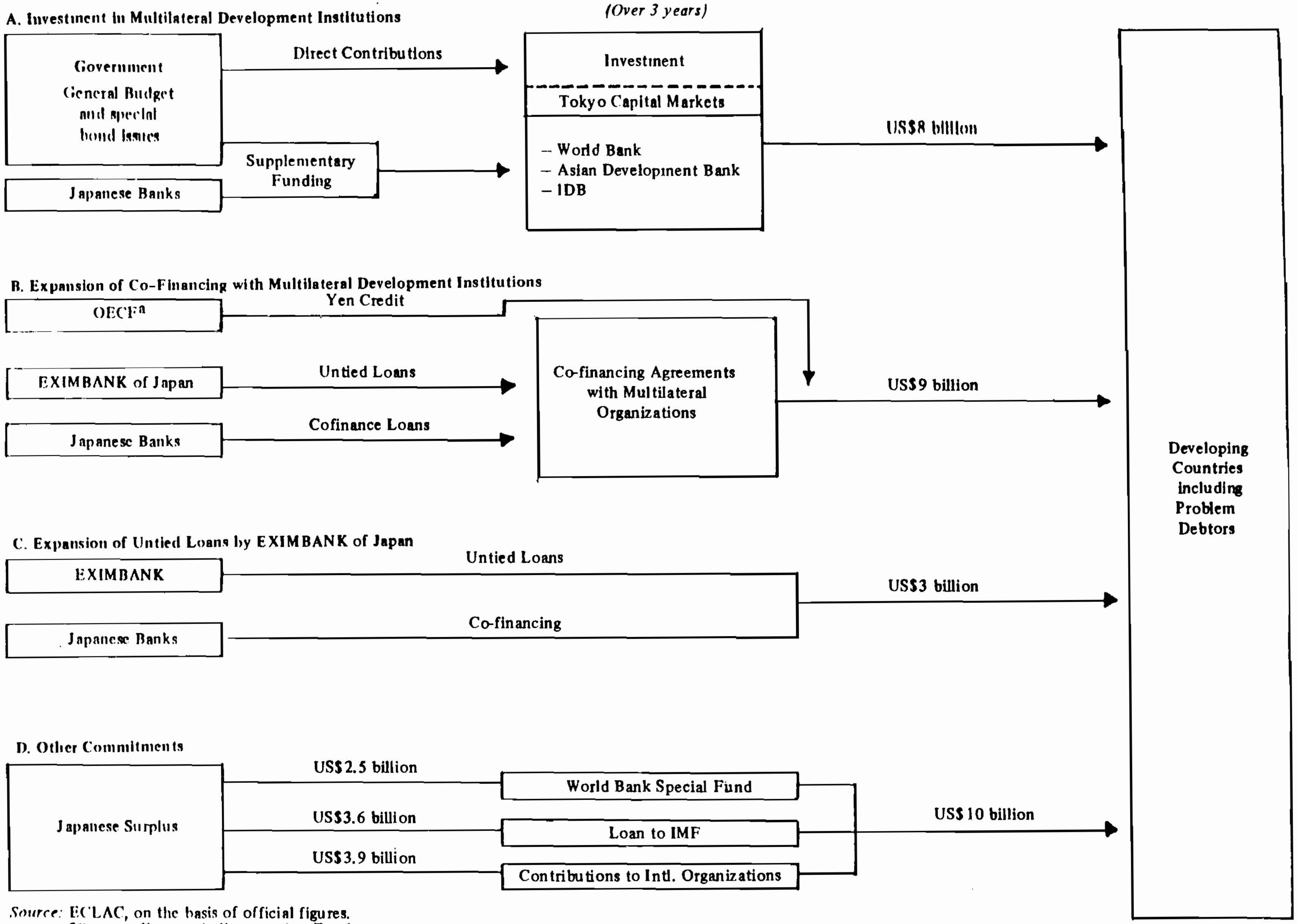
b) The debtors' menu: the contents

The debtor countries need to reduce, at least transitorily, the large outward transfer of resources to creditors in order to remove its perverse effects on the control of domestic inflation and the mobilization of savings for economic growth and restructuring. The international community has been slow to comprehend the region's problems: moreover, even when Latin American and Caribbean positions have finally won legitimization in the North (e.g., the Baker Plan's recognition that sustained adjustment can be achieved only in an environment of growth) too few resources have been made available to back up the proposition. In view of this situation, and after five years of crisis, debtors are, in practice, progressively developing their own menu of options to confront the crisis. Some of the options open to the consideration of individual debtors are the following:

Table 11

ESTIMATED DISTRIBUTION OF THE US$30 BILLION JAPANESE RECYCLING PROGRAM

(Over 3 years)



Source: ECLAC, on the basis of official figures.

[a]Overseas Economic Cooperation Fund.

i) Selection from the market menu. Countries certainly can select those items in the creditors' menu that serve their interests. Undoubtedly, some debtor countries will prefer to operate entirely within the creditors' framework by rescheduling debts, seeking new involuntary loans (where that proves feasible), opening domestic markets to debt-equity swaps, marketing exit bonds, etc. Other countries will find some items in the creditors' menu acceptable, while others not. Thus, certain non-market options will be explored.

ii) Full moratorium on medium-term debts. Facing the severe limitations of the creditors' menu, some debtor countries have no other recourse but to unilaterally enter into a moratorium on payments to the banks (and perhaps other creditors as well). Moratoria are likely to be conciliatory, since no debtor country has ever shown an interest in repudiation. Some moratoria can be very transitory, used to buy time and strengthen a bargaining position that will be eventually presented to the banks (as a group, or bilaterally) for formal negotiations. Or, in the absence of acceptable alternatives, the moratoria could take on a longer term character. In all but the most extreme cases, payments on short-term debt will be excluded from a moratorium.

iii) Formal limits on payments (partial moratorium). Countries can unilaterally limit debt service to some specified amount that reflects their capacity to pay. Limiting debt payments to a percentage of exports, or to a percentage of gross domestic product, essentially forces the creditors to take quasi-equity positions in the problem debtor country's economy. Such policies can be made more acceptable to the creditors if there were some type of guarantee concerning the future growth performance of exports volume and/or GDP. Another way to limit debt service is to simply establish a target rate of growth and assign any available excess foreign exchange reserves to the servicing of the debt.

