LATIN AMERICA AND THE CARIBBEAN: OPTIONS TO REDUCE THE DEBT BURDEN

ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN - ECLAC

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UNITED NATIONS
ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARIBBEAN
Santiago, Chile, 1990

LC/G.1605-P
March 1990

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UNITED NATIONS PUBLICATION

Sales No.: E.90.II.G.7

ISBN 92-1-121156-5

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PREFACE

Just as debt fatigue set in some time ago due to the protracted nature of the negotiations to deal with what often appears to be an intractable problem, the great amount of written material that has been produced on the matter – including the Secretariat's own frequent contributions –* has also led to a different type of fatigue. It often appears, in effect, that all that could be said on the topic has already been said. It might therefore be asked why the Secretariat has prepared yet another statement.

The answer is simple enough. The problem is still very much with us, and unless some major changes occur, it is likely to remain so during a protracted period of time. It was therefore felt that as the United Nations turns its attention to the most pressing matters on the global development agenda for the 1990s, and the Economic Commission for Latin America and the Caribbean in particular does so regarding the region, it would be timely to once more address the issue, taking into account recent developments in the matter.

For many Latin American and Caribbean countries, the debt problem, brewed in the seventies, became a permanent obstacle to development in the eighties. It now threatens to remain an important development issue as well as a contentious topic in the arena of international economic co-operation in the nineties. As stated in previous Secretariat documents, the debt overhang certainly is not the only major obstacle that the countries of the region face. Clearly, however, any discussion of development prospects for the 1990s – a topic explored in a separate document –** would be incomplete without taking a new look at this secular problem and proposing ways of overcoming it.

With the passage of time, the premise that the debt problem is systemic in nature has proven correct. Hence, the first and best option for resolving it is a comprehensive concerted or collective solution which distributes costs in a way that is functional to a rapid restoration of confidence in the system *as a whole*: only that way can losses in global output and employment be minimized.

Indeed, a relatively untold story in the development crisis of the region is the reluctance of the creditor governments to accept the systemic character of the crisis and to assume their subsequent responsibilities in an interdependent world. To highlight the importance of more ambitious public participation in any lasting solution to the debt problem, after presenting the summary and conclusions (chapter I) the study examines in chapter II the debt problem in its proper context as a systemic financial problem, and the type of role that the public sector is traditionally expected to play in resolving it. The general analysis is given more concrete form by examining public sector activism in the resolution of domestic financial crises in the industrialized countries, and by contrasting that with the relatively passive public management of the Latin American and Caribbean crises.

* See, for example: ECLAC, *Políticas de ajuste y renegociación de la deuda externa en América Latina* (LC/G.1332); "Cuadernos de la CEPAL" series, Nº 48, Santiago, Chile, 1984, United Nations publication, Sales No. S.84.II.G.18; ECLAC, *The problem of the external debt: gestation, development, crisis and prospects* (LC/G.1406), Santiago, Chile, 1986; and ECLAC, *The evolution of the external debt problem in Latin America and the Caribbean* (LC/G.1487/Rev.2-P); "Estudios e Informes de la CEPAL", series, Nº 72, Santiago, Chile, 1988. United Nations publication, Sales No. E.88.II.G.10. See also the annual report of the ECLAC Secretariat entitled "Preliminary Overview of the Latin America and Caribbean Economy", published each December.

** See ECLAC *Changing production patterns with social equity,* (LC/G.1601(SES.23/4)), Santiago, Chile, February, 1990.

Chapter III analyses the option of a concerted solution to the region's debt problem. The analytical focus is on the Brady Plan. In this chapter the Plan's achievements are elaborated on, as well as its apparent shortcomings. The shortcomings are serious enough to have already raised doubts in many circles about the Plan's likely effectiveness. Nevertheless, it has many of the necessary ingredients of a solution and therefore the Secretariat considers that it would be premature to write it off as another failed concerted strategy.

It is the potential value of the Brady Plan, coupled with its shortcomings, that inspires chapter IV. In this section of the document a series of constructive proposals are presented which are meant to fortify the Brady Plan and ensure its success in ending the severe and protracted debt problem in developing countries.

The final chapter of the document explores the experiences that have accumulated over the years regarding unilateral reduction of the transfer of resources. This option must be seriously contemplated by debtors as long as an effective comprehensive public solution to reduce the transfer of resources fails to emerge from the creditor countries. Indeed, under the heavy weight of the outward transfer of resources, most countries in the region have in fact been pushed into deploying this option.

This document, then, contains the Secretariat's considered point of view, as perceived from a Latin American and Caribbean vantage point, on how the debt overhang could be dealt with constructively and consensually. In the absence of better and more equitable management of the problem, it is difficult to see how development can be put back on track in the present decade.

I. SUMMARY AND CONCLUSIONS

A. THE INTERNATIONAL MANAGEMENT OF THE DEBT PROBLEM

The Brady Plan represents the fourth phase of the international debt management strategy. Its emphasis on debt reduction has been welcomed by the debtor countries and raised expectations that after eight years of development crisis there may at last be a solution to their protracted debt service problems.

The first phase of the international debt management strategy began in August 1982 when Mexico – the second largest debtor in the Third World – declared a temporary unilateral moratorium on debt service. This marked the beginning of a systemic financial crisis of major proportions in which the decentralized International Lender-of-Last-Resort (ILLR) underwent one of its most severe tests. The ILLR – made up of the Group of Seven (G-7) governments, some of their big banks and the IMF – moved quickly to orchestrate unprecedented co-ordination among the hundreds of bank creditors, and between them and a rapidly growing number of problem developing country debtors, in order to avoid the formal defaults that could have given rise to a 1930s-style financial collapse. The basic policy focus of this initial phase was based on the diagnosis that the debtors suffered from illiquidity; the prescription for them was austerity and adjustment. The primary instruments deployed in the rescue operation were a rescheduling of debt principal on commercial terms; "involuntary" lending by the banks to the debtor countries to refinance part of the interest payments falling due, and economic adjustment through IMF-monitored programmes.

This first phase of the international debt management strategy successfully contained the risk of system-wide defaults and destabilizing losses for the world's commercial banks. However, economic activity in the debtor countries collapsed, largely because the ILLR did not mobilize a sufficient amount of compensatory financing to sustain output and employment in the debtor countries, as would have been required in a socially efficient adjustment programme. Much of the problem can be attributed to the rudimentary functioning of the ILLR compared to its domestic counterpart.

History is replete with examples of systemic financial crises that mirror many of the events leading up to the debt problems of Latin America and the Caribbean in 1982. The origins of systemic crises are always complex, but invariably have involved market failure (generalized overlending and overborrowing), sometimes coupled with exogenous shocks which have suddenly revealed the overextended condition of the credit system. When a financial crisis with systemic dimensions has emerged in the domestic markets of the creditor countries, modern experience has demonstrated that a lender-of-last-resort is assertively deployed to achieve the two-fold objective of i) keeping the financial system solvent and ii) sustaining domestic output and employment. In effect, since a systemic problem is by nature a public problem, governments have comprehensively intervened to socialize a large part of the cost of overcoming it.

When the focal point of difficulties has been disperse and hard to identify, the public sector, in its capacity as a lender-of-last-resort, has sharply raised financing (and indirectly its assumption of credit risk) for the system as a whole through unrelenting moral suasion on the country's commercial banks. Alternatively, when a problem of systemic dimensions has been localized in an important economic unit, or a well-defined sector of the economy, the government has typically intervened directly to rescue the faltering borrower. In effect, the systemic character of the crises has made governments unwilling to let the problem unit's fate be determined by the vagaries of private

market forces and highly uncertain bankruptcy proceedings. Thus, in return for adjustment of policies by the borrower and debt relief on the part of the creditors, the government has awarded the borrower direct public loans, or public guarantees on private loans, which have provided the bulk of the emergency financing needed to resuscitate the problem unit.

These "public bailouts" of borrowers and their bankers in the domestic markets of the creditor countries have often been controversial because they violate traditional liberal tenets of economic theory. However, in times of systemic stress the bailouts have usually proven to be good economic policy, because on the one hand, a socially destabilizing collapse of the problem unit was avoided, and on the other, when there was a balanced mix of financing and adjustment, the problem units restored their creditworthiness relatively quickly and could then resume a constructive contribution to the economy.

Latin America's debt crisis had systemic origins in market failure, aggravated by the OECD governments' economic policies. In 1982 also, the systemic repercussions of default would have been devastating to the world economy. However, in comparison to the behaviour of domestic lenders-of-last-resort, the ILLR proved to be more one-dimensional in character, and therefore a less effective guardian of economic activity in an interdependent international system made up of developed and developing countries. Indeed, in phase one of the international debt management strategy, the ILLR tended to stress the private character of the problem between borrowers and bankers. Moreover, it did not mobilize the comprehensive public financing mechanisms that invariably emerge in domestic lender-of-last-resort operations. Consequently, the forces of adjustment swamped the Latin American and Caribbean countries, as testified by a dramatic turnaround in the net credit-related transfer from an average positive flow representing 2.3% of GDP per annum, in 1974-1979, to a negative flow averaging almost 3% of GDP per annum, in the crisis years of 1983-1985.

It was this massive shift to an outward transfer of resources, rather than the emergency publicly-induced countercyclical financing normally associated with lender-of-last-resort operations, that distinguished the efforts to keep the international financial system solvent. However, the sudden draining of such a large quantity of resources from the region at a critical moment could be realized only through deep cuts in the debtor countries' imports and investment. The financial drain was moreover seriously aggravated by falling export prices and the domestic private capital flight that was to be expected in a situation of such great crisis and uncertainty with respect to external finance.

The destabilizing financing constraints would have seriously undermined the effectiveness of even the best adjustment policies in the debtor countries. The region's output inevitably fell sharply: at the end of 1985 per capita GDP was 8% below the 1980 level. Moreover, the policies required by external adjustment, coupled with the difficulties in effecting the internal transfer of resources (needed to pay the public external debt) from the private to the State sector helped to fuel unprecedented rates of inflation in many debtor economies (see table 1). Thus, in the middle of a systemic international credit crisis of historic proportions, the ILLR succeeded in stabilizing one part of the international system (the banks and economies of the industrialized countries), but unfortunately at the expense of the performance of another part (many developing countries, including those of Latin America and the Caribbean).

The underfinancing of the adjustment process in Latin America and the Caribbean was ironic in the face of the widespread acceptance at the time of a diagnosis of illiquidity in the debtor countries, because when there is a liquidity problem, there is naturally also a compelling argument for a strong injection of cash into the debtor economies to normalize economic activity and stave off further erosion of the confidence of private capital. Indeed, with the outbreak of systemic crisis, an effective lender-of-last-r esort might have been expected, at the very minimum, to have stabilized private expectations by publicly committing itself to a transitory emergency policy of a zero credit-related transfer of resources from countries participating in official adjustment programmes. Why the ILLR did not respond in a more balanced fashion to the systemic crisis is an important issue in North-South relations

Table 1
LATIN AMERICA AND THE CARIBBEAN: MAIN ECONOMIC INDICATORS

Indicators	1982	1983	1984	1985	1986	1987	1988	1989[a]
Gross domestic product at market prices (index, base year 1980 = 100)	99.0	96.1	99.5	103.0	106.8	109.8	110.5	111.7
Population (millions of inhabitants)	375.5	383.6	391.8	400.3	409.0	417.8	426.5	435.5
Per capita gross domestic product (index, base year 1980 =100)	94.6	89.8	90.9	92.1	93.4	94.0	92.6	91.7
	Growth rates							
Gross domestic product	-1.4	-2.9	3.5	3.6	3.6	2.9	0.6	1.1
Per capita gross domestic product	-3.5	-5.0	1.2	1.3	1.3	0.7	-1.5	-1.0
Consumer prices[b]	84.6	130.5	184.7	274.1	64.5	198.5	757.7	994.2
Terms of trade (goods)	-9.2	1.3	6.6	-4.4	-10.3	-0.5	-1.5	1.9
Purchasing power of exports of goods	-7.7	11.0	13.4	-4.2	-10.7	7.4	7.8	3.5
Current value of exports of goods	-8.8	0.1	11.5	-5.6	-15.1	14.0	13.7	8.7
Current value of imports of goods	-19.9	-28.5	4.0	-0.3	2.6	13.1	13.0	8.0
	Billions of dollars							
Exports of goods	87.5	87.5	97.6	92.1	78.3	89.2	101.5	110.3
Imports of goods	78.4	56.0	58.3	58.1	59.6	67.4	76.2	82.3
Trade balance (goods)	9.1	31.5	39.3	34.0	18.7	21.8	25.3	28.0
Net payments of profits and interest	38.8	34.4	36.7	35.3	32.2	31.4	34.2	38.3
Balance on current account	-41.0	-7.3	-0.5	-3.4	-15.8	-10.7	-10.3	11.1
Net movement of capital[c]	20.2	2.9	10.0	2.5	8.7	14.9	5.3	13.7
Global balance[d]	-20.8	-4.4	9.5	-0.9	-7.1	4.2	-5.0	2.6
Total gross external debt[e]	331.2	356.4	373.3	382.9	399.6	422.8	419.4	422.4
Net transfer of resources[f]	-18.6	-31.5	-26.7	-32.8	-23.5	-16.5	-28.9	-24.6

Source: ECLAC, *Preliminary Overview of the Latin American and Caribbean Economy, 1989*, Santiago, Chile, December 1989.
[a] Preliminary estimates, subject to revision. [b] Variation from December to December. [c] Includes long and short-term capital, unrequited official transfer payments, and errors and omissions. [d] Corresponds to the variation in international reserves (of opposite sign) plus counterpart items. [e] Adjusted to include Trinidad and Tobago and Jamaica. [f] Corresponds to total net inflow of capital less net payments of profits and remittances. Excludes English-speaking Caribbean.

that undoubtedly merits the attention of world policy-makers.

In any event, the depressionary effects on the debtor economies of the underfinanced debt management strategy, coupled with renewed risks of formal default, gave rise in late 1985 to the second phase of the strategy, commonly known as the Baker Plan. In recognition of the fact that efficient adjustment takes time, and must involve economic growth if it is to be sustained, the Baker Plan changed the policy focus to "growth-oriented structural adjustment". The mechanisms to achieve this goal were the same as those in the first phase, with the novelty of an official commitment to boost concerted financing to the problem borrowers. The Plan promised to mobilize new net resources from the commercial banks of US$20 billion over three years, for 17 heavily indebted countries (mostly Latin American), representing a modest 2 1/2% per annum increase in exposure. Another US$9 billion of net financing was to come from official sources.

The Baker Plan, however, immediately ran into trouble regarding the mobilization of the promised new net lending. This fact, coupled with the continued depressed level of output in the foreign-exchange-constrained debtor countries, induced yet another shift in the debt management strategy in 1987. This third phase constituted an important mutation of the original Baker Plan. In view of the continued difficulties, in ensuring a stable and predictable flow of bank financing for adjusting economies, the Baker Plan supported the tapping of new sources of financing in the context of a "market menu approach". Included in the menu were debt reduction items such as debt-for-bond exchanges at a discount and debt-equity swaps. Thus, for the first time the international debt management strategy admitted the existence of a debt overhang and the probability that the problem countries' obligations would not be paid in full.

The third phase of the management strategy also quickly ran into difficulties, however. The Baker Plan's menu approach was conceived as an entirely voluntary operation of the private market involving no public sector intervention or taxpayer costs. Unfortunately, when left to their own devices, private markets unwind from a debt overhang only very slowly. Thus, while some debt reduction occurred in 1987-1988, it was sporadic and did not release financing in macroeconomically significant amounts. Meanwhile, more conventional concerted lending by the banks also failed to materialize in significant volume. With the very tight financing environment, the large outward credit-related transfer to the North continued, averaging 3% of GDP per annum during 1986-1987. Not surprisingly, economic growth in the debtor countries remained very depressed, inflation accelerated, and the development crisis deepened (see again table 1).

Notwithstanding the problems of the debtors, the commercial banks fared well during the first three phases of the debt strategy. Indeed, through a remarkable "growth-oriented adjustment" of their balance sheets, they greatly reduced their vulnerability to default in the debtor countries. Financial stability in the North also facilitated the industrialized countries' largest economic expansion in modern history; indeed, their per capita output rose at an average rate of 2.9% per annum over the period 1983-1989. Thus by mid-1988 there was an emerging consensus that the international debt strategy needed a major shift in focus that would introduce a more balanced approach to aid the still faltering debtor countries. During the year interesting proposals appeared from the governments of Japan and France to revitalize the strategy through comprehensive and direct public support of debt and debt service reduction. However, it was United States Secretary of the Treasury Nicholas Brady's proposal, announced in March 1989, that emerged as the new framework for dealing with the problem of the commercial bank debt of developing countries.

B. THE BRADY PLAN

One of the encouraging aspects of the Brady Plan is its promise to correct some of the asymmetries in the effects of the international debt management strategy. The Plan proposes to stimulate policy reform and growth in the debtor countries through voluntary case-by-case debt and debt service reduction in respect of obligations to the commercial banks. As seen earlier, the admission of debt reduction is not an entirely new development, as it was already featured in the menu approach introduced during the third phase of the debt management strategy. Indeed, the real novelty

of the Brady Plan is its willingness to decisively strengthen and accelerate the market-oriented debt reduction process through explicit public financial and institutional support. On the one hand, Secretary Brady proposed that the IMF, the World Bank and creditor governments should lend resources to the debtor countries to help them finance a significant debt reduction. On the other, he suggested that governments should review legal, regulatory, accounting and tax codes in order to reduce disincentives to the banks participating in such debt reduction. Finally, the Plan also envisaged a more flexible IMF policy on financing assurances, which would allow the Fund, when circumstances merit, to disburse its resources for adjustment programmes even though the debtor country may not have concluded negotiations with commercial banks for a rescheduling/debt reduction/new money package.

In a surprisingly short period of time the Brady initiative has moved from a conceptual plane to concrete action. First, US$30 billion of public funds have already been committed to support buybacks of debt, or guarantees on debt-for-bond exchanges. Second, creditor governments, such as England, France, Japan and the United States, made pronouncements during 1989 on certain regulatory and tax issues that could improve the bankers' response to Latin American and Caribbean countries' debt reduction proposals. Third, during the same year the IMF's Executive Board demonstrated a more flexible attitude on financing assurances by disbursing loans to Argentina, Ecuador, Mexico and Venezuela before these countries reached agreement with the banks on how to manage their debt service problems. And finally, by November 1989 three countries – Mexico, the Philippines and Costa Rica – had signed agreements in principle with their bank Steering Committees to implement Brady-style debt packages. In January 1990 Mexico completed implementation of its agreement, while the Philippines made part of its accord operational.

Notwithstanding this progress, in order to succeed in its stated objectives the Brady Plan must still overcome two important problems: underfunding and under-coordination. The Plan also suffers from certain administrative rigidities concerning the financing of debt reduction. All these problems create serious inefficiencies as well as undue delays in the negotiation of financing packages, to the point that many observers have proclaimed that the Plan is dead.

Regarding the problem of underfunding, at prevailing secondary market prices the pool of US$30 billion of public funds could finance only a marginal 13%-14% net reduction of debt and debt service in Latin America and the Caribbean. This is far less than what is generally considered to be needed to eliminate the debt overhang.

A Brady Plan which can only partially reduce the debt overhang suffers from serious inefficiencies with potentially adverse consequences for all major participants, i.e., debtor countries, commercial banks, multilateral lenders, and creditor governments. For the problem debtors, partial reduction of the debt overhang raises the crucial question of a socially efficient allocation of scarce foreign exchange. In effect, in most cases there are severe doubts about the social rate of return on an allocation of scarce foreign exchange to a debt reduction operation that does not decisively eliminate the debt overhang. Moreover, in a foreign-exchange-constrained country, this dubious rate of return must be contrasted with the high rate generally obtainable through the channeling of scarce dollars into domestic programmes which support economic reforms, investment and growth. Indeed, a debt reduction which only partially eliminates the debt overhang can actually aggravate debt servicing problems. On the one hand, when old debt is transformed into securities the country will find it more difficult to restructure principal or refinance interest as debt service problems arise. This raises the risk of formal default, which would not only besmirch the debtors' good performance in bond markets but also make the countries vulnerable to lawsuits by traditionally more sensitive bondholders. On the other, financing of debt reduction comes largely via commercially-priced loans from the World Bank and IMF which, in case of debt servicing problems, are not subject to rescheduling.