iv) Conversion of debt into bonds. A debtor could unilaterally convert its outstanding debt into long-term bonds. From a position of full or partial moratorium the debtor could make a standing offer to settle arrears with individual banks by giving them long-term bonds. Banks can be given the option to convert at par with below market interest rates, or accept its financial equivalent in the form of a discount and a commercial interest rate. Countries also can enhance the offer to the banks by unilaterally subordinating old commercially priced debt to the newly issued long-term securities. Furthermore, the bonds can carry a "bisque clause", that allows for better repayment terms on the bond if there is improvement of some objective non-manipulative indicators of capacity to pay (e.g., the terms of trade).109/ Again, the bisque clause gives the creditors a quasi-equity position in the country and may create an expectation that the below market yield on the bonds is only temporary.

v) Interest bonds. Debtor countries can unilaterally issue or offer bonds/notes for all or part of current interest payments. The instruments can be made eligible for local debt-equity swap programmes.

vi) General capitalization. Countries can unilaterally capitalize interest payments that exceed a normal real rate of 1-2%. A "shadow" commercial, or below market, interest rate could be applied to the capitalized payments for accounting purposes. The debtor also can add credibility to accumulated capitalized interest by paying the local currency equivalent into an escrow fund that banks could draw upon for the purpose of making local loans or equity investments.

vii) Payments in kind. Countries can substitute cash payments with exported goods that the individual banks could market internationally for resale.

viii) Co-ordination with other debtors. Countries can communicate and exchange information concerning their negotiations with creditors. Or, instead of confronting the bank's Steering Committee individually, debtor countries can consider joint negotiations. A joint approach also can be taken regarding negotiations with creditor governments for a political solution to the crisis. Neither of these joint negotiations has ever been tried. In any event, while the debtor countries' different economic and political situations have hindered co-operation in the past, those obstacles are more easily overcome once the countries' objectives converge on the need for below market repayment terms to deal with their debt burdens.

There are clearly other options that the debtors can explore. The options carry different benefits and risks, so selections will differ among the debtor countries. Some countries seeking alternatives to the creditors' menu may consider a moratorium the safest and least conflictive option. In any event, those countries would want to combine use of non-market options with cautionary measures, maintaining at least small trade surpluses in order to service short-term lines of credit, to make payments to banks which accept the non-conventional payment formulas for medium-term debt developed in the debtors' menu, and to avoid a drain on foreign exchange reserves. Those countries also would seek to minimize the risk of sanctions by i) projecting a conciliatory image; ii) continuing to at least partially service debt, even if only with sporadic payments, and iii) ensuring that the non-conventional payment options are deployed to support a visibly coherent economic programme that will foster investment, growth and improved payment capacity. Finally, these countries would probably retain council in New York and London to help them interpret country specific accounting and banking regulations in the North as well as to deal with law suits should an individual bank attempt to take the debt service problem to court.

c) Growth and recovery

The debtors' menu in fact reflects actual events that are now occurring in the region. Only a handful of countries are operating entirely within the market menu approach; indeed, most countries are in state of full or partial moratorium on their bank debt. Some countries have formally established a goal to limit payments to a percentage of exports or GDP, while one (Peru) has in fact kept payments on long and medium-term public debt at 10% of its exports since July 1985. Indeed, the diverse picture at the end of 1987 regarding debt service appears similar to the region's status with its creditors during the 1930s. The one big difference is that the international debt strategy has successfully bought time for the banks to strengthen their loan portfolios so that the Latin American and Caribbean irregular payments positions are unlikely to create chaos in world financial markets.

The implementation of a debtors' menu by the Latin American and Caribbean countries has been an important contributing factor in the progressive decline of the outward transfer of resources. But experience has shown that deployment of the debtors' menu, through a moratorium or other selection, does not in and of itself guarantee sustained growth for the debtor countries. Clearly, if the reduced transfer is to stimulate growth, it must be part of a coherent and sustainable economic policy that husbands resources and channels them into activities that will expand output and employment with a minimum drain of foreign exchange reserves.

There should be no illusions: the dilemma confronting the region and its creditors is of great proportions. Today most Latin American and Caribbean governments largely agree with the creditors that they must restructure their economies so that, among other objectives, they gain an international competitiveness that will allow a dynamic (as opposed to dependent) insertion into the world economy and permit them to normally service their debt.110/ However, this goal becomes more politically and technically problematical when there are limited conventional channels for trade and finance.

The countries of the region have found that co-operative participation in the international debt strategy has been rewarded with a severe and persistent drought of finance. Meanwhile, the depressive effects of slow world trade and depressed commodity prices are aggravated by protectionism of all types in the industrialized countries. Thus, it is possible that at some point the logic of more internationally integrated and efficient economies in Latin America and the Caribbean will conflict with the logic of narrowing channels of conventional international finance and trade.

Many of the selections from the debtors' menu, of course, risk narrowing even further those conventional channels of integration with the world economy. But the already severe scarcity of finance, and the deteriorating world economic outlook are progressively reducing the opportunity cost of deploying that menu. If used sagaciously, and as part of a coherent economic and political programme that makes the harsh and restrictive external environment an important endogenous policy variable, the debtors' menu could be consistent with price stabilization and higher sustained rates of growth. The big question is whether that growth must come with a marked sacrifice of gains in efficiency --as was the case of the Latin American experience in the inter-war period. Unfortunately, that could be the cost of escaping the depressing effects of the international debt strategy. This, too, is a second best strategy for all concerned. The creditors, however, cannot have it both ways.