Multilateral lenders, too, can be made worse off by an underfunded Brady Plan. It is they who are carrying the burden of financing the reduction of bank claims in the region. If the redirection of their resources from development and balance of payments lending to debt reduction does not eliminate the debt

overhang and servicing problems, however, these institutions obviously risk a serious deterioration in the quality of their loan portfolio.

Banks may also suffer from inefficiencies in an underfunded programme. A shortage of finance means that bonds received at a discount in debt exchanges will have questionable serviceability and very thin collateral. Hence, Brady bonds themselves are expected to circulate in secondary markets with heavy discounts, with the inefficient result that banks will perceive that they are ceding more in value than the countries receive in formal debt forgiveness.

Finally, creditor governments will also experience unwanted costs in an underfunded debt reduction process. Since they are the major shareholders of the multilateral lenders, all official lending for debt reduction is ultimately at their risk. Thus, increasing official loans for debt reduction that does not resolve the underlying problem of the overhang is merely an inefficient transfer of risk from the private to the public sector.

As far as under-coordination is concerned, it is important to recognize that the free-riding problem induces banks to prefer the *status quo*.[1] Consequently, for voluntary debt reduction to take place in meaningful volume, the banks must be confronted with a system of incentives and sanctions that politely push them collectively into settling their unserviceable claims. Recent agreements for debt reduction have largely depended on impressive moral suasion exerted on the banks by their governments and multilateral lenders. However, this informal jawboning has been so impressive that it is hard to contemplate that authorities will have the time and energy to apply that same degree of pressure evenly over the remaining 36 developing countries eligible for the Brady Plan. Thus there is no substitute for the construction of a coherent institutional framework of rewards for debt reduction and sanctions for free-riding.

While the Brady Plan may have many of the ingredients of a concerted public solution to the debt problem, the shortcomings outlined above seriously undermine its potential and raise legitimate questions about the Plan's effectiveness. Indeed, the obvious shortcomings have generated frustrations that are already beginning to manifest themselves in declarations that the Plan is a failure.

C. TOWARDS A SUCCESSFUL BRADY PLAN: SIX BASIC PROPOSALS FOR REMEDIAL ACTION AND A PROPOSED AMENDMENT TO THE PLAN

1. The six proposals

In spite of its shortcomings, the Brady Plan is conceptually on the right track and has contributed to some concrete advances in a relatively short period of time. However, in order to be a credible concerted solution to the chronic problem of the debt overhang, the strategy must be reinforced with the ambitious public action that characterizes domestic lender-of-last-resort operations. To this end, six proposals are put forward below which, if implemented, would contribute to a more efficient and effective debt reduction process in Latin America and the Caribbean.

a) *Tripling public resources in support of debt reduction to US$90 billion.* An additional public resource commitment of this order of magnitude, in support of buybacks and guarantees at pre-Brady Plan secondary market prices, would be a decisive signal to borrowers, bankers, and the private market generally, that it is feasible to eliminate the debt overhang in developing countries through voluntary debt reduction. With this amount of funding, banks could receive the comprehensive guarantees that they think they need to justify participation in the Brady Plan. However, the guarantees would not be a "bailout" for the banks, since to be eligible for them they would have to reach agreements with the countries to reduce debt to levels compatible with sustained serviceability. Meanwhile, the public resource commitment would not be unduly onerous. On the one hand, funding would be shared among at least ten industrialized countries, with paid-in capital amounting to no more than 5%-10% of the total commitment. Moreover, since the public

[1] The free-riding problem stems from the fact that in a voluntary scheme individual banks have incentives to avoid debt reduction in the hope that their competitors will reduce debts and assume the losses needed to restore the serviceability of the claims.

funds would reduce debt to serviceable levels, guarantees would have a low probability of being called upon and thus would represent only contingent liabilities for the public sector. Finally, it would be more efficient to have public guarantees directly applied to new discounted debt instruments, instead of taking the form of loans to the debtors which generate their own debt and debt service burdens.

b) *More flexible deployment of oficial finance.* Current official funding of debt reduction is now arbitrarily divided between loans which can be used to support principal reduction and loans which are earmarked for interest guarantees. This artificial division of funds hampers negotiations because it constrains the configuration of any debt reduction agreement. Agreements could be concluded more rapidly, and conform better to the individual needs of the borrower, if the only condition for the use of the funds were an agreement with the banks which clearly reduced debt payments to levels compatible with sustained serviceability. Another requirement for speedy debt reduction is that official lending be front-loaded. The present system, which attempts to spread official funding over an extended period, not only unnecessarily complicates negotiations between borrowers and bankers, but also reflects an exaggerated view of the moral hazard problem.[2]

c) *Accelerated elimination of legal, regulatory, accounting and tax obstacles to debt reduction.* One key need in this area is greater transparency. Regulatory, accounting, and even sometimes tax codes tend to be so broadly defined that their application requires a considerable amount of discretion. While this situation facilitates flexibility in the day-to-day overseeing of the financial system, it also creates uncertainty for debt reduction activities. It is essential for the authorities to make a special effort to generally clarify the regulatory, accounting and tax (RAT) implications of the debt reduction techniques that are likely to emerge from current negotiations. More harmonization of the Group of Ten RAT codes, at least for LDC debt, would also greatly simplify negotiations between borrowers and bankers.

In the regulatory area, governments should require their banks to set loan-loss provisions at levels consistent with secondary market prices. On the other hand, once the banks enter into definitive debt reduction agreements, they should be liberated from provisioning any new assets exchanged for debt.

As for accounting codes, forbearance can help the banks accept deep debt reduction. For example, banks might be allowed – as they often are in cases of problem domestic debt – to amortize their losses over a number of years. Authorities might also ensure that participation in debt reduction does not contaminate untraded assets. While liberalizing accounting treatment for banks participating in debt reduction, these same rules could be tightened for free-riders which remain outside of the officially-sanctioned debt reduction accords.

Finally, tax codes could be interpreted so that tax advantages currently enjoyed in some countries in respect of loan-loss reserves are contingent on eventual participation in a definitive debt reduction agreement. Interpretation of tax benefits could also be done in such a way as to ensure that those derived from developing countries debt reduction do not prejudice access to other available tax allowances.

d) *More assertive and transparent IMF policy on financing assurances.* The IMF has encouragingly supported some developing countries by disbursing to them while they still had uncompleted negotiations with the banks, and even accumulated arrears. But the debt reduction process would benefit if the IMF Executive Board could be more assertive and transparent in this area of policy.

A key feature of the IMF's new role should be to help the country define *ex ante* its medium-term capacity to service bank debt. The defined capacity to pay should incorporate requirements for a significant recovery of investment and growth, as well as a cushion for unforeseen developments. This official estimate of the country's capacity to pay should determine the appropriate amounts of debt and debt service reduction. Banks would then be expected to respect this estimate and reduce payment obligations in accordance with it. A

[2] "Moral hazard" refers to the creditors' fears that if debt is fully reduced the debtor countries will have no incentive to "behave properly" in the adjustment process.

new money option would be acceptable for filling the financing gap only if it could be justified on unambiguous *technical* grounds of the debtor's future capacity to pay. Any discrepancies the banks might have about the official estimate of capacity to pay would be dealt with *ex post* by placing appropriate recapture clauses in the debt reduction agreements.

The IMF should be unambiguous in its defence of the official estimate of repayment capacity. Furthermore, if negotiations are excessively protracted, a country should be allowed to accumulate arrears on debt service that exceeds its officially determined medium-term capacity to pay. Indeed, arrears could perhaps even be formally protected as an exchange restriction under Article VIII (2) (b) of the Articles of Agreement of the International Monetary Fund.

e) *Reduction of Paris Club debt.* The amount of debt reduction that the banks must absorb is proportionately greater when they are the only creditors subjected to this process. Likewise, reduction of bank debt will make only a modest dent in the debt overhang of countries which are heavily reliant on official transactions. For both of these reasons it would be advisable to extend the debt reduction facilities to Paris Club obligations. At a very minimum, debt reduction policies adopted at the June 1988 Toronto Summit for low-income African countries should be extended to middle-income debtors.

f) *New mechanisms to assuage the burden of debt service to the multilateral lenders.* A significant number of countries in Latin America and the Caribbean are heavily indebted to multilateral lenders. Moreover, the burden of debt service to the multilateral financial institutions has been aggravated in recent years by the emergence of a negative transfer of resources from the region. The gravity of the debt service problem is manifest in a growing problem of arrears to these lenders, who traditionally consider that they enjoy preferential status. It is clear, then, that as part of an overall solution to the debt problem ways must be found, if only transitorily, to lighten the weight of payments to these agencies.

Recent developments regarding the quick mobilization of funds for the Brady Plan have revealed an unexpected capacity to boost multilateral lending from existing capital resources. Thus, where it is not feasible to achieve definitive elimination of the debt overhang through voluntary agreements with the banks, the World Bank and the IMF might consider gradually freeing-up these earmarked resources for balance of payments and project lending.

The IMF is exceptionally liquid. Its resources could be better exploited to relieve the outward transfer of resources to the Fund currently experienced by many countries. Access to the newly established Compensatory and Contingency Financing Facility could be liberalized both in terms of conditionality and access to resources. Furthermore, the Fund's resources could be more effectively absorbed if its extended programmes were more attractive to countries seriously interested in adjustment. To this end, six-monthly reviews of performance criteria should become the standard operational practice, instead of the traditional quarterly reviews, and in certain circumstances annual reviews might be warranted. Also, as long pointed out by the Group of 24, adjustment exercises in Fund programmes should be fortified with explicit and meaningful "growth exercises".

It must be mentioned that to be a credible lender-of-last-resort, the IMF needs an unquestioned liquidity position to respond to entirely unforeseen emergencies. Thus the IMF might be more disposed to draw against current liquidity if there were adequate support for the Managing Director's legitimate call for a 100% increase in Fund quotas.

The Fund, the World Bank and the Inter-American Development Bank should also explore extending grace and amortization periods on their loans. The World Bank, in particular, might consider re-introducing a system of fixed payment quotas, as it already has done for low-income countries.

Finally, the multilateral lenders must further develop rescue systems for countries that have fallen into protracted arrears with them. Arrangements recently experimented with in Guyana – in which friendly governments have attempted to mobilize resources to help the country cancel arrears – could perhaps prove useful for other problem debtors.

2. The amendment: a Brady Plan-based debt facility

In terms of design, the Brady Plan is largely an *ad hoc,* piecemeal programme. Thus, even if strengthened by enacting the above proposals, it will still suffer from serious inefficiencies. Consolidating the Brady Plan into a specialized debt facility could sharply reduce these inefficiencies and lower the ultimate public costs of supporting debt reduction.

Unlike the tenuous arrangements of an *ad hoc* plan, a specially-capitalized facility would be an irrevocable message to all market participants, expressing determination to eliminate the debt overhang. This alone could reverse negative expectations and help create a virtuous circle of activity in the private sector. A specialized central facility also improves transparency and accountability regarding the behaviour of all agents participating in debt reduction negotiations. Moreover, flexibility in managing the problem would be enhanced because the facility would not be bound by the existing Articles of Agreement of multilateral lenders. With a more flexible structure and administration of debt reduction exercises, the facility could also better contain any moral hazard problems. Finally, a more formal institution would ensure more evenness in the distribution of debt reduction among different developing countries.

In sum, if incorporated in a formal facility the Brady Plan could probably eliminate the debt overhang more rapidly and equitably, as well as at less cost than the present *ad hoc* approach. Moreover, by quickly eliminating the overhang in a broad range of countries, the facility would accelerate, rather than hinder, the debtor countries' return to voluntary market borrowing.

All the above proposals, of course, sharply raise the public sector's profile in the management of the debt problem. However, as long as the banks are required to reduce their claims to levels consistent with sustained growth in the debtor countries, the public sector's assumption of more risk would not be a "bailout of the banks". Rather it would be a "bail in" of the international public sector which has been exceedingly reluctant to assume responsibilities that are proper to its domain when there is a systemic problem like that observed in the overly indebted developing countries.

The six basic proposals for remedial action outlined here are systemic in character. Negotiating their implementation requires concerted action of debtors as well as of creditors, while their application to each individual case lends itself to a case by case approach.

D. THE OPTION OF A UNILATERAL RESTRICTION ON PAYMENTS

Making the Brady Plan more robust will not be an easy task. The driving force behind the Plan is the United States Government, but the latter's capacity to finance ambitious international initiatives is now hampered by a very serious fiscal disequilibrium. It remains to be seen to what extent the European and Japanese governments will be willing and able to pick up the slack in the management of the problem. In the meantime, many countries faced with the destabilizing effect of an excessive outward transfer of resources will be obliged to opt for a unilateral restriction of debt service payments.

Since 1987 the number of countries opting for a unilateral restriction on payments has risen sharply: indeed, during 1989 no less than 15 countries in Latin America had accumulated arrears in the service of their debt. Most restrictions on debt service adopted over the last eight years have been informal, but some countries have had formal moratoria and explicit plans for partial payment of their obligations. These unilateral restrictions on debt service are usually reflections of the serious flaws in the international debt management strategy.

Payments restrictions on debt service have not been generally associated with economic success. However, at least two internationally acclaimed "success stories" regarding adjustment –Bolivia and Costa Rica– have been partly financed by non-negotiated restrictions on payments of debt to private commercial banks and other creditors. As these cases represent a good portion of the very limited number of such "success stories" that can be pointed to over the last eight years, it can be concluded that, at least under certain circumstances, payment restrictions can be

part of an orderly process of structural adjustment.

Massive retaliation of creditors, which has so often been pointed to as a potential cost of default, has so far not materialized in the current crisis. However, history suggests that this type of creditor behaviour is usually associated with broader political conflicts between countries. Restrictions on debt payments by Latin American and Caribbean countries during the 1980s have had costs such as restricted access to credit, sporadic lawsuits, and irritation of certain segments of society in the debtor countries. Nevertheless, experience has shown that when the restriction was administered efficiently, the negative impact of arrears could be kept to tolerable levels.

With the advent of the Brady Plan the distance between a unilateral restriction on debt payments and the official international debt strategy has narrowed. Indeed, when a country finds itself compelled to adopt such a restriction, that potentially becomes a good starting point for negotiating a Brady-style debt reduction package. However, the Brady Plan requires an IMF programme as a prior condition for debt reduction, and in view of the fact that some adjusting countries have considered it prudent to postpone entering into a Fund agreement until they could consolidate their own economic programmes, efficient administration of existing payments restrictions has often been a precondition for an orderly adjustment process.

There is now sufficient experience with payments restrictions in Latin America and the Caribbean to permit the description of some of the policies that countries have actually used to minimize the costs of being in arrears with their commercial bank creditors. Some recent case studies of this phenomenon show that economically effective restrictions have depended on coherent and sustainable economic policies which have used the breathing space from payments to finance fundamental adjustments. Efficient administration of restrictions on payments has also been dependent on a relatively broad internal political consensus supporting the view that, in the light of the options offered by the creditors, a temporary restriction on debt service was justified to support the domestic economic programme of structural adjustment.

Countries imposing unilateral restrictions on payments have found that excluding some types of creditors from the restriction has been an effective way to minimize strains in creditor relations. However, the favoured lenders have not necessarily been more forthcoming with their credit during the period of restriction. Arrears in Latin America and the Caribbean have mainly been accumulated with private banks and Paris Club lenders. Most countries have made great efforts to avoid breaching the preferential status of multilateral lenders.

Since restrictions on payments have invariably induced some retaliation by private creditors, countries have in practice used diverse techniques to protect their international reserves and short-term lines of credit. An examination of the experience of the countries shows that in most circumstances these techniques can be reasonably effective in temporarily controlling the costs to the country of falling into arrears with the banks and other creditors.

Although a unilateral restriction on debt payments is clearly not the first best solution to the debt problem, in the absence of an effective public solution it may prove to be a second best alternative for many debtor countries which are forced to reduce the outward transfer of resources.

II. AN OVERVIEW OF THE NATURE OF THE DEBT PROBLEM

The Brady Plan is the most recent phase of the international debt management strategy. The Plan, introduced in March 1989, represents a major conceptual advance on the part of the creditor countries; indeed, there is now a substantial convergence of opinion between the creditor and debtor nations that debt reduction is a necessary condition for efficient structural adjustment and resolution of the development crisis in the region. The Brady Plan moreover marks the first time that the creditor governments have been willing to explicitly support the debt reduction process with a significant commitment of public resources.

The reason the Brady Plan has so sharply raised expectations in the region is that the debt overhang has played a pivotal role in the region's development crisis, which is now eight years old. The origins of the crisis and the reasons for its protracted nature are complex. One common factor that has stood out, however, is the debt burden and the massive outward transfer of resources associated with it.

Independently of the other factors affecting the economic performance of Latin America and the Caribbean, it is clearly essential to find a solution to the debt problem. The region's foreign debt totalled US$422 billion at the end of 1989, of which roughly 60% was with private commercial banks (table 2).[1] As might be expected in developing areas, foreign debt had been a source of positive resource transfers during the 1970s, when it provided stimulus to growth. Since 1982, however, the resource flow between North and South has been reversed, with Latin America and the Caribbean transferring an unprecedented amount of net resources to its creditors for service of the debt (figure 1).

By most estimates, there is a large overhang in the region's stock of debt that is seriously impinging upon the debtor countries' economic performance. This overhang is furthermore confirmed by the large discounts on bank debt in secondary markets, where the average valuation of the region's obligations in late 1989 was only 28 cents on the dollar (table 3). If the overhang and corresponding outward transfer of resources were eliminated, the debt problem could be put behind the Latin American and Caribbean countries once and for all. It would then be more possible not only to concentrate efforts on the task of economic restructuring and development, but also to evaluate that domestic effort more precisely. Indeed, in view of the debt overhang's perverse effects on incentives and domestic economic performance,[2] elimination of the debt problem is a precondition for resolving the broader crisis of development in the region.

The circumstantial facts behind the emergence of the debt problem and its evolution over the last eight years are by now relatively well known.[3] What has been less evident, at least judging by official pronouncements on the debt issue, is the

[1] Note that for a few countries data are from the Bank for International Settlements, which underestimates debt because of limitations on coverage and the fact that it incorporates the effects of loan writedowns that do not necessarily reduce the debtor's obligation.

[2] See Paul Krugman, "Market-Based Debt Reduction Schemes", Cambridge, Mass., National Bureau of Economic Research, Working Paper No. 2587, May 1988.

[3] See ECLAC, *The evolution of the external debt problem in Latin America and the Caribbean* (LC/G.1487/Rev.2-P), Estudios e Informes de la CEPAL series, No. 72, Santiago, Chile, 1988. United Nations publication, Sales No. E.88.II.G.10.