Notes

1/ For an historical review of the frequent booms and crashes in financial history, see, ECLAC, External Financing in Latin America (E/CN.12/649/Rev.1), New York, United Nations publication Sales No.: 65.II.G.4, 1965; Charles Kindleberger, Manias, Panics and Crashes, New York, Basic Books, Inc., 1978, and Charles Kindleberger, Keynesianism vs. Monetarism and other Essays in Financial History, London, George Allen and Unwin, 1985, pp. 190-205.

2/ See Charles Kindleberger, "The 1929 world depression in Latin America - from the outside", Latin America in the 1930s, Rosemary Thorp (ed.), New York, St. Martin's Press, 1984, p. 323.

3/ The ex-Managing Director of the IMF, J. de Larosière, formally observed that the debt problem represented "a very serious threat to the world system of trade and finance". IMF Survey, 9 January 1984.

4/ For a detailed analysis of the mechanisms used to manage the crisis, see ECLAC, External Debt in Latin America, Boulder, Colorado, Lynne Rienner Publishers, 1985, pp. 57-86.

5/ The amount of reschedulings involves double counting due to the multiple restructurings of the same principal. For comprehensive data on the Latin American and Caribbean reschedulings, see ECLAC, Economic Survey of Latin America and the Caribbean, 1983, 1984 and 1986 editions.

6/ See Jeffrey Sachs, "LDC debt in the '80s: risk and reforms". Crisis in the Economic and Financial Structure, Paul Wachtel (ed.), Lexington, Mass., Lexington Books, 1982, pp. 197-244.

7/ This was partly because a rescheduling of interest (as opposed to principal) could induce bank regulatory authorities to insist on a writedown of the loan. See, E. Fred Bergsten, William Cline and John Williamson, Bank Lending to Developing Countries: The Policy Alternatives, Washington, D.C., Institute for International Economics, 1985, p. 154.

8/ For example, until 1970 IMF quotas were equivalent to approximately 10% of the annual value of world trade. At the outbreak of the crisis in 1982 quotas had fallen to the equivalent of only 4% of trade. See William Cline, International Debt Washington, D.C., Institute for International Economics, 1984, p. 124.

9/ The free rider problem refers to the incentive of an individual bank to withhold new loans with the expectation that its more exposed competitors will provide the finance needed to avoid default.

10/ See, for example, Cline, op.cit., pp. 86-93, who presents the conventional wisdom concerning the costs of default.

11/ See, for instance, Cline, op.cit.

12/ In January 1984 President Osvaldo Hurtado of Ecuador, with the help of ECLAC and SELA, organized a high-level government meeting on debt in Quito, in which 27 countries participated. The latter meeting produced the Quito Declaration and a regional Plan of Action, which are reproduced in CEPAL Review No. 22 (E/CEPAL/G.1296) Santiago, Chile, April 1984, United Nations publication Sales No.: E.84.II.G.3.

13/ Philip Wellons, Passing the Buck, Boston, Harvard Business School Press, 1987, p. 253.

14/ See Gary Hector, "Third World debt: the bomb defused", Fortune, 18 February 1985, pp. 36-50.

15/ That success is well illustrated by the balance sheets of the U.S. banks: even though loans to Latin America and the Caribbean represented a fifth of the leading U.S. banks' assets, up through 1986 the non-performing component of their international portfolio never exceeded 1% of total assets. Estimated from data in Salomon Brothers, Review of Bank Performance: 1987 Edition and U.S. Federal Financial Institutions Examination Council, Statistical Release (various numbers). Wellons, op.cit., p. 253, observes that during the debt crisis Latin American and Caribbean countries effectively became "luminous profit centers" for the banks.

16/ The effect of provisioning on the incentive to lend is analytically derived in Jack Guttentag and Richard Herring, "Provisioning, Charge Offs and Willingness to Lend", June 1986.

17/ See Steven Kyle and Jeffrey Sachs, "Developing Country Debt and the Market Value of Large Commercial Banks", Working Paper 1470, National Bureau of Economic Research, Cambridge, Mass., September 1984.

18/ Alfred Watkins, "To Lend or Not to Lend", Washington, D.C., September 1987, p. 14.

19/ See Richard Evans, "New debts for old - and the swapper is king", Euromoney, September 1987, p. 72.

20/ The decline is slightly overstated because of loan write offs and swaps. It also should be noted that some countries, in an effort to improve their image of creditworthiness, did not solicit new involuntary loans in 1984/1985.

21/ See Patricia Wertman, "The Citicorp Initiative: A Brave New World For the Third World Debt Problem", Congressional Research Service, Report 87-750E, September 1987.

22/ This popular threshold can be found in Cline, op.cit. For a discussion of that threshold see C. Massad, "Debt: an overview", Journal of Development Planning No. 16, New York, 1985, United Nations publication Sales No.: E.85.II.A.12.

23/ IMF, World Economic Outlook, October 1987, p. 59.

24/ ECLAC, Preliminary Balance of Latin America, 1986 (LC/G.1454), Santiago, Chile, December 1986.

25/ See Institute of International Finance, "Restoring Market Access", Washington, D.C., June 1987, p. 10.

26/ See ECLAC, Recent Economic Development in Latin America and the Caribbean (LC/L.422), Santiago, Chile, June 1987, pp. 36-49.

27/ See Institute of International Finance, op.cit., p. 11 and John Reed, "New money in new ways", The International Economy, October/November 1987, p. 52.

28/ The banks' concern is expressed in Institute of International Finance, op.cit., p. 7.

29/ See Group of Twenty-Four, "The Role of the IMF in Adjustment With Growth", Washington, D.C., March 1987.

30/ Richard Ground, "Origin and magnitude of the recessive adjustment of Latin America", CEPAL Review, No. 30 (LC/G.1441), Santiago, Chile, December 1986, pp. 67-86.

31/ Address by M. Camdessus to the Board of Governors of the Fund and the World Bank, 29 September 1987, p. 11.

32/ Organization of American States, Despachos de la OEA, Washington, D.C., October 1987, p. 8.

33/ Robin Broad, "How about a real solution to Third World debt", The New York Times, 28 September 1987.

34/ For the debtor countries' cautious response, see Cartagena Consensus "Declaración de Montevideo", Montevideo, Uruguay, December 1985, p. 2.

35/ See Patricia Wertman, op.cit., p. 1.

36/ For details of the regulation see Karin Lissakers, "Bank regulation and international debt", Uncertain Future: Commercial Banks and the Third World, Richard Feinberg and Valeriana Kallab (eds.), London, Transaction Books, 1984, pp. 45-68.

37/ See Peter Truell, "Brazil's proposed loan accord hindered by fighting with banks on margin, fees", Wall Street Journal, 5 November 1987 and Peter Truell, "Brazil's finance chief is feeling heat at home amid talk he may resign", Wall Street Journal, 4 November 1987.

38/ See Andrés Bianchi, Robert Devlin and Joseph Ramos, "Adjustment in Latin America, 1981-1986", Growth-Oriented Adjustment Programs, Vittorio Corbo, et al. (eds.), Washington, D.C., The International Monetary Fund and World Bank, 1987, p. 207. Published in Spanish in El Trimestre Económico, vol. LIV(4), No. 216, October-December 1987, pp. 855-911.

39/ IMF Survey, 19 October 1987, p. 291.

40/ An analysis of this question is found in Anatole Kaletsky, The Costs of Default, New York, Priority Press, 1985.

41/ Argentina is the exception as it accumulated considerable arrears in 1984, which were eliminated in a later settlement with the banks.

42/ Payments of debt in kind and the service of short-term debt are excluded from the 10% limit.

43/ For instance, see Bela Balassa, et al., Toward Renewed Economic Growth in Latin America, Washington, D.C., Institute for International Economics, 1986, p. 176.