Table 2

LATIN AMERICA AND THE CARIBBEAN: TOTAL DISBURSED EXTERNAL DEBT AND DEBTS WITH PRIVATE COMMERCIAL BANKS [a]

(End-of-year balances in millions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989 [b]
Latin America and the Caribbean										
Total (1)	231 345	288 591	331 160	356 388	373 319	382 865	399 608	422 778	419 440	422 400
Private banks (2)	157 545	201 823	232 260	244 693	256 954	259 514	263 336	273 212	256 846	...
(2)/(1) %	68.1	69.9	70.1	68.7	68.8	67.8	65.9	64.6	61.2	...
Oil-exporting countries										
Total (1)	97 267	125 583	140 503	152 937	156 243	158 207	163 628	170 396	170 244	172 805
Private banks (2)	72 789	97 664	109 150	113 532	116 416	116 843	118 296	121 603	113 465	...
(2)/(1) %	74.8	77.8	77.7	74.2	74.5	73.9	72.3	71.4	66.6	...
Bolivia										
Total (1) [c]	2 340	2 653	2 803	3 176	3 208	3 294	3 536	4 162	3 993	4 100
Private banks (2)	1 112	1 153	1 221	1 153	1 112	941	977	1 025	575	...
(2)/(1) %	47.5	43.5	43.6	36.3	34.7	28.6	27.6	24.6	14.4	...
Ecuador										
Total (1)	4 167	5 272	5 365	7 381	7 596	8 111	9 077	10 267	11 034	11 700
Private banks (2)	3 277	4 083	4 319	4 681	4 582	4 769	4 720	5 226	5 400	...
(2)/(1) %	78.6	77.4	80.5	63.4	60.3	58.8	52.0	50.9	48.9	...
Mexico										
Total (1)	50 700	74 900	87 600	93 800	96 700	97 800	100 500	102 400	100 400	99 900
Private banks (2)	41 918	63 071	69 329	73 793	75 948	76 245	77 324	79 163	72 704	...
(2)/(1) %	82.7	84.2	79.1	78.7	78.5	78.0	76.9	77.3	72.4	...
Peru										
Total (1)	9 595	9 606	11 465	12 445	13 338	13 877	15 630	16 942	18 725	19 980
Private banks (2)	3 829	4 028	5 128	3 454	5 395	5 597	6 111	6 580	7 048	...
(2)/(1) %	39.9	41.9	44.7	27.8	40.4	40.3	39.1	38.8	37.6	...
Trinidad and Tobago										
Total (1)	857	1 052	1 220	1 423	1 539	1 763	1 988	2 181	2 269	2 300
Private banks (2)	521	667	833	1 014	885	910	859	789	699	...
(2)/(1) %	60.8	63.4	68.3	71.3	57.5	51.6	43.2	36.2	30.8	...
Venezuela										
Total (1) [d]	29 608	32 100	32 050	34 712	33 862	33 362	32 897	34 444	33 823	34 825
Private banks (2)	22 132	24 662	28 320	29 437	28 494	28 381	28 305	28 820	27 039	...
(2)/(1) %	74.8	76.8	88.4	84.8	84.1	85.1	86.0	83.7	79.9	...

Table 2 *(continued)*

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989[b]
Non-oil-exporting countries										
Total (1)	134 078	163 008	190 657	203 451	217 076	224 658	235 980	252 382	249 196	249 595
Private banks (2)	84 756	104 159	123 110	131 161	140 538	142 671	145 040	151 609	143 381	...
(2)/(1) %	63.2	63.9	64.6	64.5	64.7	63.5	61.5	60.1	57.5	...
Argentina										
Total (1)	27 162	35 671	43 634	45 069	46 903	49 326	51 422	54 700	59 000	61 100
Private banks (2)	18 084	23 706	30 327	30 480	31 046	34 905	36 016	38 070	37 261	...
(2)/(1) %	66.6	66.5	69.5	67.6	66.2	70.8	70.0	69.6	63.2	...
Brazil										
Total (1) [e]	70 565	80 373	91 922	97 484	104 926	105 126	111 045	121 174	113 300	111 100
Private banks (2)	48 354	55 318	64 431	70 022	76 975	74 830	76 242	82 380	76 309	...
(2)/(1) %	68.5	68.8	70.1	71.8	73.4	71.2	68.7	68.0	67.4	...
Colombia										
Total (1)	6 805	8 518	10 269	11 458	12 350	14 063	14 987	15 663	16 454	16 950
Private banks (2)	3 838	5 298	6 498	7 156	7 316	7 211	7 512	7 085	7 592	...
(2)/(1) %	56.4	62.2	63.3	62.5	59.2	51.3	50.1	45.2	46.1	...
Costa Rica										
Total (1)	2 209	2 687	3 188	3 532	3 752	3 742	3 922	4 194	4 100	4 500
Private banks (2)	1 231	1 391	1 564	1 942	1 803	1 856	1 925	1 977	2 049	...
(2)/(1) %	55.7	51.8	49.1	55.0	48.1	49.6	49.1	47.1	50.0	...
Chile										
Total (1)	11 207	15 591	17 159	18 037	19 659	20 403	20 716	20 660	18 971	17 610
Private banks (2)	8 289	12 737	13 805	13 981	15 323	15 570	15 287	13 835	11 815	...
(2)/(1) %	74.0	81.7	80.5	77.5	77.9	76.3	73.8	67.0	62.3	...
El Salvador										
Total (1)	1 176	1 608	1 710	1 890	1 949	1 980	1 928	1 880	1 913	1 825
Private banks (2)	212	214	155	213	222	218	225	231	223	...
(2)/(1) %	18.0	13.3	9.1	11.3	11.4	11.0	11.7	12.3	11.7	...
Guatemala										
Total (1)	1 053	1 385	1 839	2 156	2 495	2 694	2 674	2 700	2 647	2 830
Private banks (2)	432	405	346	580	486	604	506	477	504	...
(2)/(1) %	41.0	29.2	18.8	26.9	19.5	22.4	18.9	17.7	19.0	...

Table 2 *(concluded)*

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989[b]
Haiti										
Total (1) [c]	290	372	410	551	607	600	697	741	785	800
Private banks (2)	27	41	40	40	29	28	30	26	25	...
(2)/(1) %	9.3	11.0	9.8	7.3	4.8	4.7	4.3	3.5	3.2	...
Honduras										
Total (1)	1 388	1 588	1 986	2 162	2 392	2 794	3 018	3 105	3 045	3 260
Private banks (2)	372	356	244	396	394	345	332	349	343	...
(2)/(1) %	26.8	22.4	12.3	18.3	16.5	12.3	11.0	11.2	11.3	...
Jamaica										
Total (1)	2 252	2 674	3 071	3 582	3 452	3 828	3 971	4 245	4 185	4 200
Private banks (2)	531	484	496	478	493	480	477	481	521	...
(2)/(1) %	23.6	18.1	16.2	13.3	14.3	12.5	12.0	11.3	12.4	...
Nicaragua										
Total (1) [c]	1 825	2 566	3 139	3 788	4 362	4 936	5 760	6 270	7 220	7 570
Private banks (2)	368	500	552	663	554	783	564	543	412	...
(2)/(1) %	20.2	19.5	17.6	17.5	12.7	15.9	9.8	8.7	5.7	...
Panama										
Total (1) [f]	2 974	3 366	3 923	4 388	4 368	4 774	4 935	5 324	5 400	5 500
Private banks (2)	1 307	1 344	1 718	1 764	2 051	2 170	2 213	2 226	2 393	...
(2)/(1) %	43.9	39.9	43.8	40.2	47.0	45.5	44.8	41.8	44.3	...
Paraguay										
Total (1)	861	948	1 203	1 469	1 654	1 772	1 855	2 043	2 002	2 150
Private banks (2)	272	394	336	401	614	545	561	691	626	...
(2)/(1) %	31.6	41.6	27.9	27.3	37.1	30.8	30.2	33.8	31.3	...
Dominican Republic										
Total (1)	2 173	2 549	2 966	3 313	3 536	3 720	3 812	3 795	3 844	3 900
Private banks (2)	827	983	858	874	854	882	845	861	857	...
(2)/(1) %	38.1	38.6	28.9	26.4	24.2	23.7	22.2	22.7	22.3	...
Uruguay										
Total (1)	2 138	3 112	4 238	4 572	4 671	4 900	5 238	5 888	6 330	6 300
Private banks (2)	612	988	1 740	2 171	2 378	2 244	2 305	2 377	2 451	...
(2)/(1) %	28.6	31.7	41.1	47.5	50.9	45.8	44.0	40.4	38.7	...

Source: Total external debt: ECLAC, on the basis of official information; External debt with private international banks: ECLAC, from various international sources.

[a] Total external debt includes debt with IMF. It should also be noted that in some countries the figures on debt with private banks are underestimated due to inadequate coverage and to the fact that the data include adjustments for debt write-offs that do not necessarily release them from their obligation with respect to the debt. [b] Preliminary figures.
[c] Public debt. [d] Total debt according to official information and information from international financial agencies.
[e] Until 1984 corresponds to World Bank figures. [f] Information provided by the World Bank.

Figure 1

LATIN AMERICA AND THE CARIBBEAN: NET TRANSFER ON CREDIT TRANSACTIONS a/

Source: ECLAC, on the basis of data from the IMF.

a/ Net loan disbursements less net payments of interest.

Table 3

LATIN AMERICA AND THE CARIBBEAN: VALUE OF EXTERNAL DEBT IN THE SECONDARY MARKET

(As a percentage of face value)

	1986			1987			1988			1989		
	January	June	December	January	June	December	January	June	December	January	June	December
Argentina	62	65	66	64	52	35	32	25	21	20	13	13
Bolivia	...	6	7	8	9	11	11	11	10	10	11	11
Brazil	75	74	74	72	62	46	46	51	41	37	31	22
Chile	65	67	67	68	70	61	61	60	56	60	61	59
Colombia	82	81	86	86	85	65	65	65	57	56	57	64
Costa Rica	...	48	35	35	36	15	15	11	12	13	14	17
Ecuador	68	64	65	65	50	37	35	27	13	13	12	14
Guatemala	...	52	60	61	67	77	57	...	...	...	...	...
Honduras	...	40	40	40	39	22	22	22	22	22	17	20
Jamaica	...	45	45	45	38	33	33	38	40	40	41	40
Mexico	69	59	56	57	57	51	50	51	43	40	40	36
Nicaragua	...	4	4	4	5	4	4	2	2	2	1	1
Panama	...	69	68	68	67	39	39	24	21	19	10	12
Peru	25	20	18	18	14	7	7	6	5	5	3	6
Dominican Republic	...	45	45	45	45	23	23	20	22	22	22	13
Uruguay	...	63	66	68	74	60	59	60	60	60	57	50
Venezuela	80	76	74	75	71	58	55	55	41	38	37	34
Average [a]	**...**	**64.9**	**64.2**	**63.7**	**58.5**	**46.5**	**45.1**	**45.4**	**37.7**	**35.2**	**31.9**	**28.0**

Source: United Nations, DIESA, as based on bid prices compiled by Salomon Brothers, High Yield Department.
[a] Weighted by amount of bank debt.

systemic origin of the problem and the persistence of systemic obstacles to its solution. The failure to fully appreciate the systemic dimensions of the region's plight has undoubtedly been a contributing factor to many of the shortcomings of the official management of the international debt problem.[4] Hence, the departure point for the current study will be to emphasize the systemic characteristics of the debt problem and the continued urgency of more comprehensive collective solutions.

A. THE SYSTEMIC ORIGINS OF THE DEBT PROBLEM

The outbreak of a debt crisis in Latin America in 1982 has been most usually attributed to the debtors' poor management of their economies. Another factor that has been mentioned with some frequency is the exogenous external shocks of the early 1980s, such as the sharp rise in international interest rates.[5] More recently, some analysts have begun to focus on the role of the commercial banks' overlending in the development of the crisis.[6] These different perspectives on the problem are, however, often treated as competing explanations, when in fact they should be perceived as interacting components of a supply and demand relationship which went astray during the turbulent decade of the 1970s.

Indeed, it could be argued that what "failed" during the 1970s was neither the borrowers nor the bankers as such, but rather the "market". This should come as no surprise, since private credit markets historically have been prone to over-expansion and crisis. This historical pattern –which belies the frequently heard assertion of the 1970s that "the market knows best"[7]– has inspired a number of important interpretations of financial crisis by well known economists with very different perspectives on capitalist development.[8]

1. The general framework

While the specifics may differ, the broad outline of these different interpretations of systemic financial crisis are sufficiently similar to allow a stylized pattern to emerge. In essence, a credit cycle begins to take off in an economy due to some exogenous event(s) –e.g., a rise in commodity prices, an important innovation in the industrial or finance sectors, etc.– which changes private expectations about the profitability and perspectives of some important segment of the market. A boom develops in the sector and in the economy more generally. However, as the economic expansion and prosperity continue unabated, credit markets become complacent. Many borrowers and lenders begin to develop myopia concerning the underlying future repayment capacity and default risk; indeed, the protracted economic expansion and a favourable repayment experience can create a state of euphoria in the market that causes the subjective risks of borrowing or lending to fall well below the actual probability of default. At some stage in the cycle, positive expectations can feed upon themselves to such a degree that the subjective evaluation of risk of the economic agents falls to a critical threshold in

[4] The insensitivity to the systemic nature of the crisis is clearly brought out in the Group of Ten, "The Role of the IMF and the World Bank in the Context of the Debt Strategy", a Report to the Ministers and Governors by the Group of Deputies, June 1989.

[5] See for instance, Group of Ten, *op. cit.* and William Cline, *International Debt,* Washington, D.C., Institute for International Economics, 1984.

[6] Jack Guttentag and Richard Herring, "Commercial Bank Lending to Developing Countries: From Overlending, to Underlending, to Structural Reform", in Gordon Smith and John Cuddington (eds.), *International Debt and the Developing Countries,* Washington, D.C., World Bank, pp. 129-150, 1985; Robert Devlin, "Comportamiento de la Banca Internacional en los Años Setenta y su Efecto en la Crisis de América Latina", in Miguel Wionczek (ed.), *La Crisis de la Deuda Externa en América Latina,* vol. 1, Mexico City, Fondo de Cultura Económica, 1987, pp. 177-238; William Darity Jr. and Bobbie Horn, *The Loan Pushers,* Cambridge, Mass., Ballenger Publishing Co., 1988; ECLAC, *Transnational bank behaviour and the international debt crisis* (LC/G.1553), Santiago, Chile, March 1989, and Michael Mortimore, "The conduct of Latin America's creditor banks", *CEPAL Review,* No. 37, April 1989, pp. 7-26.

[7] See, for instance, Monroe Haegele, "The Market Knowns Best", *Euromoney,* May 1980, pp. 121-128.

[8] To mention just a few, see Joseph Schumpeter, *The Theory of Economic Development,* Oxford, Oxford University Press, 1980; Thorstein Veblen, *The Theories of Business Enterprise,* New York, Charles Scribner's Sons, 1904; Hyman Minsky, *Can "It" Happen Again?,* Armonk, New York, M.E. Sharpe, 1982; Charles Kindleberger, *Manias, Panics and Crashes,* New York, Basic Books, 1978 and Jack Guttentag and Richard Herring, "Credit Rationing and Financial Disorder", *Journal of Finance,* vol. 39, No. 5, December 1984, pp. 1359-1382.

which everyone begins to act as if the default probability of borrowing or lending were zero (figure 2). In this euphoric stage one also finds that the credit boom is fuelled by new lenders who enter the market hoping to duplicate the easy profit-making of the market leaders. They are, however, usually even less informed than the leaders and therefore more prone to having their decision to lend influenced by market myopia and bandwagon effects.

During the period of euphoria, borrowers are never really required to "pay" their debt. This is because creditors are willing to easily rollover upcoming debt service payments with new loans and to extend additional credit, thereby creating a large positive transfer of resources to the borrowers. And just as the credit cycle is fed by marginal lenders, so too is it given momentum by marginal borrowers, who often gain market access well beyond their ability to efficiently absorb the resources.

The result of this process is that in the absence of effective banking supervision borrowers and lenders can become overleveraged and dependent on the market's rollover of upcoming debt service to keep the accumulated mountain of obligations from collapsing. Some creditors – usually the better informed – begin to anticipate the unsustainability of the credit expansion and therefore attempt to pull back their lending. This initially has little effect on gross credit volumes, as reticent lenders are quickly displaced by eager, less informed new entrants seeking to expand their share of lending in the market. But there are tight institutional links within the credit network, which will cause the sense of financial stress of some lenders to gradually permeate the market. The stress manifests itself in a slowing down of the growth of net credit volume, even while gross volume reaches record levels. The terms of indebtedness will also begin to deteriorate as creditors attempt to reduce their own risk by shortening the term of new loans and charging higher risk premia. However, here the fallacy of composition begins to set in, because as more and more lenders tighten their loan terms to protect their own individual portfolios, this greatly accelerates the growth of debt service and the global demand for a rollover of credit. The accelerated demand for a rollover can in turn pressure the credit system to such an extent that even the most euphoric lenders begin to sense vulnerability.

Financial stress can often degenerate into a full-blown crisis. The crisis is usually precipitated by a single major event – e.g. a sharp fall in the terms of trade, a default of a large borrower, collapse of a major lender – or a series of events which cause creditors to drastically alter their expectations about the capacity of a group of clients to service their debts. Moreover, the suddenness of the unexpected negative event(s), coupled with informational barriers, tends to cause creditors to now "overadjust" their expectations in a negative direction (figure 2). The same factors also tend to make many creditors as indiscriminating in their evaluation of troubled clients as they were in the selection of their creditworthy customers during the upswing of the cycle. Consequently, the market experiences "revulsion" with respect to a whole class of borrowers, and good and bad borrowers in the class are lumped together as many creditors perceive a "neighbourhood problem".

Panicked lenders refuse to rollover debt service because they demand for the first time an effective payment of the debt. In these circumstances even creditors with a more sanguine view of the borrowers' creditworthiness will be unwilling to lend, because they perceive that individually their loans will do little to offset the negative effect of retreating banks on the borrower's capacity to service his obligations. The flight of creditors can be intense enough to virtually halt the flow of new private credit, and under the weight of unrefinanced debt service, all but the most creditworthy of debtors will default. The defaults in turn can cause exposed lenders to fail. Unless there is effective compensatory liquidity provided by a lender-of-last-resort, the tight links among creditors, and between debtors and their suppliers, can cause primary defaults to have large secondary repercussions in the economy that contribute to a general financial collapse.