44/ It already has been mentioned that the 1986 loan package for Mexico followed threats of a unilateral moratorium in that country. The new money package awarded to Argentina in 1987 evolved out of tough negotiations in which there was fear in creditor circles that the country might follow Brazil into moratorium. Finally, the tentative agreements that emerged in late 1987 to provide new finance for Brazil and Ecuador were designed to eliminate accumulated interest arrears.

45/ "Statement by the Honorable James A. Baker, III, Secretary of the Treasury and Governor of the Bank and Fund for the United States, at the Joint Annual Discussion", Board of Governors of the World Bank and IMF, 1987 Annual Meetings, Washington, D.C., pp. 4-6.

46/ See IMF Survey, "Camdessus and Ruding discuss debt strategy, SAF enhancement, increase in Fund quotas", 19 October 1987, p. 290.

47/ "Statement by the Honorable James A. Baker, III...", op.cit.

48/ Ibid.

49/ Reed, op.cit.

50/ For details see Eugenio Lahera, La conversión de la deuda externa: antecedentes, evolución y perspectivas (LC/R.614), UNDP/ECLAC Project, "Finance for Development", Santiago, Chile, ECLAC, September 1987.

51/ Charles Kindleberger, "The 1929 world depression...", op.cit. p. 321 and Carlos Díaz Alejandro, "The Early 1980s in Latin America: 1930s One More Time?", paper presented to ECLAC's Expert Meeting on Crisis and Development in Latin America and the Caribbean, Santiago, Chile, May 1985.

52/ Morgan Guaranty Trust Co., World Financial Markets, New York, June/July 1987, p. 3.

53/ Ibid.

54/ Herve de Carmoy, "Debt and Growth in Latin America: A European Bankers Proposal", Institute for European-Latin American Relations, Working Paper No. 9, Madrid, 1987, p. 11.

55/ Barry Eichengreen, "'Til debt do us part: the U.S. capital market and foreign lending; 1920-1955", Developing Country Debt, Jeffrey Sachs (ed.), Cambridge, Mass., National Bureau of Economic Research, 1987.

56/ Barbara Stallings, Banker to the Third World, Berkeley, University of California Press, 1987, pp. 75-84.

57/ Since 1982, Colombia's voluntary loans have had characteristics of a "forced loan"; i.e., syndications have often been based on a pro rata distributions of existing exposure among the banks.

58/ Kindleberger, "The 1929 world depression in Latin America ...", op. cit., p. 324.

59/ Lahera, op.cit. One calculation shows that in 1986 there were US$68 billion in secondary trading of Latin American and Caribbean debt. However, the actual cancellation of debt was only US$1.5 billion. See John Whitelaw, "Estimates of trading can be deceptive", The American Banker, 25 September 1987.

60/ Ibid., p. 14.

61/ A recent purchase of US$650 million of Bolivian debt for a price of US$100 thousand allowed a conservation group to finance a programme that protects land in the Beni region. See Spencer Beebe and Peter Stroh, "Using debt to save nature", The New York Times, 28 July 1987.

62/ These problems are analysed very well in Lahera, op. cit. Also see Group of Thirty, Finance for Developing Countries, New York, 1987 and Ricardo Ffrench-Davis, "An interview with Ricardo Ffrench-Davis", CTC Reporter, No. 23, New York, Spring 1987.

63/ Although debt is retired, there is no liquidation of the external liability; it just takes the new form of a direct investment.

64/ The savings, of course, is temporary since the investment will eventually require profit remittances, probably at a rate higher than the interest rate on the original loan.

65/ For estimates of financial requirements see ECLAC's documentation for the twenty-second session to be held in Brazil.

66/ Citibank, which has set the standard for loan-loss reserves in the U.S., has reserved against 25% of its Third World loans. As shown earlier, discounts are running at 50% or more. Recently, more regional banks in the United States have made loan-loss reserves of up to 60% of their exposed loan portfolio. The situation is different in Europe, where loan-loss reserves are substantially higher, reaching in some countries up to 100% of the exposed portfolio.

67/ Even if a bank directly swaps a loan for an equity investment, it still cannot assume that accountants will value the investment at par.

68/ The banks know that the more complicated the picture, and the more protracted the crisis, the greater the pressure for direct or indirect public bailouts. Thus there is an incentive to postpone losses, with the intention to share them later with taxpayers. See Wellons, op.cit., p. 284.

69/ Group of Thirty, op. cit.

70/ "Proposal with Respect to Certain Brazilian External Debt Held by Commercial Banks", September 25, 1987. It was reported that Brazil had contemplated conversion of 50% of the medium- and long-term bank debt into bonds. See Ann Charters, "Brazil to seek new debt conversion", Financial Times, 4 September 1987.

71/ Mahesh Kotecha, "Repackaging Third World debt", Standard and Poor's International Credit Week, August 1987, p. 9.

72/ See William Cline, Mobilizing Bank Lending to Debtor Countries, Washington, D.C., Institute for International Economics, 1987, pp. 13-20.

73/ Kotecha, op.cit.

74/ Ibid.

75/ Clare Pearson, "Eurodollar market treads a vertiginous path", Financial Times, 9 November 1987.

76/ Richard Omohundro Jr., "High yield sovereign bonds", Global Debt Strategies, Washington, D.C., Inter-American Development Bank, 1987, p. 49.

77/ Kotecha, op.cit.

78/ Louis Lowenstein, "Junking the junk bond market", The New York Times, 16 November 1987.

79/ Steven Dizard, "Corporate precedents", Prospects for Securitization of Less Developed Country Loans, New York, Salomon Brothers, June 1987.

80/ If the bond were very marketable, the bearer of that bond would not be easily identifiable for the purpose of soliciting new money to refinance interest payments.

81/ Donald Lessard and John Williamson, Financial Intermediation Beyond the Debt Crisis, Washington, D.C., Institute for International Economics, 1985, p. 86. In 1977 Mexico issued peso-denominated bonds with a yield linked to the international price of oil. Ibid., pp. 83-84.

82/ Kotecha, op.cit.

83/ Stewart Fleming and Alexander Nicoll, "U.S. blocks Brazil's plan to convert bank debt to bonds", Financial Times, 9 September 1987.

84/ Eric Berg, "Banks cool to Brazil debt for bond plan", The New York Times, 26 September 1987.

85/ The earlier mentioned problem about the banks having incentives to hold back losses today in the expectation that they can be shared with taxpayers tomorrow also applies here.

86/ Kotecha, op.cit.

87/ See Evans, op.cit.

88/ Dizard, op.cit. Note that speculators' opportunity costs are high because they can receive 20% yields on investments in the U.S. market involving bankrupt Chapter 11 corporate debt. Evans, op.cit., p. 79.

89/ This is exactly what occurred in Latin America during the period of settlement of debts between World War I and II.

90/ In fact the main contribution of an exit bond is to take the small lenders out of the debt negotiations. These smaller banks have usually resisted participation in restructuring packages, making it difficult for the Steering Committee to finalize a restructuring agreement with the debtor country.

91/ Kenneth Telljohann, "Analytical framework", Prospects for Securitization of Less Developed Country Loans. Salomon Brothers, New York, June 1987, p. 11.

92/ Discounts on old debt telegraph to new potential creditors that existing contracts are not being honoured. This creates expectations that the new creditor will risk falling into the pool of bad debt. The new creditor will entre only if there are adequate institutional guarantees that isolate the new obligation from the old debt, or if the creditor has reason to dismiss the market's collective judgement of the borrowers' creditworthiness.

93/ Telljohann, op.cit.

94/ See Bianchi, Devlin and Ramos, op.cit., for an analysis of the problems of adjustment over 1981-1986.