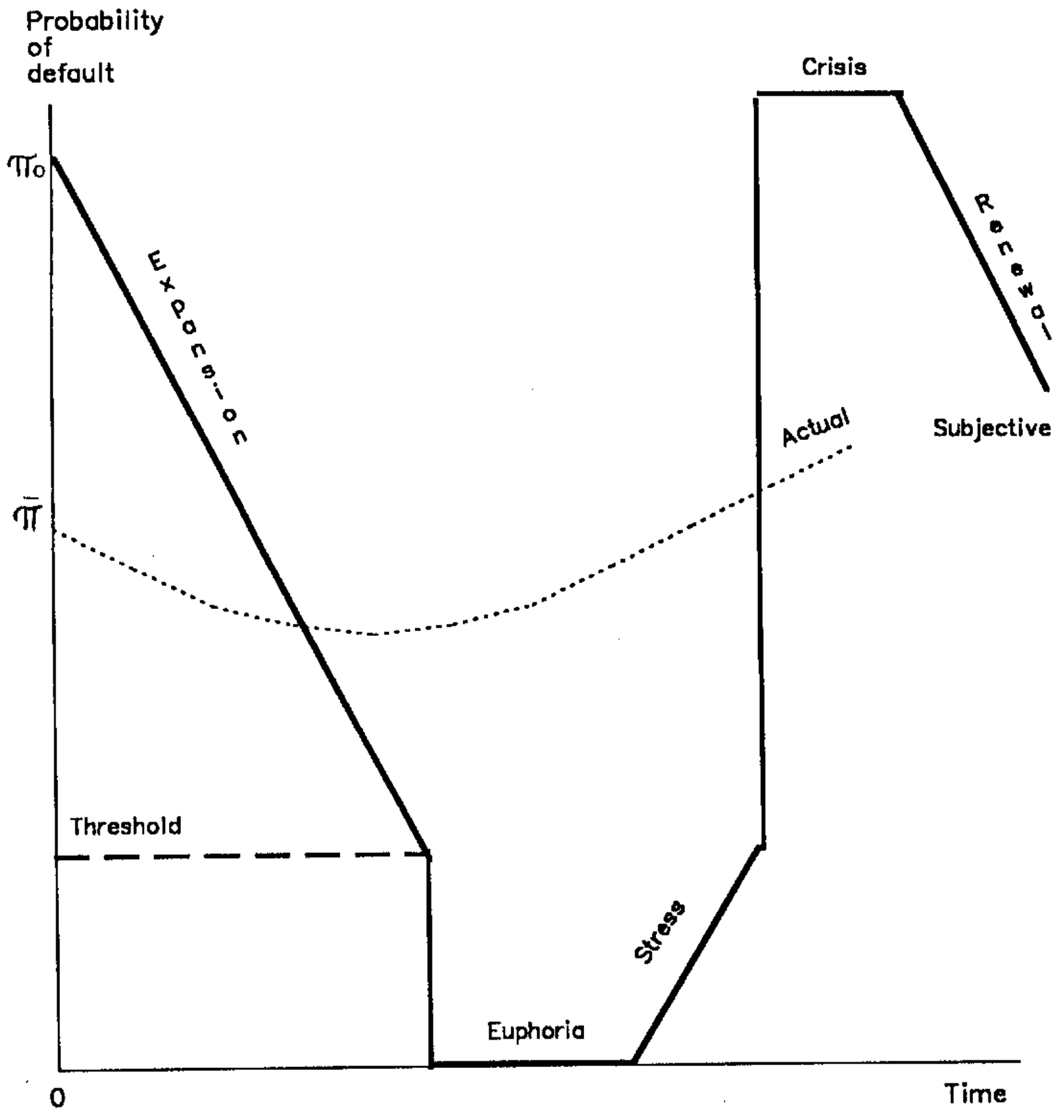
2. Latin America in the 1970s

The framework described as being conducive to financial crisis has a basis in history.[9] One of the insights to be gained is that when an

[9] See Kindleberger, *Manias, Panics and Crashes, op. cit.*

Figure 2

THE CREDIT CYCLE a/



a/ This is a variant of a framework presented by Jack Guttentag and Richard Herring in "Credit Rationing and Financial Disorder" *Journal of Finance*, Vol. 39, No. 5, December 1984, p. 1 364.

overaccumulation of debt appears simultaneously in a broad range of borrowers with differing characteristics, it can be highly misleading to focus on any single cause of the problem, be it excess demand, excess supply or exogenous factors. Rather, it can be most fruitfully interpreted as a failure *of the system* in which the *interaction* of market supply and demand in a particular conjunctural context has led to a socially inefficient allocation of resources.[10]

The development of the Latin American crisis had important parallels with historical patterns. During the 1970s, for different and complex internal reasons –some of them rooted in their pattern of development–, most countries of the region pursued heavily debt-leveraged development strategies. Many economies inserted themselves into international capital markets at a much faster rate than they were willing or able to insert themselves into international goods trading markets. This created a potential problem in the transformation of domestic income into dollars for the service of foreign obligations. In addition, the tapping of foreign capital markets sometimes involved debt accumulation which exceeded the capacity of the country to absorb the resources efficiently in productive ventures. In any event, a common result was that many countries of the region became overly reliant on a favourable external environment (especially automatic debt rollover) to service their obligations in a timely fashion.[11]

The overborrowing of the debtors would, however, have been impossible without corresponding overlending by commercial banks. In this regard it is important to remember that the industrialized countries' commercial banks had been going through a phase of dynamic financial innovation as part of an international portfolio adjustment that had begun in earnest in the mid-1960s. The platform for this expansion was the unregulated eurocurrency market, which in many circles enjoyed the reputation of efficiency that frequently is attributed to laissez-faire. An overly crowded OECD loan market, coupled with an economic recession there in 1970, caused some banks to consider new marketing frontiers in the developing world. At that time the leaders in the oligopolistic world banking market were the big United States banks. They were naturally attracted to Latin America because of the United States' historical, political and commercial ties with that region, coupled with the strong post-war growth experience of most of its countries, and rising commodity prices in the early 1970s. The entrance of the large United States banks into the Latin American market validated the region's creditworthiness for the banking community as a whole, making it a focal point of an oligopolistic price war among the world's commercial banks, in which the main determinant of lending often became expansion of market share rather than the underlying creditworthiness of the borrower and default risk.[12]

Financial stress began to appear in the market in the late 1970s and deepened in 1980-1981 when an unexpected tightening of OECD monetary policy brought a sharp rise in real international interest rates from their very low or negative levels of the 1970s. The 1982 recession in the OECD that grew out of the creditor governments' tight monetary policy only made matters worse. As everyone knows, the financial stress in the region turned into a full-blown crisis in 1982, and as panic took hold

[10] The inefficiency can be looked at from two angles. One possibility is that the time preference of private creditors is shorter than the time of the payout on investments/reforms financed with the loans. This situation is akin to a liquidity problem. A more serious situation would be where the present value of future debt service exceeds the present value of future returns on borrowed finance; this would be akin to a situation of insolvency. An intermediate case would be where the present value of debt service and returns on financing are symmetric, but payment problems arise nevertheless due to an inability to transform domestic currency into foreign exchange through the generation of trade surpluses.

[11] For detailed analysis of the causes of the crisis see ECLAC, *Políticas de ajuste y renegociación de la deuda externa en América Latina* (LC/G.1332), Cuadernos de la CEPAL series, No. 48, Santiago, Chile, 1984. United Nations publication, Sales No. S.84.II.G.18, and the country case studies in Miguel Wionczek (ed.), *La Crisis de la Deuda Externa en América Latina*, vol. 2, Mexico City, Fondo de Cultura Económica, 1987.

[12] In modern banks decision-making variables go beyond the default risk-return calculation of a traditional portfolio manager. Indeed, during the 1970s it was found that the default risk calculation was only latent in most banks' credit departments; market share and prestige were the primary decision-making variables. See Devlin, "Comportamiento de la Banca Internacional en los Años Setenta y su Efecto en la Crisis de América Latina", in Miguel Wionczek (ed.), *La Crisis de la Deuda Externa en América Latina*, vol. 1, Mexico City, Fondo de Cultura Económica, 1987. pp. 177-238.

of the market even the most responsible borrowers came to be viewed by bankers as still further examples of half-collapsed economies in a bad neighbourhood. New credit flows came to a virtual halt, and with the cut-off of the rollover process, by early 1983 almost every Latin American debtor with significant exposure with the banks had fallen into *de facto* default.

The above role of the debtors and creditors in the crisis is now more or less accepted. What is less frequently highlighted is that the permissive interaction of supply and demand was moreover fundamentally influenced by conjunctural factors that were offshoots of the industrialized countries' economic policy. Thus, lax regulation of national and international banking systems is the only way to explain how individual banks could have extended loans to the Latin American countries in volumes that violated any basic conventional notion of prudence. For example, by 1982 many of the top United States banks had loans outstanding in Brazil and Mexico equivalent in each case to much more than 50% of their capital. Surprisingly high coefficients were registered for loans to most other Latin American and Caribbean countries as well.[13]

Meanwhile, the governments of the industrialized countries – confident that "the market knew best" – encouraged sustained petrodollar recycling by their private banks, when in fact the great magnitude of world macroeconomic disequilibria at that time suggested the need for comprehensive official recycling mechanisms.[14] Thus, in the 1970s banks were hailed for saving the western world from collapse;[15] now in retrospect that same role is considered to be part of "the historic bungle of petrodollar recycling".[16]

In relation to the same phenomenon, the governments of the industrialized countries also consciously let the relative positions of the IMF and the World Bank in world finance slip dramatically in the 1970s.[17] Thus, when the banks went into a procyclical retreat in 1982, the anticyclical component of the international financial system – i.e., the official sector – could respond only in a feeble way to fill the financing gap.[18] The hyper-expansion of the banks into Latin America in the 1970s and their wholesale retreat in the 1980s was also stimulated by loose OECD monetary policy in the 1970s and the subsequent unexpected monetary crunch of the early 1980s, which was introduced by the same governments to combat their domestic inflationary problems.

In sum, the Latin American and Caribbean debt crisis emerged out of a complex interaction of borrowers, their bankers, and policy makers in the industrialized countries. It is therefore the market, in a particular institutional context, which failed rather than any banker or borrower as such, and in this sense the debt problem is a public problem of the international community at large. It will be seen that the social, or public, character of the crisis has implications for the development of solutions to the problem.

B. THE SYSTEMIC OBSTACLES TO THE SOLUTION OF THE PROBLEM

Historically, the solution to a systemic overaccumulation of credit has been found in

[13] See Cline, *International Debt*, Washington, D.C., Institute for International Economics, 1984, table 2.2.

[14] Roughly three-fourths of the financing of deficit countries between 1974-1976 was from private sources. (See Benjamin Cohen in collaboration with Fabio Basagni, *Banks and the Balance of Payments*, Montclair, Allanheld, Osmun, 1981, p. 19). The United States government's encouragement of recycling by private banks receives attention in United States Congress, House of Representatives, *Report on An International Debt Management Authority*, Washington, D.C., September 1988, pp. 39-40.

[15] See Marina Whitman, "Bridging the Gap", *Foreign Policy*, vol. 30, Spring 1978, pp. 148-156.

[16] "Fine Tuning the Brady Plan", editorial in the *Financial Times*, 10 November 1989.

[17] For example, IMF quotas relative to world import trade fell from 12% in the 1960s to 4% in the early 1980s. See United States Congress, Senate, Committee on Banking, Housing and Urban Affairs, "A Report", Washington, D.C., 24 January 1985, p. 6, and Carlos Massad and Roberto Zahler, *Dos Estudios sobre Endeudamiento Externo*, Cuadernos de la CEPAL series, No. 19, Santiago, Chile, United Nations, 1986, p. 22.

[18] For example, as annual net bank flows to the non-oil developing countries fell from US$51 billion to US$17 billion between 1981-1983, IMF lending was able to rise by only US$4 billion. See Richard Feinberg, "LDC Debt and the Public-Sector Rescue", *Challenge*, July/August 1985, p. 29.

unbridled market forces: a pattern of defaults, followed by a devaluation of loans, bankruptcies of lenders/borrowers, asset exchanges, financial reorganization and eventual renewal of the system. There have been economists and policy makers who have gone on record as supporting the classic market solution to an excessive accumulation of debt.[19] In a somewhat Darwinian vein, the cycle of collapse and renewal has been interpreted as a process which expels inefficient economic units and thus strengthens the overall system in the long run. This interpretation also frequently has moralistic overtones, as those who do not survive the collapse are perceived as having been the imprudent decision-makers in the system.

Nevertheless, there are undoubtedly potent negative externalities in the market solution that make it socially very costly and raise doubts as to whether it aids at all in promoting long-term efficiency. First, in articulated markets the panic that breaks out during a crisis creates contagion which causes an initial outbreak of financial problems to ripple through the system and adversely affect even lenders and borrowers who are several steps removed from the immediate problem area. Second, renewal of the system takes time, as informational barriers cause negative expectations to be reversed only slowly. This is further complicated by institutional and psychological interdependencies among market participants which tend to create critical thresholds through which expectations must pass before the market begins to respond to objective improvements in any situation. Third, financial disruptions and devalued capital stocks depress disposable income and private sector expectations to such a degree that investment, output and employment may also collapse. The resulting economic depression can be deep and protracted;[20] moreover, it sets off a vicious circle as depressed output further aggravates the financial crisis in the system. In sum, the market, when left to its own devices, effectively socializes the systemic debt problem, but in a highly arbitrary and costly way.

Mainstream economic thought now recognizes that the costs of financial crisis can and should be contained by the rapid response of a lender-of-last-resort (LLR). Indeed, some now argue that, historically, the economic depressions following a financial collapse have been the longest and deepest in those cases where no effective LLR has emerged.[21]

It is generally agreed that the primary role of an LLR is to contain the crisis and avoid the widespread loss of output and employment that will occur during a severe financial disruption of the economic system. The classic notion of the LLR –which has its origins in late 18th century economic thought –[22] attempts to minimize its distance from the advocates of laissez-faire, who oppose all public intervention in the market. Essentially, in the former view the role of the LLR should be to rapidly provide liberal amounts of liquidity to a financial system in crisis, so that the money stock does not shrink. In the classic argument, recipients of the liquidity should be solvent and able to provide good collateral to the LLR, while poorly managed institutions should be allowed to fail, since the LLR's function is not to "bail out" bad decision-making by economic agents. Thus, in the words of one analyst, the LLR's "watchwords should be 'no public absorption of private losses due to faulty management', 'no subsidization of risks', and 'no bailouts of unwise, erroneous loan decisions'".[23]

Contrasting with this classic notion of the LLR is an alternative conception that is at least partially Keynesian in spirit. As Kindleberger has pointed out, it is not persuasive to argue that an LLR should extend liquidity only to sound borrowers with collateral. First, it is obviously quite difficult to differentiate between good and bad borrowers or lenders in the midst of a crisis. Second, and more

[19] Perhaps the most aggressive proponent was Schumpeter, *The Theory of Economic Development*, Oxford, Oxford University Press, 1980.

[20] The longest depressions following a financial collapse have lasted a decade or more. See Kindleberger, *Manias, Panics and Crashes*, New York, Basoc Books, 1978.

[21] *Ibid.*, and Michael Bernstein, *The Great Depression*, Cambridge, Cambridge University Press, 1987, p. 30.

[22] See Thomas Humphrey and Robert Keleher, "The Lender of Last Resort: A Historical Perspective", *The Cato Journal*, vol. 4, No. 1, Spring/Summer 1984, pp. 282-289.

[23] *Ibid.*, p. 306.

importantly, the classic notion of an LLR is analytically unsound because it confuses a general equilibrium problem with a partial equilibrium one. In effect, in a financial crisis soundness is a function of how fast the LLR responds with liquidity for problem economic units. Moreover, in a severe systemic crisis, it is usually necessary to rescue "the sinners with the faithful" because externalities intimately link their fates.[24] This pragmatic approach often guides public policy when a financial threat with systemic dimensions emerges in national economies.

1. National responses to systemic financial problems

In practice, it will in fact be found that public-sector rescues of the economic system are frequent and the modalities of action do not rigidly conform to any one school of thought. The classic notion of the LLR, whereby attention is given to the provision of general liquidity rather than to the plight of an individual borrower or lender, has certainly held sway on occasions. In these cases the liquidity has been provided to the system directly by the central bank, or indirectly through the central bank's application of moral suasion to the system's commercial banks so that they "freely" lend in the middle of a crisis. One recent example of this latter strategy can be found in the United States during the great stock market crash of October 1987. In effect, the Federal Reserve "urged" banks to lend to their brokerage firm customers in order to avoid illiquidity; banks in New York City responded by raising their lending from US$16.7 billion to US$24.4 billion within a two-week period, representing a very remarkable 46% rise in credit! Citibank alone reportedly increased its lending over that period from US$200-400 million to US$1.4 billion.[25] It is also important to note that the private-market character of an LLR rescue of this type is more apparent than real; the underlying risk is public because behind the scenes the central bank is guaranteeing the solvency of the banking system.

But rescue operations have also often gone beyond the classic approach and have involved public relief that is more direct and explicit in character, geared to aiding specific economic units which are clearly uncreditworthy, but whose failure would have negative systemic repercussions. In effect, the systemic implications of the problem contribute to an unwillingness to resolve it as a purely "private" matter between debtor and creditor in bankruptcy courts, where the outcome for the debtor is highly uncertain.[26] The public sector therefore directly intervenes in the market place; the solution to the problem is the outcome of tripartite negotiations between the debtor, his creditors and the government, which contributes to the design of a rescue plan and the sharing of costs among the three parties. Table 4 presents some of the better-known direct public bailouts recorded in recent years in the OECD economies.

The nature of these public sector bailouts is extremely complex and displays a broad range of techniques.[27] Nevertheless, they also share some common patterns. First, the unit to be rescued was considered to be so important economically and/or politically to the national system, or to a geographical region, that it was deemed inappropriate to allow it to collapse through the workings of market forces. In other words, the repercussions of a market-induced collapse on output, employment, financial stability or national

[24] Charles Kindleberger, *The International Economic Order,* Cambridge, Mass., MIT Press, 1988, p. 203.

[25] Andrew Brimmer, "Distinguished Lecture on Economics in Government: Central Banking and Systemic Risks in Capital Markets", *The Journal of Economic Perspectives,* vol. 3, No. 2, Spring 1989, p. 15.

[26] Most countries do not allow a "pure" market-induced collapse as declarations of bankruptcy are subject to a special legal process which is designed to deal with this specific business problem. However, the road through bankruptcy court is very difficult and uncertain, as manifest in the United States, where only one in eight companies manages to reorganize successfully. See Thomas Jackson, *The Logic and Limits of Bankruptcy Law,* Cambridge, Mass., Harvard University Press, 1986 and Laurie Cohen, "Pulling a Company Through Chapter 11 is Risky Business as Hurdles Abound", *Wall Street Journal,* 16 January 1989.

[27] For precise details on the bailouts, see the references cited in table 4.

Table 4

MAJOR PUBLIC SECTOR BAILOUTS IN THE INDUSTRIALIZED COUNTRIES

The rescued (date)	Activity	Origin of financial crisis	Systemic dimension	Cost of rescue plan	Public sector share of risk/cost
1) Lockheed Corp., USA (1971)	Aerospace	Underestimated cost of reentry into commercial jet aircraft market and the bankruptcy of the firm's supplier of engines for a newly developed jetliner[1]	Bankruptcy would cost 60 000 jobs, GNP loss of between US$120 million and US$475 million, much of it concentrated in the State of California[2]	US$750 million[3]	33%[4]
2) British Leyland, United Kingdom (1974)	Vehicle manufacturing[5]	Inadequate capital investment, poor labour-management relations, and inefficiently organized production[6]	211 000 workers directly employed in 70 plants in England; last surviving domestic automobile manufacturer; and important to national economy[7]	US$6.2 billion	50%[8]
3) Conrail, USA (1974-1981)[9]	Rail transport	Competition from trucking, labour costs, and regulated tariffs[10]	Liquidation would create widescale unemployment, paralyse transport and destabilize commercial paper market[11]	US$7 billion[12]	100%[13]
4) New York City, USA (1975) (1978)	Municipality[14]	Expansion of public expenditures unmatched by growth of tax revenue[15]	Default by the City would have cut vital public services, raised regional unemployment, destabilized the municipal bond markets, created "huge" losses for 200-300 banks and threatened the stability of the United States and world monetary systems[16]	US$13.0 billion[17] US$4.5 billion[18]	52%[19] 100%[20]
5) Chrysler Corp., USA (1980)	Auto production[21]	High unit costs and poor marketing decisions[22]	Effects of bankruptcy on mid-west output and employment[23]	US$3.5 billion[24]	50%[25]
6) AEG Telefunken A.G., Germany (1982)	Electronics manufacturing[26]	Foreign competition, excessive debt due to acquisitions, and incoherent integration of new acquisitions[27]	Over 60 000 jobs in Germany alone[28]	US$800 million	50%[29]
7) Continental Illinois, USA (1984, May)	Banking[30]	Bad lending decisions and volatile short-term deposit base[31]	Money center bank whose closing would have "catastrophic consequences" for other banks and the United States economy[32]	US$ 7.5 billion[33]	20%
(1984, July)				US$20 billion[34]	35%
(1984, July)				US$4.8 billion[35]	95%
8) 700 Savings and loan associations, USA (1989)	Financial savings depository institutions[36]	Bad credit decisions, fraud, and deficient banking supervision[37]	Stability of the United States financial system	US$136 billion[38] US$188 billion[39]	68%[40] 85%[41]

Table 4 (*concluded*)