95/ See ECLAC, Restrictions on Sustained Development in Latin America and the Caribbean and the Requisites for Overcoming Them (LC/G.1488(SES.22/3)), Santiago, Chile, January 1988.

96/ For overviews of proposals see Martine Guerguil, "The international financial crisis: diagnosis and proposals", CEPAL Review, No. 24 (LC/G.1324), Santiago, Chile, December 1984, pp. 147-169. Stephany Griffith-Jones, "Proposals to Manage the Debt Problem", Sussex University, Institute of Development Studies, 1985, C. Fred Bergsten, et al., op.cit., and William Cline, Mobilizing Banks Lending, op.cit., Appendix B.

97/ In the contemporary debate the earliest proposals were made by Peter Kenen and Richard Weinert. Kenen proposed the conversion at a discount, while Weinert proposed a conversion at par with below market interest rates on the grounds that this would spread the banks' losses over time. See Peter Kenen, "A bailout for the banks", The New York Times, 6 March 1983 and Richard Weinert "Banks and bankruptcy", Foreign Policy, No. 50, Second Quarter, 1983, pp. 138-149. Kenen has recently updated and expanded his proposal. See Peter Kenen, "A Proposal for Reducing the Debt Burden of Developing Countries", Princeton, New Jersey, Princeton University, March 1987.

98/ Patricia Wertman, "International Debt Problem: Congressional Proposals", Congressional Research Service, Washington, D.C., October 1987.

99/ The loss could be interpreted as salutary. On the one hand, politicians could avoid charges of bailing out the banks. On the other, it also assuages moral hazard problems by making the banks pay a penalty for their poor credit decisions during the 1970s.

100/ Unlike loans, the bond holdings of banks do not have to be backed by capital.

101/ Problem Savings and Loan Associations in the U.S. were allowed to write down losses on securitized bad loans over a 40-year period. See Evans, op.cit., p. 81.

102/ See U.S. Congressman John LaFalce, "Third World debt crisis: the urgent need to confront reality", Congressional Record, Washington, D.C., vol. 133, No. 34, 5 March 1987.

103/ The debt conversion facility would presumably discount the debt at a lower rate than that which is found in the secondary market.

104/ For an excellent analysis of the problems of conditionality, see Group of Twenty-Four, op.cit.

105/ ECLAC, Políticas de ajuste y renegociación de la deuda externa, Santiago, Chile, January 1984. Cuadernos de la CEPAL series No. 48, 1984. United Nations publication Sales No.: S.84.II.G.18.

106/ It often is overlooked that the debt crisis has had very negative effects on the export performance of the creditor countries. This, of course, means lost markets and jobs. See Joint Economic Committee, "Trade, Deficits, Foreign Debt and Joint Economic Committee, "Trade, Deficits, Foreign Debt and Sagging Growth", U.S. Congress, Washington, D.C., September 1987.

107/ This procyclical behaviour of financial markets has been recognized for long. See, for example, League of Nations, Economic Stability in the Post-war World, Geneva, 1945.

108/ "Japanese banks wary of Miyazawa debt proposal", IMF Morning News, Washington, D.C., 22 September 1987 and Michael Sesit, "Japan appears to be moving toward a bigger role in resolution of debt crisis", Wall Street Journal, 1 October 1987.

109/ Bisque clauses were employed by the U.S. Government in some of its postwar loans. For example, in 1945 the government made a US$4 billion loan to the United Kingdom to be repaid over 50 years, in which a bisque clause in the loan agreement allowed the repayment schedule to adjust to economic conditions of the borrower. See, G. Abbott, "The case for cancellation", Inter-Economics, No. 7, July 1975, pp. 217-221.

110/ There is, however, disagreement on the means to achieve this. For contrasting views see Bela Balassa, et al., op.cit., and ECLAC, Latin American and Caribbean Development: Obstacles, Requirements and Options (LC/G.1440-P), Cuadernos de la CEPAL series No. 55, Santiago, Chile, 1987. United Nations publication Sales No.: E.87.II.G.9.