1 General Accounting Office of the United States (GAO), "Guidelines for Rescuing Large Failing Firms and Municipalities", Washington, D.C., 29 March 1989, p. 11.
2 *Ibid.*, p. 12.
3 *Ibid.*
4 The total emergency financing plan consisted of US$250 million in Federal Government loan guarantees, US$400 million of debt restructurings with banks, and US$100 million of prepayments of purchases of aircraft. Ibid.
5 England's only car manufacturer, with 33% of the local automobile market and more than 200 000 workers. Robert Reich, "Bailout: A Comparative Study in Law and Industrial Structure", Yale Journal on Regulation, vol. 2, No. 2, 1985, p. 170.
6 Ibid., p. 171.
7 Ibid., and Terry Golards, "Britain Planning Leyland Rescue", New York Times, 25 April 1975, p. 45.
8 Government plan involved public financing of one-half of US$6.2 billion to be spent over seven years.
9 Created in 1984 to merge eight bankrupt or near bankrupt railroads.
10 GAO, op. cit., p. 7.
11 Ibid.
12 Ibid.
13 Federal Government support in the form of loan guarantees and grants. No account is taken of any financing that might have been indirectly derived from losses assumed by creditors in bankruptcy proceedings. Ibid.
14 The nation's largest city had the largest public budget of all United States state and local governments; it was also the most important tax-exempt borrower. The City's debt totalled US$6.5 billion in 1976. See Municipal Assistance Corporation, Annual Report 1976, New York, p. 4.
15 GAO, op. cit., p. 13.
16 Ibid., pp. 13-14.
17 When the City reached the point of default in 1975 the State of New York formed the Municipal Assistance Corporation (MAC) to sell bonds and notes on behalf of the City, with those bonds secured by State tax revenue. In addition, the MAC negotiated with private lenders to restructure debts at reduced interest rates and to lend new money to the City. A condition for this relief was policy and expenditure reform in the City.
18 Four-year plan.
19 Public support involved an agreement with the Federal Government to extend up to US$2.3 billion of direct short-term loans each year over 1976-1978 and US$4.4 billion of bonds sold by MAC and secured with tax revenue of the State of New York. Private financing support was to come from a partial moratorium on debt service, debt restructurings, reduced interest rates and new taxes. See MAC (1976), op. cit., pp. 15-16.
20 The Federal Government offered up to US$1.65 billion in long-term Federal guarantees. The rest of the funds would be raised by the MAC. While incorporated and therefore separate from the State of New York, the MAC was an entity of the State of New York and its credibility was derived from State backing and earmarked State tax revenue. MAC, Annual Report 1978, pp. 8-9.
21 In 1978, Chrysler was the tenth largest industrial firm in the United States and its third largest auto producer. Assets were US$7 billion and debt outstanding totalled nearly US$5 billion. Chrysler directly employed 135 000 workers, but including its suppliers, total employment effects were estimated at 500-700 thousand workers. See Reginald Stuart, Bailout, South Bend, Indiana, And Books, 1980, pp. 10-13 and 115-116.
22 GAO, op. cit., p. 15.
23 Ibid.
24 Stuart, op. cit., p. 142.
25 U.S. Federal Government support was in the form of loan guarantees of US$1.5 billion, while local governments had to provide US$250 million in funds. The remaining US$1.75 billion was to come from concessions by workers, private creditors, and suppliers. In particular, private banks were required to lend US$550 million in new credit, and make US$100 million in concessions on existing loans. Workers were required to make US$600 million in wage concessions. Other funds were raised from suppliers and sales of assets. The U.S. government had first claim to assets should Chrysler enter into bankruptcy. See Stuart, op. cit., p. 150 and GAO, op. cit., p. 16.
26 Second largest manufacturer in Germany, contributing 1% of the nation's GDP, Reich, op. cit., p. 166.
27 Accumulated debt at the end of 1982 of US$3.2 billion.
28 Ibid., p. 170.
29 Federal and State government guarantees on half of US$800 million of new bank loans. Additionally, there was an undisclosed amount of subsidized loans from State governments. Prior to approval of the financing plan, some debt was written off in a reorganization scheme drawn up under partial bankruptcy proceedings known in Germany as "Vergleich". Ibid., pp. 168-169. Prior to the government-supported rescue, there was a relief operation sponsored by AEG Telefunken's private creditors in 1981. However, the creditors' scheme fell short of what was needed and failed to stem the company's losses.
30 The U.S.'s seventh largest bank. James McCollom, The Continental Affair, New York, Dodd, Mead & Co., 1987, p. 6.
31 Ibid., p. 316.
32 U.S. Congress, House of Representatives, "Continental Illinois National Bank: Report of an Inquiry into its Federal Supervision and Assistance", Washington, D.C., July 1985.
33 A rescue plan which involved a US$5.5 billion line of credit plus a US$0.5 billion loan as capital, all from 28 large U.S. private banks, and a US$1.5 billion loan from the U.S. Federal Deposit Insurance Corporation for capital. Ibid., p. 143.
34 Accumulated emergency liquidity provided to the bank to cover a US$20 billion run on deposits. The loans were US$5 billion from the U.S. Federal Reserve, US$2 billion from the U.S. Federal Deposit Insurance Corporation, US$4 billion from U.S. banks and US$5 billion from asset sales.
35 The final US$4.75 billion bailout plan in which the U.S. government took control of the bank and invested US$4.5 billion of public money. Ibid., p. 355.
36 Insolvent or very unprofitable savings and loans associations throughout the U.S. with assets of US$365 billion at the end of 1988. R. Dan Brumbaugh, Andrew Carron and Robert Liton, "Cleaning Up the Depository Institutions Mess", Brookings Papers on Economic Activity, No. 1, 1989, p. 368.
37 "Failed Thrifts", Statement of Frederick Wolf, Assistant U.S. Comptroller General, before the U.S. House of Representatives, Subcommittee on Criminal Justice, Washington, D.C., 22 March 1989.
38 The U.S. Administration's rescue plan. See R. Dan Brumbaugh, et al., op. cit., table 12.
39 Alternative scenario if domestic interest rates are higher, the Saving and Loan Associations' deposit growth is slower and losses are more severe than estimated by the U.S. Administration. Ibid.
40 Ibid.
41 Ibid.

strategic interests were perceived to be so adverse to the economic system as to justify an organized socialization of the problem through an overt public bailout. In effect, the economic unit was deemed to be worth more to society alive than dead and the taxpayer was called upon to finance its resuscitation.[28]

An additional argument used to justify the government bailout was that the costs of comprehensive public intervention would be less than the probable public costs that would eventually emerge if the economic unit's problems were allowed to fester. Those costs could include unemployment insurance paid to workers who lost their jobs, the need to maintain the liquidity of a stricken financial system, lost tax revenue on the unit's primary and secondary outputs, and in some cases, even interruptions in the supply of critically important goods and services that were formerly provided by the problem unit.[29] Since important economic entities are also important national or regional social units, there could obviously be additional political costs in letting the problem entity fail.

Second, almost invariably comprehensive public intervention has followed on the heels of repeated failures to find private market solutions for the problem unit.[30] The market-oriented initiative was usually led by the unit's major commercial creditors (or in the case of the financial sector, its public regulators); yet the relief provided by the market participants tended to be piecemeal and fall short of the requirements for liquidity and efficient restructuring. The consequence was that the crisis deepened for the problem unit. In the face of persistent deterioration, the private market withdrew its support altogether, forcing a decision –often politically controversial– to explicitly socialize the problem via a direct public bailout of the problem unit.

Third, since public intervention materialized after the private market displayed revulsion with respect to the problem unit, the public sector had to assume a very large proportion of the risk involved in the financial plan to restructure the unit. Table 4 shows that the public sector's potential exposure in direct bailouts usually ranged between 50% and 100% of the total financing plan designed to rescue the problem unit.[31]

Fourth, in exchange for a public bailout sacrifices were demanded of both creditors and borrowers. Borrowers were required to restructure; this would involve a reduction in real wages and salaries, labour force reduction, sales of assets, and close public monitoring of policy reform in the problem unit. Creditors in turn were asked to make major concessions which inevitably cut earnings and imposed losses. For instance, in return for public loans or loan guarantees, existing creditors were

[28] In some cases such as the Municipality of New York the economic unit in principle could not be liquidated. This situation is akin that of a sovereign developing country.

[29] This latter cost was most obvious in the case of New York City, but would also apply to Chrysler and Lockheed, which were important contractors in the United States defence industry.

[30] There are exceptions: for instance, the successful bailout of the Japanese auto producer Toyo Kogyo in the mid-70s was an entirely private affair. Yet Reich attributes successful private sector bailouts to situations in which either custom or interlocking ownership contribute to a tradition of co-operation among firm managers, workers and banks. See Robert Reich, "A Comparative Study in Law and Industrial Structure", *Yale Journal on Regulation,* vol. 2, No. 2, 1985, p. 222.

[31] It must be emphasized that the public costs in the last column of table 4 are only the potential costs of a specific financial plan. Moreover, sometimes the government's investment in the bailout was backed by collateral or preferential creditor status, which in principle made risk lower than nominal commitments. However, as the United States General Accounting Office has pointed out, in the middle of the crisis of a problem unit it is in fact very difficult to value collateral and preferential status, because the firms' assets are usually so specialized that they are often not very marketable. See United States General Accounting Office, *Guidelines for Rescuing Large Failing Firms and Municipalities,* Washington, D.C., 29 March 1989, p. 2.

typically required to restructure outstanding debt, lower interest rates and write-off part of existing obligations.[32] Concessions by the creditors, management and the work force did not come easily, however, and often required the exercise of direct pressure by the state and federal governments.

Fifth, most of the public bailouts proved successful in restoring, within a reasonable period of time, the creditworthiness of the problem unit. Indeed, the reforms needed to save the unit perhaps would not have appeared without the comprehensive intervention of the public sector. The bailouts, in effect, bought the problem entity time for an adjustment and restructuring that was probably more socially efficient than if the unit had been left on its own to fail and thereby suddenly release all its resources to a shaken private market. Indeed, some of the public bailouts were so successful as to actually create positive returns on the public sector's investment. The most celebrated case is the Chrysler Corporation, which in three years was converted from a collapsing enterprise into a dynamic competitor which restored its creditworthiness and returned a large profit to the United States Government.[33] In general, during public bailouts the speed with which the problem unit was able to turn itself around usually depended on the generosity of initial funding and the seriousness of policy reforms; i.e., skimpy public funding and/or inadequate pressure for policy reform usually prolonged the problem and raised eventual public costs.[34]

In sum, at the national level public bailouts and the use of taxpayers' money to resolve a financial crisis with systemic dimensions are not uncommon events. Moreover, in this context public aid is explicitly designed and tailor-made to deal with the specific difficulties of the problem unit. The government aid is not without sacrifices, however, as all parties are faced with demands for reform in order to restore the health of the system. In view of the revulsion in private credit markets and the sheer weight of the problem, the government has invariably had to assume responsibility for the bulk of the financial plan designed to restructure the problem unit.

Such public bailouts have clearly run counter to certain traditional liberal concepts of market efficiency and consequently were often controversial. Of course, it is always possible that a market-oriented, hands-off approach might have been a more efficient way to treat the crisis. But when dealing with economic units that have systemic dimensions, the uncertainties of a laissez-faire approach are so large that policy makers have rarely been willing to assume the economic and political risks of such a decision. Thus, until a more plausible proposition is presented, public bailouts of problem debtors, in circumstances of systemic crisis, can be good economics. In fact, as stated, the public bailouts have often restored the creditworthiness of the problem entity.

2. The international response to the Latin American crisis

The crisis that emerged in Latin America and the Caribbean in 1982 was a systemic problem in every sense of the word. The discipline of the market broke down in the 1970s as both borrowers and lenders became overextended. Adverse events shifted expectations and broke off the rollover of credit that had kept the system afloat. Nearly all of the countries in the region entered into *de facto* default in 1982/1983. In view of the high level of credit exposure in the region of hundreds of commercial banks, the transition from *de facto*

[32] As an illustration, in the Chrysler case banks agreed to convert one-third of the company's outstanding debt into equity and to write down another one-third. See Reich, "A Comparative Study in Law and Industrial Structure", *Yale Journal on Regulation*, vol. 2, No. 2, 1985, p. 222.

[33] United States General Accounting Office, *Guidelines for Rescuing Large Failing Firms and Municipalities*, Washington, D.C., 29 March 1989. p. 2.

[34] Nowhere is this more evident than in the United States' management of the Savings and Loan (S & L) Crisis. During 1980-1986, attempts to minimize public involvement in the growing S & L problem, coupled with reluctance to introduce policy reforms, merely allowed the industry's crisis to deepen and raised the eventual cost of the direct public sector bailout. See R. Dan Brumbaugh, Andrew Carrion and Richard Litan, "Cleaning Up the Depository Institutions Mess", *Brookings Papers on Economic Activity*, No. 1, 1989, pp. 244-250.

default to *de jure* default would have induced record losses for the world's commercial banks and a devastating erosion of their capital. A classic collapse of world financial markets and economic activity was clearly a potential outcome of this delicate situation.[35]

A collapse of global proportions was avoided, however, because of the effective deployment of an international lender-of-last-resort (ILLR). In contrast to domestic markets, where the LLR has a well-defined place in economic management, the ILLR is a relatively new and rudimentary instrument of post-war economic co-operation.

The ILLR is not sharply defined.[36] However, practice suggests that it is an informal, decentralized alliance of the Group of Seven (G-7) governments, some of their big commercial banks, and the major multilateral lenders, especially the IMF. Since the ILLR is decentralized, there is a continuous and important give and take among its various components, each of which has a sufficient degree of freedom to substantially affect the management of the crisis. The axis of movement, however, is located in the G-7 governments. It is in this sense that the ILLR cannot be considered a truly global multilateral lending facility; it is very much nation-based and broadly guided by decisions emanating from a handful of industrialized nations. Moreover – reflecting its *ad hoc* formulation –, leadership is often delegated to the country with the closest political and financial/commercial ties to the region in crisis.[37] This explains the central role of the United States Government and some large United States banks in the management of the Latin American and Caribbean debt crisis.

It was shown earlier that domestic LLRs tend to have the dual systemic objective of i) preserving financial stability and ii) maintaining economic activity. A review of the behaviour of the ILLR, however, suggests a more monolithic focus in which financial stability is the key input for decision-making.[38] This can perhaps be attributed to the narrow, decentralized nation-based character of the ILLR facility, which tends to impose upon it a modus operandi designed to preserve the *status quo* among the leading creditor nations. Given the very tight integration of international capital markets, financial stability is an uncontroversial common denominator on which all can easily converge. On the other hand, an ambitious economic growth formula emanating from the ILLR for a country or geographic area in crisis is a potentially divisive strategy. This is because it might cause disproportionate benefits to accrue to the creditor nation(s) with the most developed political and commercial ties to the problem debtor country.

Be that as it may, it is evident that since 1982 the international management of Latin America's debt problem has been geared primarily to international financial stability. Growth in the debtor countries was for a long time at best a residual consideration; it has gained prominence only gradually as it has become obvious that without growth there is no solution to the problem.

a) *Financing and adjustment*

To achieve the dual objectives of world financial stability and economic growth in the creditor *and* debtor countries there is a need for symmetry between adjustment and financing. Adjustment is necessary because, as mentioned earlier, the debtors' economies have tended to be overleveraged on foreign debt and underleveraged in terms of their competitive insertion into the world economy. For Latin America and the Caribbean to restore its creditworthiness it must, *inter alia*, demonstrate to private credit markets that it has, at least in principle, the capacity to produce more than it absorbs on a sustained basis, i.e., to raise domestic savings to levels sufficient to meet scheduled debt service.[39]

[35]* See *IMF Survey*, Washington, D.C., 9 January 1984.

[36] See Philip Wellons, *Passing the Buck*, Cambridge, Mass., Harvard Business School Press, 1987, Chapter 7, and Kindleberger, *Manias, Panics and Crashes*, New York, Basic Books, 1978, pp. 182-226.

[37] Wellons, *Passing the Buck*, Cambridge Mass., Harvard Business School Press, 1987, Chapter 7.

[38] *Ibid.*

[39] It must be emphasized that creditors only seek the capacity to make a transfer on a sustained basis; that is, once creditors perceive that this sustained capacity actually exists, they want to renew lending to the borrower. Thus, ironically, the ability to make the sustained transfer establishes conditions whereby it need not be undertaken.

The counterpart of this domestic effort is the adjustment of the external accounts so as to give rise to a trade surplus of sufficient size to transform domestic savings into foreign exchange for transfer to the creditors abroad. In this latter regard, the countries of Latin America and the Caribbean have undergone a dramatic adjustment: a trade deficit averaging almost US$7 billion per annum between 1978-1982 was transformed into a massive average trade surplus of US$26 billion per year between 1983-1987 (see table 5).

The trade surpluses registered since 1983 – equivalent to two-thirds of interest payments falling due on the debt – have been the primary vehicle for effecting a large transfer of resources abroad, amounting on average to 4% of the region's GDP, of which 3 percentage points go to foreign creditors (table 6).[40] The magnitude of this transfer can perhaps be better appreciated when it is realized that it is greater than the controversial transfer of resources that was imposed upon Germany after World War I when its victors demanded sizeable reparations.[41]

The domestic and external adjustments required to make the transfer of resources are complex processes that have repercussions on output and employment. Not only must there be a reduction in expenditure *vis-à-vis* product, but domestic expenditure must be reassigned to non-tradeable goods and services, and domestic resources assigned to the production of tradeable goods. Moreover, when the foreign debt is mostly the responsibility of the public sector – as in the case of Latin America and the Caribbean – there is an internal transfer problem as well: the government must raise taxes and lower expenditures to corner domestic resources for outward transfer.[42]

The switching of expenditure and output are, however, typically time-consuming processes due to domestic rigidities of a structural, political and cultural nature. Altering tax and expenditure policy can also be a very difficult and protracted process. Given these inherent rigidities, any effort to generate a sudden, large outward transfer of resources will very likely rely disproportionately on compression of domestic expenditure – with consequent falls in output and employment – and monetized fiscal deficits – with consequent inflationary pressures. Moreover, the resulting recessionary adjustment with inflation may do little to restore creditworthiness; if the achievement of the outward transfer of resources induces depressed levels of domestic output and severe inflationary pressures in the debtor economy, it clearly is not sustainable, and the private creditors know that. Thus, creditors will gladly receive any resources made available for debt service, but a renewal of voluntary lending will be highly unlikely.

For the external adjustment to take place efficiently, i.e., with no losses in potential output and stable prices, the country must receive adequate compensatory financing in the interim until the policy-induced internal reallocation of resources takes hold. As the capacity to "produce" a structural trade surplus rises, financing can be gradually pared back and the transfer smoothly effected. Moreover, when private creditors observe that resources can be transferred simultaneously with growth and price stability, they will be more likely to believe that the process is sustainable, which in turn changes their perceptions of creditworthiness. So that, all things being equal, there would at least be the potential for voluntary lending in capital markets to resume.

b) *The ILLR in practice*

The importance of adequate financing in a successful adjustment process has been officially recognized from the very beginning of the crisis.[43] Yet the above-mentioned ILLR has been very ineffective in mobilizing the

[40] As shown in table 6, the rest – equivalent to 1% of GDP – left the region largely in the form of capital flight.

[41] See Andrés Bianchi, Robert Devlin and Joseph Ramos, "The adjustment process in Latin America", in *Growth-oriented Adjustment Programs,* Vitorio Corbo, *et al.* (eds), Washington, D.C., IMF-World Bank, 1987.

[42] For a more complete analysis of the internal and external transfer problems, see ECLAC, *Towards sustained development in Latin America and the Caribbean: restrictions and requisites,* Cuadernos de la CEPAL series, No. 61, Santiago, Chile, United Nations, 1989, pp. 46-50. See also see ECLAC, *The economic crisis: policies for adjustment, stabilization and growth,* Cuadernos de la CEPAL series, No. 54, Santiago, Chile, United Nations, 1986, ECLAC, *Políticas de Ajuste..., op.cit.,* and Ricardo Ffrench-Davis and Sergio Molina, "Prospects for Bank Lending to Developing Countries 1980s", *Journal of Development Planning,* No. 16, 1985, pp. 234-237.

[43] See "Fund Policy on Adjustment and Financing Clarified in Address by Managing Director", *IMF Survey,* Washington, D.C., 9 January 1984.

Table 5

LATIN AMERICA AND THE CARIBBEAN: RELATION BETWEEN TRADE SURPLUS AND INTEREST PAYMENTS [a]

(Annual averages)

	1978-1982	1983-1987
	Billions of dollars	
1) Trade balance [b]	-6.6	25.6
2) Interest due on foreign debt	25.1	38.6
	Ratios	
3) (1):(2)	-0.26	0.66

Source: ECLAC.
[a]Excludes English-speaking Caribbean and Panama. [b]Goods and services.

Table 6

LATIN AMERICA AND THE CARIBBEAN: NET TRANSFER OF RESOURCES AS A PERCENTAGE OF GROSS DOMESTIC PRODUCT [a]

(Annual averages)

	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Credit transactions	0.3	1.3	2.3	1.4	-3.0
Direct foreign investment	-0.9	-0.4	0.1	0.5	-0.1
Unilateral transfers	0.1	0.1	0.1	0.1	0.2
Other [b]	-0.1	0.3	0.1	-2.0	-1.1
Total	**-0.5**	**1.3**	**2.5**	**0.0**	**-4.0**

Source: ECLAC, on the basis of official data.
[a]Excludes English-speaking Caribbean. [b]Includes errors and omissions of the balance of payments and short-term capital movements of the non-bank private sector, which are often used as a proxy for capital flight.

resources required to ensure the dual objectives of global financial stability and truly global growth (i.e., growth in which the debtor countries participate). Indeed, the primary tool to achieve world financial stability has not been financing as such, but rather the exertion of pressure on the debtors to effect a large outward transfer of resources to the creditors. In other words, financing has been merely a residual which has covered the difference between the resources that could be extracted from the debtor countries for transfer to the creditors and the amount that had to be paid to them to avoid formal defaults and destabilizing losses in the international financial system. Since financing was thus viewed as a residual policy tool in the ILLR facility, so too did growth in the debtor countries necessarily become a residual policy objective, for the technical reasons outlined above. Thus, after eight years of international management of the Latin American crisis, it is not at all surprising that the results have been highly skewed in favour of the creditor countries.

In the industrialized countries, commercial banks have undergone a remarkable "growth-oriented adjustment" to their problem Latin American loan portfolio. By way of illustration, thanks to the time bought by the international debt management strategy, United States banks have sharply boosted their capital and cut back their absolute exposure in the debtor countries (figures 3 and 4). Consequently their Latin American exposure, as a percentage of primary capital, has declined from 124% in June 1982 to 39% in September 1989 (figure 5 and table 7). Moreover, commercial banks generally are fairly well provisioned for loan losses. In 1989 European banks had reserves equivalent to 50%-80% of their exposure in developing countries, while United States money center banks had reserves on their medium-term exposure ranging between 30% and 70%. Loan-loss provisions for Japanese banks were relatively low at a uniform 15%, but are scheduled to rise to 25% by March 1990. Moreover, their provisioning is significantly compensated by considerable "hidden reserves" in the asset portfolios[44] (table 8).

The financial stability engendered by the smooth adjustment of the commercial banks has facilitated prosperity in the industrialized countries. After a recession in 1981-1982, their economies have experienced one of the most protracted, low- inflation expansions in modern history. Thus the growth of per capita GNP in the industrialized countries between 1983 and 1989 has averaged 2.9% per annum, while the average rise in domestic prices has been about 3.9% over the same period.[45]

In contrast to the industrialized economies and their commercial banks, the countries of Latin America and the Caribbean have generally fared very poorly, with dramatic stagflation in the 1980s. The region's per capita product has fallen in four of the last eight years and by the end of 1989 was 8% below the level recorded in 1980. Meanwhile, inflation – and even hyperinflation – plague most economies.[46]

The poor performance of the countries of the region has many causes, of both a domestic and external nature.[47] Notwithstanding deficiencies on many fronts, however, one single factor stands out in *all* cases: the lack of an adequate, sustained and predictable flow of external finance, which has precluded a socially efficient adjustment process. The extremely negative social and political consequences of this adjustment have also hampered the very sustainability of adjustment policies, contributing to a vicious circle of failed programmes and stop-and-go policies. Indeed, in view of the dearth of the sustained and predictable finance on which socially efficient adjustment must be based, it is reasonable to assume that those few countries which have shown signs of recovery have done so not so much because of the international debt management strategy, but rather in spite of it.

The shortfall in sustained and predictable external financing for the debtors is clearly the responsibility of the ILLR. In the middle of a crisis, private risk perception is distorted by

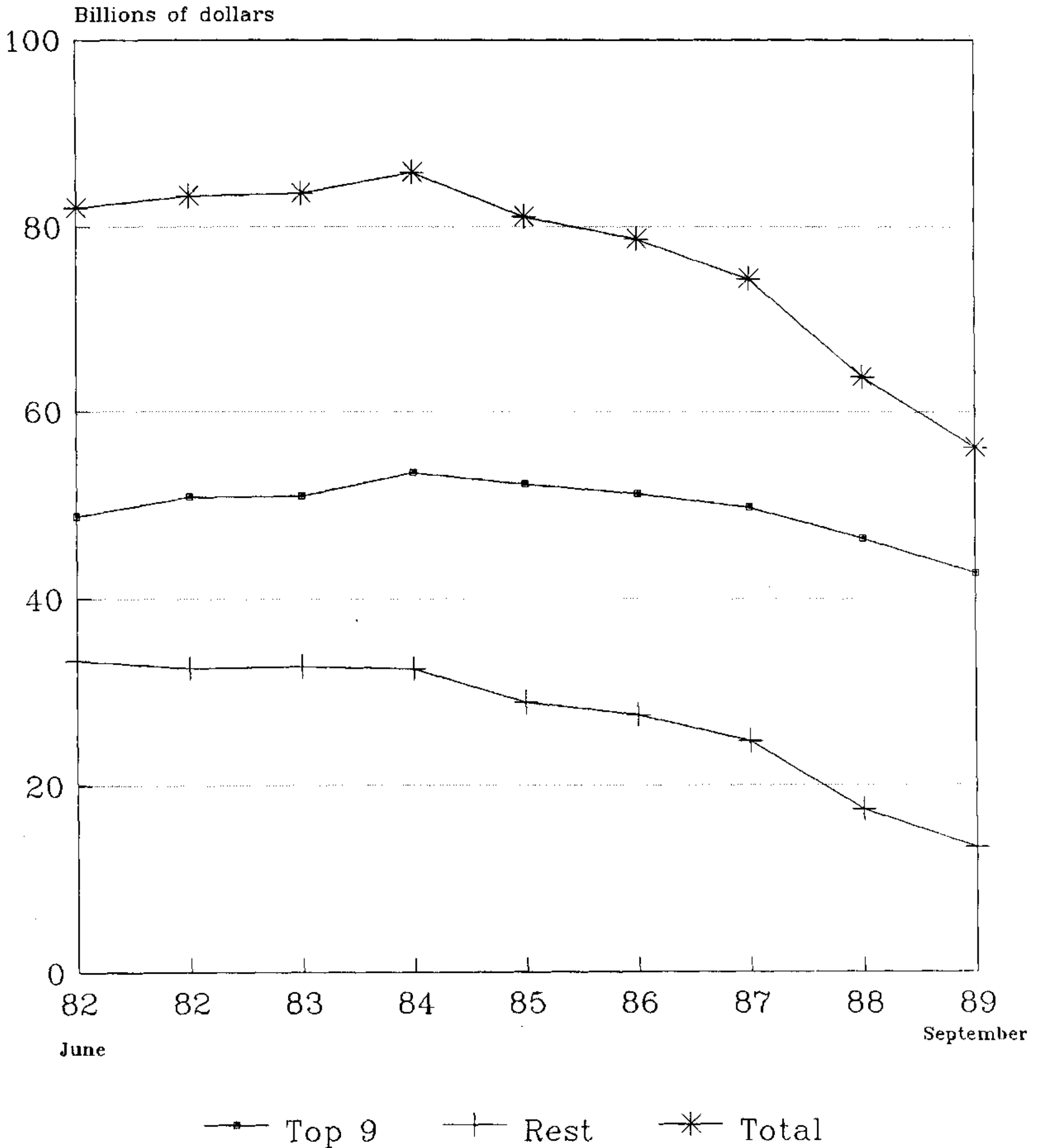
[44] Hidden reserves are composed of very undervalued assets.

[45] IMF, *World Economic Outlook*, Washington, D.C., September 1989, pp. 92-94.

[46] See ECLAC, *"Preliminary Overview of the Latin American and the Caribbean Economy, 1989"*, Santiago, Chile, December 1989.

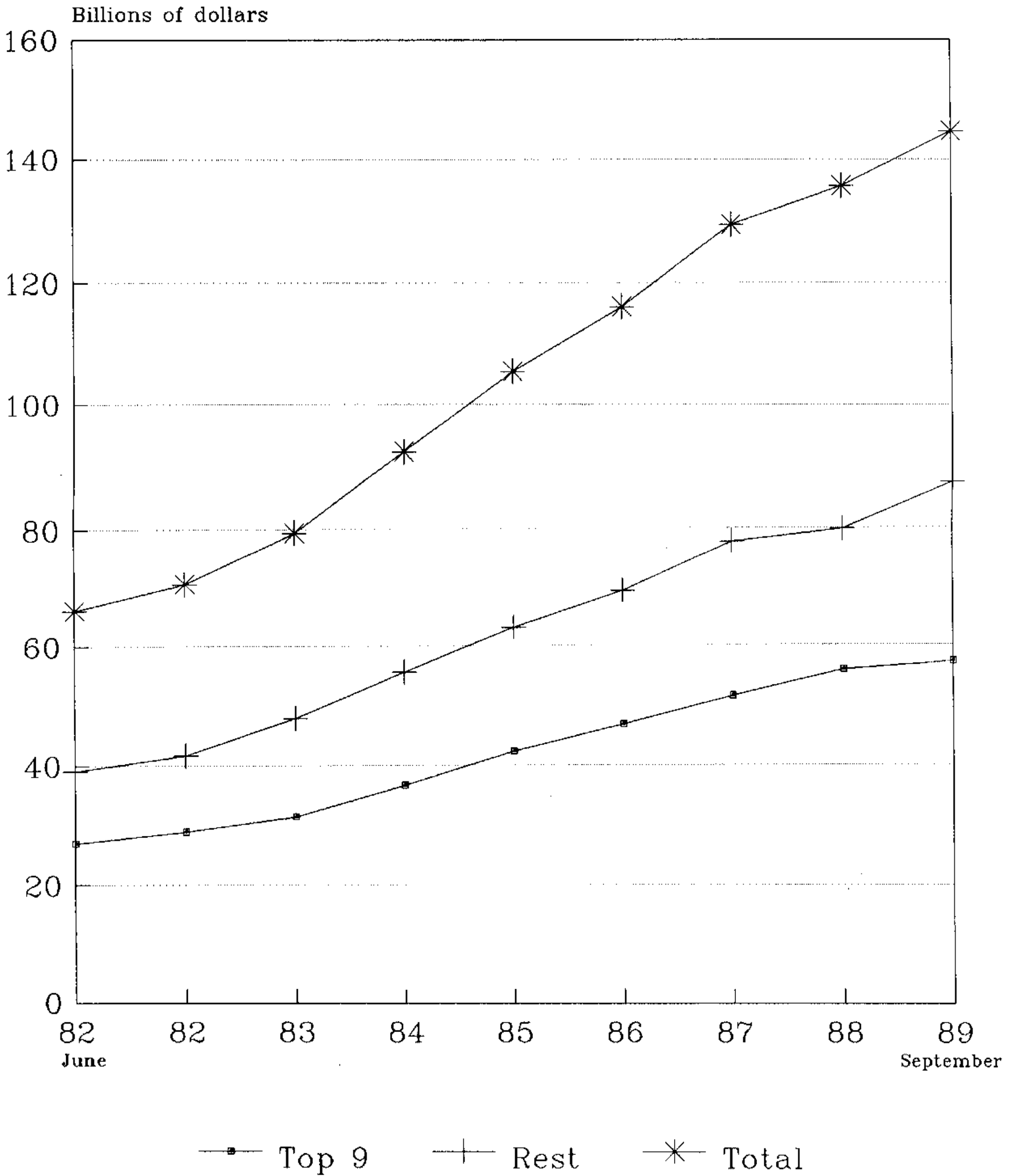
[47] See ECLAC, *Towards sustained development in Latin America and the Caribbean: restrictions and requisites*, Cuadernos de la CEPAL series, No. 61, Santiago, Chile, United Nations, 1989, pp. 46-50.

Figure 3
EXPOSURE OF U.S. BANKS IN
LATIN AMERICA AND THE CARIBBEAN



Source: U.S. Federal Financial Institutions Examination Council, *Statistical Release*, Washington, DC.

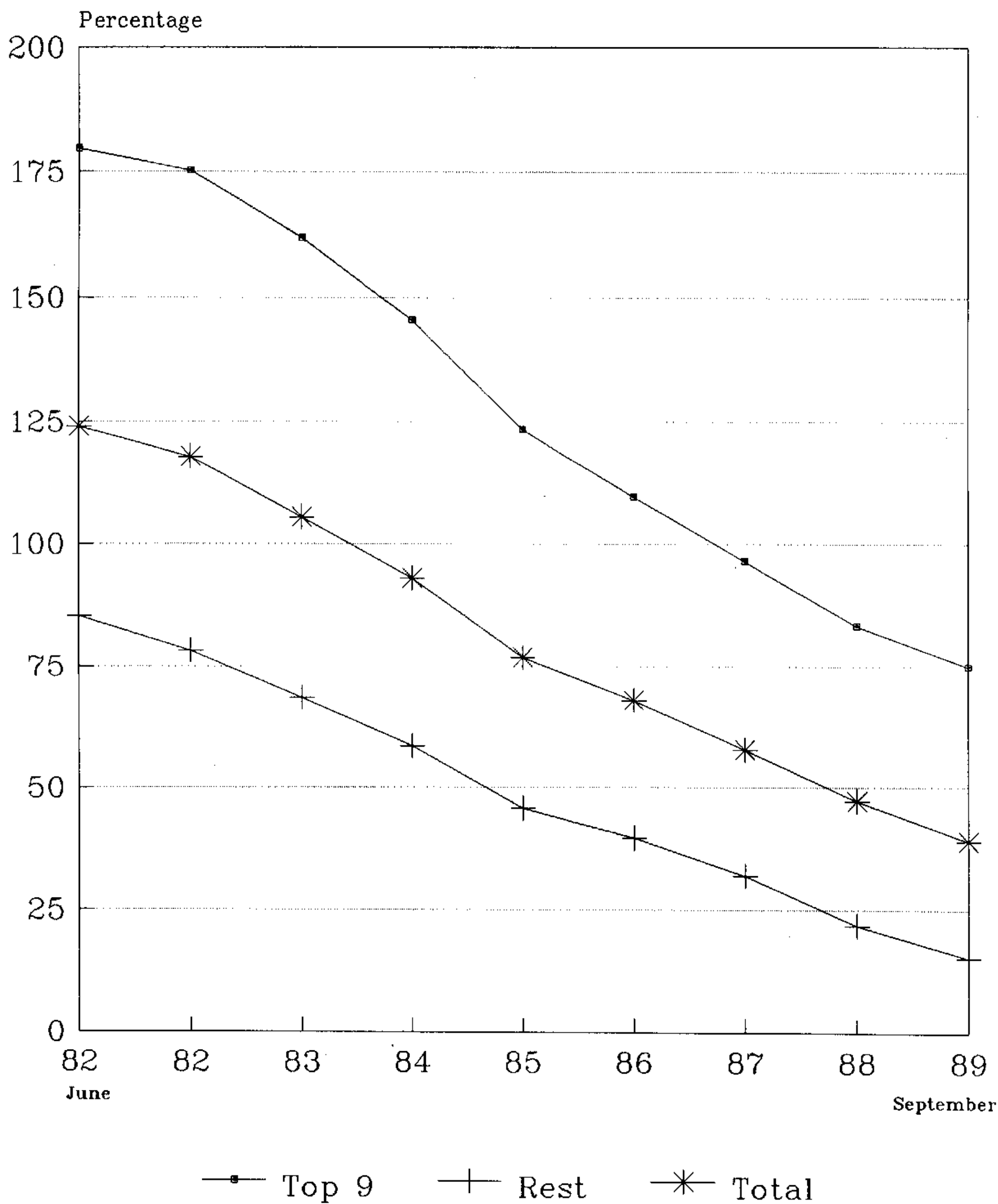
Figure 4
PRIMARY CAPITAL OF U.S. BANKS



Source: Idem Figure 3.

Figure 5

EXPOSURE OF U.S. BANKS IN LATIN AMERICA
AS A PERCENTAGE OF PRIMARY CAPITAL



Source: Figures 3 and 4.

Table 7

EXPOSURE OF U.S. BANKS IN LATIN AMERICA AS A PERCENTAGE OF PRIMARY CAPITAL

	June 1982			December 1982			December 1983		
	Top 9	Rest	Total	Top 9	Rest	Total	Top 9	Rest	Total
Latin America	**179.8**	**85.3**	**124.0**	**175.2**	**78.2**	**118.0**	**161.7**	**68.4**	**105.4**
Oil-exporting countries	**87.0**	**44.2**	**61.7**	**80.7**	**40.8**	**57.2**	**75.8**	**35.6**	**51.6**
Bolivia	0.9	0.4	0.6	0.8	0.3	0.5	0.6	0.2	0.4
Ecuador	4.6	2.3	3.3	4.0	2.2	2.9	3.6	1.8	2.5
Mexico	50.2	29.7	38.1	45.2	26.9	34.4	43.6	24.5	32.1
Peru	4.9	2.6	3.5	4.5	2.7	3.5	4.1	2.1	2.9
Venezuela	26.4	9.2	16.2	26.2	8.7	15.9	23.9	7.1	13.7
Non-oil-exporting countries	**92.8**	**41.1**	**62.3**	**94.5**	**37.3**	**60.8**	**85.9**	**32.8**	**53.9**
Argentina	20.6	8.2	13.3	19.1	7.3	12.1	18.3	6.4	11.1
Brazil	45.5	20.9	31.0	48.8	18.7	31.1	43.7	16.4	27.2
Colombia	7.7	2.5	4.6	8.9	2.6	5.2	7.6	2.5	4.5
Costa Rica	0.8	0.7	0.7	0.7	0.6	0.6	0.7	0.5	0.6
Chile	12.2	7.1	9.2	11.0	6.5	8.3	10.3	5.6	7.5
El Salvador	0.2	0.0	0.1	0.2	0.0	0.1	0.2	0.1	0.1
Guatemala	0.4	0.1	0.2	0.3	0.2	0.2	0.2	0.1	0.2
Honduras	0.5	0.2	0.3	0.3	0.1	0.2	0.3	0.1	0.2
Nicaragua	0.9	0.4	0.6	0.9	0.4	0.6	0.7	0.2	0.4
Paraguay	1.1	0.1	0.5	0.9	0.1	0.4	0.7	0.0	0.3
Dominican Republic	1.2	0.3	0.7	1.0	0.3	0.6	0.9	0.2	0.5
Uruguay	1.6	0.7	1.1	2.2	0.7	1.3	2.4	0.6	1.3
Primary capital (billions of dollars)	**27.1**	**39.1**	**66.2**	**29.0**	**41.6**	**70.6**	**31.5**	**47.8**	**79.3**

Table 7 *(continued)*

	December 1984			December 1985			December 1986		
	Top 9	Rest	Total	Top 9	Rest	Total	Top 9	Rest	Total
Latin America	**145.5**	**58.4**	**93.1**	**123.5**	**45.7**	**76.9**	**109.7**	**39.6**	**67.8**
Oil-exporting countries	**65.4**	**29.8**	**44.0**	**54.2**	**23.6**	**35.9**	**46.3**	**20.0**	**30.6**
Bolivia	0.3	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Ecuador	3.1	1.4	2.1	2.9	1.2	1.9	2.6	1.1	1.7
Mexico	38.9	20.7	28.0	32.7	16.8	23.2	28.9	14.5	20.3
Peru	3.1	1.7	2.3	2.0	1.0	1.4	1.4	0.7	1.0
Venezuela	19.9	5.8	11.4	16.4	4.5	9.3	13.4	3.6	7.5
Non-oil-exporting countries	**80.1**	**28.6**	**49.1**	**69.3**	**22.1**	**41.1**	**63.3**	**19.6**	**37.2**
Argentina	15.1	5.2	9.1	14.7	4.0	8.3	13.8	3.8	7.8
Brazil	44.2	15.5	26.9	37.4	12.3	22.4	34.6	10.8	20.3
Colombia	6.0	1.5	3.3	4.4	1.1	2.4	3.3	0.9	1.9
Costa Rica	0.6	0.4	0.5	0.5	0.3	0.4	0.4	0.3	0.3
Chile	9.9	4.9	6.9	9.2	3.7	5.9	8.6	3.2	5.4
El Salvador	0.1	0.0	0.1	0.1	0.0	0.0	0.0	0.1	0.0
Guatemala	0.2	0.1	0.1	0.1	0.0	0.1	0.1	0.0	0.0
Honduras	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Nicaragua	0.3	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Paraguay	0.5	0.0	0.2	0.4	0.0	0.2	0.2	0.0	0.1
Dominican Republic	0.9	0.2	0.5	0.7	0.2	0.4	0.6	0.1	0.3
Uruguay	2.1	0.5	1.1	1.6	0.3	0.8	1.5	0.3	0.8
Primary capital (billions of dollars)	**36.7**	**55.5**	**92.2**	**42.3**	**63.1**	**105.4**	**46.7**	**69.4**	**116.1**

Table 7 *(concluded)*

	December 1987			December 1988			September 1989		
	Top 9	Rest	Total	Top 9	Rest	Total	Top 9	Rest	Total
Latin America	**96.6**	**31.8**	**57.6**	**83.3**	**21.8**	**47.1**	**74.9**	**15.3**	**38.9**
Oil-exporting countries	**40.2**	**16.0**	**25.7**	**33.4**	**10.6**	**19.9**	**31.1**	**7.1**	**16.6**
Bolivia	0.1	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Ecuador	2.2	0.8	1.4	1.7	0.5	1.0	1.5	0.3	0.8
Mexico	26.0	11.6	17.3	21.3	7.1	13.0	20.1	4.8	10.9
Peru	0.9	0.5	0.7	0.6	0.2	0.4	0.2	0.1	0.1
Venezuela	11.0	3.1	6.2	9.7	2.8	5.6	9.7	1.8	4.8
Non-oil-exporting countries	**56.4**	**15.8**	**32.0**	**49.9**	**11.2**	**27.1**	**43.8**	**8.1**	**22.3**
Argentina	13.0	3.2	7.1	11.1	2.2	5.9	8.6	1.4	4.3
Brazil	30.6	8.4	17.2	28.2	6.0	15.1	26.5	4.5	13.2
Colombia	2.7	0.9	1.6	2.6	0.8	1.5	2.0	0.6	1.1
Costa Rica	0.3	0.2	0.2	0.2	0.1	0.2	0.2	0.1	0.1
Chile	7.6	2.5	4.5	6.1	1.6	3.4	4.9	1.1	2.6
El Salvador	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Guatemala	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Honduras	0.1	0.1	0.1	0.1	0.0	0.0	0.1	0.0	0.0
Nicaragua	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Paraguay	0.1	0.0	0.1	0.1	0.0	0.0	0.1	0.0	0.0
Dominican Republic	0.5	0.1	0.3	0.5	0.1	0.3	0.4	0.1	0.2
Uruguay	1.3	0.3	0.7	1.1	0.3	0.6	1.1	0.2	0.5
Primary capital (billions of dollars)	**51.5**	**77.7**	**129.2**	**55.8**	**79.8**	**135.6**	**57.2**	**87.4**	**144.6**

Source: ECLAC, on the basis of information from the U.S. Federal Financial Institutions Examination Council, *Statistical Release*, Washington, D.C. (various numbers).

Table 8

ESTIMATED LOAN LOSS RESERVES OF INTERNATIONAL BANKS ON THEIR DEVELOPING COUNTRIES LOANS [a]

(Percentages)

France	**41-52**
(BNP)	(52)
(Crédit Lyonnais)	(46)[b]
(Société Générale)	(53)
(Banque Paribas)	(41)[b]
Germany	**50-80**
(Deutsche Bank)	(77)
(Dresdner)	(50)
Switzerland	**80**[c]
United Kingdom	**45-72**
(Midland Bank)	(58)
(Barclays)	(48)
(Lloyds Bank)	(72)
(Standard Chartered)	(46)
(National Westminster)	(65)
Canada	**45-70**
(Royal Bank of Canada)	(70)
(Canadian Imperial)	(45)[d]
(Bank of Montreal)	(41)[d]
(Bank of Nova Scotia)	(45)[d]
Japan [e]	**15**
United States [f]	
Money center banks	30-70
(Citicorp)	(30)
(Bank of America)	(32)
(Manufacturers Hanover)	(29)
(Chase Manhattan)	(39)
(Chemical Bank)	(33)
(Bankers Trust)	(70)
(J.P. Morgan)	(64)
(First Chicago)	(53)
(Bank of New York)	(-)
Super Regionals	30-75
(Security Pacific)	(30)
(Bank of Boston)	(75)

Source: Keefe, Bruyette and Woods, Inc.; S. G. Warburg, IBCA Banking Analysis; Michel Bouchet and Jonathan Hay, "Overview of Banking Regulations in OECD Countries and the Potential Accounting and Fiscal Obstacles to Negotiated Market-Based Debt Restructurings", Washington, D.C., World Bank, 1989, p. 67, and ECLAC, Economic Development Division.

[a] November 1989. [b] December 1988. [c] September 1989. [d] June 1989. [e] Uniform for all Japanese banks. The Ministry of Finance of Japan has issued a guideline of a 25% reserve by March 1990. [f] December 1989.

lagged portfolio reassessments and contagion; banks simply cannot be expected to lend the required amounts of financing. The financing must come from the ILLR, which in principle is able to perceive risk in systemic rather than private terms. The financing can come in either of two ways. Thus, the ILLR can lean heavily on the commercial banking system to induce lenders to provide the required financing, implicitly guaranteeing them liquidity should the need arise. It was shown that this was how the domestic LLR functioned during the stock market crash of 1987. Alternatively, the ILLR can directly finance the borrowers, either by explicitly guaranteeing bank loans, or by extending credit itself. It was shown that this latter approach, too, characterizes many of the rescue operations of domestic LLRs. The important point to note is that in either modality the risk of compensatory financing is borne (directly or indirectly) by the lender of last resort, i.e., the public sector.

In Latin America, the ILLR used both of the above-mentioned techniques, but the major stress was on maintaining the private character of the management strategy. Hence, unsecured bank financing was the principal instrument of the official rescue programme. IMF lending and rescheduling of Paris Club debt were a backdrop to the banks' credit decisions. In the first round of negotiations in 1982/1983 commercial banks instinctively rescheduled their loans on extremely harsh credit terms.[48] Under pressure from the ILLR, they also less instinctively committed themselves to "involuntary", commercially-priced loans to the debtor countries equivalent to a 7% expansion of their loan portfolio. The initial net expansion was somewhat less and then fell off rapidly in subsequent rounds of negotiations. The operation successfully avoided technical defaults and losses for the banks; indeed, due to the sharply increased "penalty rates" charged on their commercial credit,[49] Latin American countries, in the words of one business school professor, "became luminous profit centers for the banks in their darkest hour".[50]

The debtors' economies, however, already under strain due to adverse conditions in their international trade, collapsed under the weight of the ILLR's financing scheme. How much financing Latin America should have had at its disposal is now a matter of judgement. But the actual financing made available falls far short of any plausible criterion for efficient adjustment.

One simple and plausible strategy for the ILLR in the initial years of the crisis would have been, at the very minimum, to have firmly and publicly announced an emergency policy guideline of zero credit-related transfers for debtor countries committing themselves to IMF adjustment programmes. This would have made sense on a number of counts. In 1982/1983 the bankers, their governments and many respected analysts quite categorically pronounced that the crisis in Latin America was only a problem of liquidity.[51] That being the case, there was a logical and compelling argument to respond to the liquidity problem with a strong injection of cash in order to preserve confidence in the problem countries and assist them in an orderly adjustment. Moreover, without such financing the liquidity problem could easily degenerate into a solvency problem due to i) spiralling negative expectations of private investors about foreign exchange availability and ii) decapitalization of the borrower. Another important point is that the psychological impact of a firm announcement by the ILLR of a zero credit-related transfer might also have staved

[48] The negotiated price of credit rose by 100-250% with respect to its pre-crisis levels. For details on the rescheduling practices, see ECLAC, *Políticas de ajuste y renegociación de la deuda externa en América Latina,* Cuadernos de la CEPAL series, No. 48, Santiago, Chile, 1984, United Nations publication, Sales No. S.84.II.G.18.

[49] In view of the banks' role in the emergence of the debt problem, it is hard to understand how the ILLR could allow them to charge the borrowers the penalty rates.

[50] Wellons, *Passing the Buck,* Cambridge Mass, Mass., Harvard Business School Press, 1987, Chapter 7, p. 253.

[51] For one of the best-known analyses of liquidity problem see Cline, *International Debt,* Washington, D.C., Institute for International Economics, 1984. Also see Beryl Sprinkel, "Grounds for Increasing Optimism", *Economic Impact,* No. 2, 1984, pp. 35-39.

off the corrosive effects of domestic capital flight, which was especially virulent in 1981-1983.

Table 9 illustrates how much additional financing would have been needed to achieve a zero credit-related transfer in the initial years of the crisis: an average of the order of US$13 billion per year during 1983-1985.[52] This additional lending could have come about in either of two ways. The ILLR could have exerted more severe pressure on its commercial banks to lend resources (either in the form of new loans or of capitalization of interest), insisting as well that the loans be on very moderate terms.[53] As mentioned earlier, pressure was in fact placed on the banks to lend, albeit at very excessive interest rates. If the actual amounts of bank lending appearing in table 9 represent the maximum volume of lending that could have been mobilized through the moral suasion of the ILLR, then the only alternative would have been to offer banks direct public guarantees for their additional loans, or directly boost official lending in the required amounts. As events actually materialized, table 9 demonstrates that the ILLR was not very successful in preventing a harsh cutback in bank lending, or in compensating that fall with provision of its own resources. Moreover, the financing that did become available came on a short leash of annual commitments obtained in an environment of protracted negotiations and extreme uncertainty --not exactly a formula very conducive to efficient adjustment or investor confidence.

It should also be mentioned that a public policy of a zero credit-related transfer, while perhaps providing a more propitious psychological environment for private investors and better conditions for adjustment, would still have constituted a very conservative strategy that would have required severe sacrifices from the debtor countries. As shown in table 9 a zero credit related transfer would nevertheless have involved a sharp cutback in net financing compared with pre-crisis levels. Moreover, it must be remembered that the nominal interest burden displayed in table 9 grossly understates the real interest burden that faced the debtor countries. Deflating the nominal interest rate on the debt by the change in the region's export prices generated an average real interest rate of nearly 20% per annum in 1982-1985. The equivalent annual refinancing of this extraordinarily high real interest rate in the period is more than 50% greater than the amounts implied by the nominal zero transfer presented in table 9. Of course, with a properly functioning ILLR, at least part of the increase in these real interest rates would have been financed.

A more conventional and generous alternative criterion for refinancing highlights the shortcomings in the away the ILLR has managed the Latin American crisis. In an abstract world of no rigidities or distortions, it is conventionally argued that, for efficient adjustment, deficits stemming from permanent shocks should be adjusted to, while deficits caused by temporary shocks should be financed. In any event, one study which used this criterion found evidence of an extreme deficit of the kind of financing warranted by this approach: during 1982-1985 the non-oil-exporting countries of the region received financing for only 37%, 25%, 36%, and 16% of the transitory component of external shocks.[54] This is a disturbing shortfall, especially since it is based on the unreal assumption of no rigidities or distortions in the adjustment process. In the real world, where rigidities and distortions exist, the amount of financing required for efficient adjustment is naturally greater.

Of course, while more financing during the crisis might have aided the efficiency of adjustment, it would also have increased the foreign debt by more than what was actually recorded (table 2). How much new debt the region could have effectively absorbed in this period may be a matter of debate. Indeed, for some, the debt accumulation implied by the refinancing requirements of a zero credit-related transfer might be judged to exceed the countries' long term capacity to

[52] 1982 is excluded because it mostly reflects voluntary lending up through August 1982.

[53] As mentioned in an earlier footnote, no penalty rate was merited. The imposition of a "penalty", if it is needed at all, should be in the form of the conditionality of the IMF. The banks' overcharging of the debtors clearly just aggravated problems.

[54] Richard Lynn Ground, "Perturbaciones, Deficit, Crisis y Políticas de Ajuste: Un Enfoque Normativo", *El Trimestre Económico,* vol. LIII, No. 212, October-December, 1986, p. 769.

Table 9

LATIN AMERICA AND THE CARIBBEAN: SURPLUS OR DEFICIT ON ROLLOVER OF INTEREST PAYMENTS [a]

(Billions of dollars)

	1980	1981	1982	1983	1984	1985
1) Total interest payments	21.5	31.9	41.3	36.5	40.7	38.4
2) Total bank lending	36.0	41.0	28.1 [b]	15.1	13.0	4.8
3) Total official lending, of which:	11.9	12.6	12.3	16.0	15.1	13.4
IMF	(-0.1)	(0.3)	(1.9)	(6.9)	(3.9)	(1.5)
4) Surplus or deficit on rollover (2+3-1)	26.4	21.7	-0.9	-5.4	-12.6	-20.2

Source: ECLAC, and OECD, *Financing and External Debt of Developing Countries: 1988 Survey*, Paris, 1989.
[a] Includes the English-speaking Caribbean but excludes Panama. [b] This figure reflects the effects of voluntary lending by banks up through mid-year.

service the obligations.[55] However, if this were the case the correct alternative –from the standpoint of efficient adjustment in an interdependent economic system– was clearly not a destabilizing outward transfer of resources from the problem debtors, but rather an organized reduction of debt and debt service, with the ILLR providing the banks with the appropriate institutional and financial assistance to effectively realize this objective.

In sum, the systemic crisis that emerged in 1982 had its origins in the behaviour of debtor countries, creditors and their governments. Managing such a severe crisis was inherently difficult due to the international scope of the problem, the adverse external environment, and the natural reluctance of debtors to undergo adjustment and of private lenders to expand their exposure in adverse conditions. Indeed, in view of historical experience of collapse following a large financial crisis, the stability in the industrialized countries during the 1980s is no small achievement. Yet all this still does not diminish the fact that during the crisis of 1982 the ILLR clearly failed to carry out to the full the traditional systemic role that has been defined by its domestic counterpart. It promoted financial stability, but not broad-based maintenance of economic activity. One possible interpretation of the problem is that the ILLR facility is still underdeveloped and incapable of achieving the dual objectives of preserving financial stability and economic activity that are paramount in the operation of the domestic LLR. The problem may lie in the narrow nation-based character of the ILLR. On the one hand, the benefits of financial stability are clear to the creditor nations and are internalized immediately. On the other –in contrast with the operation of the domestic LLR– the economic benefit of preserving the growth of the problem debtors is initially externalized *vis-à-vis* the creditor nations. Moreover, the creditor nations' eventual internalization of this benefit through secondary effects of growth in the debtor countries is hard to assess in terms of its timing and distribution, and may be small with respect to the alternative opportunities for the deployment of public resources. It must also be remembered that developing countries are not powerful constituents of politicians in the industrialized countries, so the political benefits of a comprehensive rescue may also be perceived as small.

But whatever the reason, the ILLR did not, and still does not, mobilize adequate financing in support of a socially efficient adjustment process in Latin America and the Caribbean.[56] Although the enormous social costs of a disorderly and abrupt adjustment cannot be undone, it is not too late to rectify the situation. Of course, any hope for a successful concerted public solution to the problem of debt and development in the region will involve strengthening the adjustment process of the debtor countries. But this in turn will require a much more even-handed and ambitious public intervention that models itself more on the balanced financing and adjustment mix often observed in the operation of the domestic LLR. This leads us to the next topic: how to resolve the protracted debt serving problems of the region which impinge so negatively on the growth and adjustment processes.

[55] See, for instance, Cline, *International Debt*, Washington, D.C., Institute for International Economics, pp. 174-179.
[56] For a concise overview of the shortcomings in the international financial system, see Carlos Massad, "Debt: an Overview", *Journal of Development Planning*, No. 16, 1985, pp. 16-20.

III. A CONCERTED APPROACH: THE BRADY PLAN

Both theory and practice suggest that a concerted public solution to the debt problem is the best option for the world community as a whole. This is because market-based solutions for a systemic problem suffer from serious inefficiencies. Market outcomes are strongly influenced by the relative bargaining power of the debtor and his creditors; this, coupled with the fact that a given bargaining stance is influenced by complicated externalities, means that there is no *a priori* reason to expect the outcome of negotiations to distribute costs in a way that is functional to quickly restoring the health of the entire system at minimum social cost. Indeed, because costs and benefits are distributed in rather arbitrary fashion, the market approach can have extremely negative repercussions on valuable economic activities, thereby exacerbating problems and adversely affecting the growth potential of the system as a whole.

A concerted public solution brings the institutional and financial resources of government to bear on the problem. Negotiations cease to be a private affair between a debtor and his creditors; in recognition of the systemic dimension of the problem, they become tripartite, with the government representing the broader interests of society at large. The notion of private gain/loss is subordinated to the broader goals of i) restoring the health of the system at minimum social cost and ii) establishing new rules of the game so that errors of the past are not repeated. The public sector, moreover, may have to bear a significant part of the cost of restoring the efficient functioning of the system. On the one hand, in practice the debtor, creditor, or both, may be able to bear their share of the cost of resolving the problem only at the expense of their economic performance, which could be counterproductive to the renewal of the system. On the other hand, public policy may have clearly been a factor behind the emergence of the crisis, which makes it imperative for governments to assume a fair share of the costs of resolving it. Either way, a significant part of the costs of a solution are socialized, but in a way that is better planned than in the case of a market-type collapse.

As pointed out earlier, the above logic has frequently guided solutions to stress situations of systemic proportions in the industrialized countries. In the Latin American and Caribbean debt problem, however, creditor governments have been reticent to assume their systemic role in the broad sense of the word. In the name of respecting "market" solutions and avoiding public sector "bailouts," they have intervened only very selectively in the crisis, and then in ways which have often skewed benefits in favour of the creditor banks.[1] Perversely, the results have been singularly negative for one half of the credit equation, i.e., the debtors, who have been confronted with economic costs that may well be larger than those that would have emerged if a real market solution (i.e., *de jure* default and devaluation of the bank loans) had been allowed to occur in 1982.[2]

[1] For a detailed review of the phenomenon, see ECLAC, *Políticas de ajuste y renegociación de la deuda externa en América Latina* (LC/G.1332), Cuadernos de la CEPAL series, No. 48, Santiago, Chile, 1984, United Nations publication, Sales No. S.84.II.G.18 and ECLAC, *Economic Survey of Latin America and the Caribbean, 1988*, Santiago, Chile, United Nations, 1989 (chapter IX).

[2] Defaults in 1982 would certainly have led to the use of the full capacity of the ILLR and perhaps contributed to the financial costs being more evenly distributed. It is also interesting to note that in the 1930s defaults were in practice a risk-sharing mechanism that helped to prop up economic activity in Latin America. As pointed out by Díaz-Alejandro in reference to the market solution of the 1930s: "Travellers to South America around 1932 would report that in cities like So Paulo textile mills were working three shifts per day, and that the prevailing mood contrasted with the gloom found in North America. During 1984 economic optimism has returned to New York and Washington, D.C., but not to Buenos Aires and Brasilia". Carlos Díaz-Alejandro, "The Early 1980s in Latin America: the 1930s One More Time?", paper presented to the Expert Meeting on Crisis and Development in Latin America and the Caribbean, Santiago, Chile, ECLAC, 29 April-3 May 1985, p. 13.

Moreover, reluctant public sector intervention in the debt problem has ultimately proved to be a poor vehicle for eluding public costs. As shown in table 9, the international public sector had limited and diminishing success in encouraging commercial banks to lend to the problem debtor countries; indeed, more recent data from the Bank for International Settlements (BIS) suggest that since 1986 annual bank lending to most of the countries of the region in net terms has been negligible or even negative.[3] Thus, despite rhetoric to the contrary, the official debt strategy has been effectively bailing out part of the scheduled interest payments to the private commercial banks. The other side of this coin is that the international public sector's share of the total debt problem in Latin America and the Caribbean has risen dramatically since 1982, with the multilateral lenders assuming a disproportionate amount of the increased official commitment (figure 6). The higher profile for the public sector in and of itself is not bad; what is troublesome, however, is that this has been occurring in a fashion that has not been functional to resolving the underlying problem. The public sector has, effectively, been assuming a growing share of a decomposing debt pie; hence (much like the experience in the United States with the problem Savings and Loan Associations), the costs to the international public sector could end up being much larger than if a decisive public solution had been imposed at the outset of the crisis.

A. AN OVERVIEW OF THE PLAN

The Brady Plan, which was announced in March 1989, represents the fourth phase of the official international debt management strategy. Although still in the making, the Brady initiative is the first time the official debt strategy has had the basic ingredients of a true concerted public solution.

The first phase of the official strategy began in 1982. Since this initial phase was characterized by the diagnosis that there was a liquidity problem in the debtor countries, the policy prescription was a rescheduling of the debtors' payments *cum* involuntary loans, all on terms that avoided accounting losses for the commercial banks. This was followed in September 1985 by a second phase, termed the "Baker Plan". Here the diagnosis shifted from a short-term liquidity problem to a more protracted structural problem. The policy prescription also changed from austerity to "growth-oriented structural adjustment". Moreover, in order to foster growth the Plan proposed raising, over three years, US$20 billion of new net bank exposure and US$9 billion of net official credit for 17 countries to complement their ongoing rescheduling exercises. Once again, all transactions were to be at commercial rates, thereby avoiding accounting losses for the commercial banks.

The third phase of the strategy emerged in 1987, when the Baker Plan underwent a very significant mutation. Given the strategy's failure to raise promised net lending from the banks,[4] the Baker Plan supported a new debt relief vehicle called the "market menu of options". In effect, while formally supporting continued new bank money as part of the rescheduling packages, the Plan condoned mechanisms of voluntary debt reduction such as debt securitization at a discount, debt-equity swaps, buybacks, etc. Thus, for the first time in the official management of the problem it was admitted that there was a debt overhang and that at least part of the outstanding obligations could not be paid.

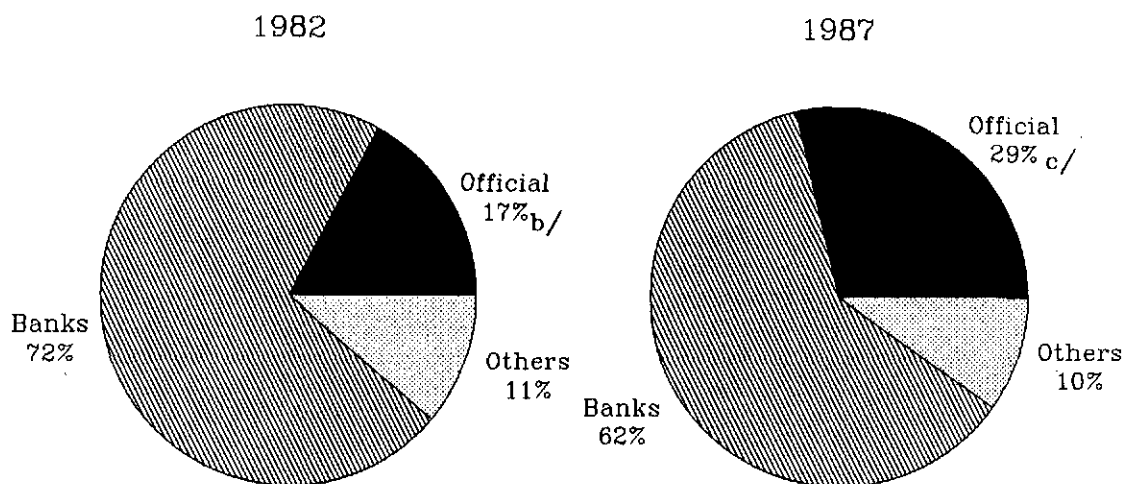
Throughout these first three phases the public sector was in the background, providing general guidance, pressuring debtors and

[3] Bank for International Settlements (BIS), *59th Annual Report*, Basle, June 1989, p. 113. The BIS figures, which measure changes in the stock of commercial bank assets in the region, were negative in 1986-1988. As mentioned earlier, the figures overstate the contraction of bank lending because they include the effect of write-offs and debt conversions. Since write-offs and conversions began to take on importance in 1988, it is now more difficult to derive precise estimates of bank lending to the problem LDCs.

[4] According to the World Bank, net lending by the banks to the highly-indebted developing countries was only US$6 billion in 1986-1988. See World Bank, *Quarterly Review*, Washington, D.C., March 1989, p. 3.

Figure 6

LATIN AMERICA AND THE CARIBBEAN: EXTERNAL DEBT BY TYPE OF CREDITOR a/



Source: OECD, *Financing External Debt of Developing Countries, 1988 Survey*, Paris, 1989.

a/ Includes English-speaking Caribbean.
b/ Bilateral:11%, Multilateral: 6%.
c/ Bilateral:14%, Multilateral: 15%.

creditors to conform to the broad outline of the strategy, awarding relatively risk-free bridge loans to the debtors as interim financing before rescheduling agreements, restructuring Paris Club debt, and directly providing loans, usually as part of official adjustment programmes. As mentioned earlier, all this was done in the name of supporting private market-based solutions and avoiding explicit costs for the creditor governments' taxpayers.

From the above, it is clear that the international debt strategy has not been static; it too has "adjusted" over the eight years of the debt problem. The adjustments have tended to lag behind objective events, however, and have therefore fallen short of the requirements for resolving problems.[5] Indeed, by the end of 1988 there was a broad consensus in both debtor and creditor circles that the Baker Plan was seriously adrift; that the banking community was escaping from the debt problem in the region; and that the debtor countries were in a crisis of deepening proportions.

The main feature of the Brady Plan is its proposal to stimulate policy reform and growth in the debtor countries excessively burdened with commercial bank debt by offering them an unprecedented official commitment to support debt reduction. Like the Baker Plan, the new initiative envisions debt reduction taking place on a case-by-case basis through voluntary agreements negotiated between the debtor country and creditor banks. But the Plan proposed four key innovations that in principle could give more impulse to debt reduction than has been achieved in the past.[6]

First, the Plan suggested that the private banks waive, for a period of three years, the negative pledge and sharing clauses which have a pervasive presence in the developing countries' loan contracts with the commercial banks. These clauses essentially provide for equal treatment among creditor banks regarding the debtor's pledging of his assets and payment of the debt, respectively. These and other clauses have tended to slow down negotiations for voluntary debt reduction because buybacks and exchange offers require that they be waived by a majority of the lending banks.[7] The idea behind the across-the-board waiver is that it would not only make debt reduction negotiations more agile, but could also enhance the credit terms for the debtors. This is because it would in principle create a more competitive environment on account of the potential for countries to negotiate bilaterally with their creditors.

Second, the Brady Plan also called for the creditor governments to explore ways to reduce regulatory, accounting and tax impediments to the banks' participation in debt reduction schemes.

Third, the Plan proposed to allow the international debt management strategy for the first time to directly commit public resources in support of the debt reduction process. More precisely, the IMF and World Bank will be allowed to channel part of their policy-based lending to collateralization of principal and interest on debt-for-bond exchanges involving significant discounts for the debtor countries, or to replenish reserves after a buyback operation. To achieve this financing, resources will be drawn from the existing capital of the two organizations. Countries with balance-of-payments surpluses will also be asked to contribute to the Plan's financing. The availability of public funds is designed to overcome one of the major shortcomings of the Baker Plan's scheme for voluntary debt reduction: that the foreign-exchange-constrained debtors do not have the resources to finance guarantees for large-scale debt reduction exercises.[8]

The fourth key dimension of the Brady Plan involves a proposal which could delink IMF

[5] For instance, a Baker Plan type of focus certainly would have been more helpful, and probably more successful, if it had emerged in 1982 instead of 1985. For more detailed analysis of the serious shortcomings of the Baker Plan, see ECLAC, *The evolution of the external debt problem in Latin America and the Caribbean* (LC/G.1487/Rev.2-P), Estudios e Informes de la CEPAL series, No. 72, Santiago, Chile, 1988, United Nations publication, Sales No. E.88.II.G.10; *and ECLAC, Economic Survey of Latin America and the Caribbean, 1988, op. cit.*

[6] See "Remarks by Secretary of the Treasury Nicholas F. Brady to the Brookings Institution and the Bretton Woods Committee Conference on Third World Debt", *Treasury News*, Washington, D.C., United States Department of the Treasury, 10 March 1989.

[7] A waiver of the negative pledge clause usually requires the consent of between 50% and 66% of a country's creditor banks, while the sharing provision generally needs the consent of 95%-100% of the banks. See Michel Bouchet and Jonathan Hay, "The Rise of the Market-Based Menu Approach and Its Limitations", Washington, D.C., World Bank, 1989, p. 29.

[8] For details, see ECLAC, *Economic Survey of Latin America and the Caribbean, 1988, op. cit.*

adjustment programmes from the management of the banks' balance sheets. In effect, the Plan permits the IMF to move ahead with disbursements on its adjustment programmes even if there are no prior financing assurances from the private commercial banks. This policy would effectively reverse the policy in place since 1982, in which IMF disbursements have generally been contingent upon a country reaching prior agreement with its banks to close the financing gap through a combination of commercial bank reschedulings, new money and, more recently, debt reduction. That traditional arrangement – introduced to stave off the retreat of the banks – may in practice greatly weaken the debtor countries' bargaining power with the banks, because failure to reach an agreement with them has led to payments arrears that would violate the performance criteria established in the macroeconomic programme negotiated with the Fund. The skewed bargaining power has also manifested itself in underfinanced and overpriced adjustment programmes that have contributed to economic recession in the debtor countries. As a consequence of the policy followed in the past, the IMF's role as an honest broker in the management of the debt problem began to be questioned; indeed, by 1987 there was a marked falling off in the number of countries willing to commit themselves to Fund programmes.[9]

B. THE ACHIEVEMENTS OF THE BRADY PLAN

The Brady Plan is an important conceptual advance. From the outset debtor and creditor countries agreed about the importance of adjustment in any solution to the debt problem. But with the advent of the Brady Plan, there is now also convergence on the central support role of debt reduction, and a general awareness that the process needs public financial and institutional support to work efficiently.

Another less obvious, but nonetheless important, advance is in the political arena. Earlier creditor initiatives largely arose out of the urgent need to avoid debtor defaults and losses for the banks.[10] In contrast, the Brady Plan appears to have emerged from a growing political consensus in the North that after eight years of economic and social decline, the debtor countries are in need of greater attention if a serious foreign policy problem is to be avoided. Indeed, it is a telling indication of the changed political environment that the Brady Plan emerged after even more ambitious debt reduction proposals launched by Japan and France.[11]

Another achievement is that in a short span of time, the Brady Plan has gone beyond conceptual formulation and entered into the realm of concrete action, albeit not without some difficulties.

1. A commitment of public funds

A significant amount of public money has already been committed to support debt reduction. The World Bank and IMF are each to make US$12 billion available out of their current capital base to support debt reduction packages. Half of the US$24 billion from these organizations will come from "existing" loan programmes for eligible countries; the other half is from so-called "additional" resources that the countries presumably would not have

[9] For more details, see ECLAC, *The evolution of the external debt problem in Latin America and the Caribbean, op.cit* and Robert Devlin, "Options tackling the external debt problem; *CEPAL Review,* No. 37, April 1989, table 8.

[10] There is at least circumstantial evidence that up through 1987 shifts in the debt management strategy were responses to fears of default and the formation of a debtor cartel. See Robert Devlin, *Debt and Crisis in Latin America: The Supply Side of the Story,* Princeton, Princeton University Press, 1989, chapter 5.

[11] In June 1988 Japan launched the "Miyazawa Proposal", which suggested that the IMF lend the problem debtor countries resources to establish special deposits in the Fund that would then finance buybacks. The IMF would also guarantee long-term bonds which the countries could exchange for old debt at par. Meanwhile, in September 1988 France launched the "Mitterrand Proposal", which involved the establishment of an international debt conversion facility in the IMF, financed by SDRs.

had available to them before. The "existing" resources are restricted to the support of buybacks and principal reduction in bond exchanges, while the "additional" resources are earmarked for guaranteeing interest payments on bond exchanges. The resources for debt reduction will be made available to the countries in the form of loans carrying normal terms; this way the Bank and Fund aim to avoid direct entanglement in the debt reduction process. It is understood that some front-loading of the disbursement of the debt reduction funds will be considered on a case-by-case basis.[12] In addition to the Bank-Fund resources, the Government of Japan will contribute at least US$6 billion of loans for debt and debt service reduction. Thus the total pool of public resources available to support the Brady Plan at the end of 1989 was of the order of US$30 billion.

2. Debt reduction agreements

During 1989 three Brady Plan accords for debt reduction emerged, benefitting Mexico, the Philippines and Costa Rica. Reflecting the case-by-case approach, each of these agreements displays a unique financing configuration (see Box).

The Costa Rican accord is designed entirely for debt and debt service reduction. Mexico's agreement is also geared primarily to debt and debt service reduction, but it has a small new money component. The Philippines agreement, however, although it includes debt reduction, was most notable for its new money provision.

The financial mechanisms are also different among the three countries. In Costa Rica, the primary instruments are a direct buyback at an 84% discount, exchange of old debt for par bonds at a fixed below-market interest rate, and a conventional rescheduling. Mexico's plan involves bonds discounted at 35%, par bonds at a fixed below-market interest rate, and a rescheduling *cum* new money in the form of conventional loans or direct capitalization of interest. As for the Philippines, its accord involves a direct buyback at a 50% discount and a bond issue for the new money. A commitment to a minimum level of debt-equity swaps accompanies the Mexican and Costa Rican accords, while the Philippines did not expressly agree to any specific amount of these transactions.

The scope of debt reduction also reflects a varied pattern. Costa Rica's debt reduction could affect nearly 60% of its outstanding obligations with the banks; the reduction of bank debt in Mexico will involve 29% of its total bank debt, while in the Philippines' agreement, only 10% of the bank debt is subject to reduction.

All the initial agreements were signed with the corresponding Bank Advisory Committee and were in principle only. This was followed by protracted negotiations with other creditor banks for their approval of the proposed terms. By early 1990, only Mexico had finalized a complete agreement with its creditors.

[12] The monies are formally organized as follows. On a case-by-case basis the World Bank will "set aside" 25% of a country's adjustment lending programme over a three-year period, or about 10% of total lending. The Bank could also provide "additional" resources equivalent to 15% of the overall three-year lending programme.The IMF, for its part, on a case-by-case basis, will consider "setting aside" 25% of a member's access under an Extended or Stand-by Arrangement to support debt reduction operations. The Fund could also provide "additional" resources equivalent to 40% of a member's quota. See World Bank News Release No. 89/531, Washington, D.C. (no date) and IMF, Press Release No. 89/17, Washington, D.C., 24 May 1989.

BOX

THE BRADY PLAN AGREEMENTS: MEXICO, COSTA RICA AND THE PHILIPPINES

1. *Mexico.* Mexico began its negotiations with the commercial banks in April 1989. In July it finally reached an accord with the bank Steering Committee that gave the commercial creditors three options for dealing with eligible medium-term debt of US$48 billion (of a total bank debt of about US$68 billion). The first option involves an exchange of debt at a 35% discount for a single-maturity, 30-year bond that carries an interest rate of 0.81% over LIBOR. The second option is a 30-year par bond carrying a fixed 6.25% interest rate (compared to a commercial rate in excess of 9% in 1989). It is important to note, moreover, that these bonds are exempt from rescheduling or new money requirements. The third option offered the banks is new lending over the next four years equivalent to 25% of a bank's outstanding exposure. The terms for the loans were set at a spread of 0.81% over LIBOR and a 15-year maturity (seven years' grace). Banks additionally enjoy a clause in the credit agreement which allows them, beginning in 1996, to gradually increase the yield on their bonds by up to 3 percentage points if the price of petroleum exceeds US$14 a barrel in real terms. The banks are also entitled to limited and specific types of debt-equity swaps equivalent to US$1 billion per year over the next three and one-half years.

The bonds were designed to have US$5.7 billion in enhancements financed by the IMF, World Bank and Japan, with an additional US$1.3 billion coming from Mexican international reserves. The total of US$7 billion of enhancements provides collateral for the bond principal, in the form of 30-year United States Treasury zero-coupon bonds; 18 months of rolling interest guarantees are also granted.

The Steering Committee originally estimated that the banks would select the options in such a way that 20% of the eligible debt would be exchanged for the discounted bonds, 60% would be traded into par bonds, and 20% would be subject to the new money provision. However, the actual selection of the banks proved to be quite different: 41% in discounted bonds, 47% in par bonds and 12% in new money. Moreover, the new configuration induced a greater than anticipated requirement for collateral. The shortfall, of about US$500 million, will reportedly be covered through the sale of the United States Treasury zero-coupon bonds to Mexico at a favourable yield (worth about US$350 million); an additional Mexican contribution; and an undisclosed financial transaction to be engineered by the Steering Committee.

2. *Costa Rica.* This second Brady Plan initiative in Latin America emerged in Costa Rica in late October. The agreement in principle deals with US$1.5 billion of medium-term bank debt and US$325 million of interest arrears accumulated since 1986. In the agreement banks are given no new money option; debt and debt service reduction is the only formal alternative. In effect, banks will have an opportunity to sell their debt to Costa Rica at about 16 cents on the dollar. Those banks selling 60% or more of their portfolio will receive an offer to exchange their remaining loans for a 20-year bond (10 years' grace) at a fixed 6.25% interest rate. Moreover, as an inducement to commit to a large sell-off, these will be the only bonds with a credit enhancement, in the form of a one-year rolling interest guarantee. Meanwhile, banks selling off less than 60% of their loans will receive on the remainder of their portfolio a 25-year unsecured bond (15-years' grace) with a fixed 6.25% interest rate and no guarantees.

Arrears remaining after the buyback will be eliminated via a 20% cash payment and a rescheduling of the balance over 15 years (no grace period) at 0.81% over LIBOR. Banks participating in a 60% sell-off will moreover receive a three-year guarantee on the interest payments of the rescheduled debt. The banks also enjoy a recapture clause that entitles them to greater payments when GDP in real terms exceeds 120% of the level registered in 1989. Another part of the agreement is that the government will sponsor debt-equity swaps for a minimum amount of US$20 million a year for five years.

Total official money needed to support the Costa Rican scheme is US$175 million of loans to finance the buyback and US$78 million for interest guarantees. Of the total of US$253 million of loans, US$102 million will come from the IMF and World Bank. Costa Rica has secured the rest of the resources from bilateral sources, including Japan, Taiwan and the United States.

3. *The Philippines.* Under this agreement, which appeared immediately after Mexico's in August 1989, the country agreed to use US$650 million of World Bank and IMF loans to repurchase US$1.3 billion of its US$13.3 billion bank debt in secondary markets. Meanwhile, the government agreed to raise more than US$1 billion in new money by issuing 15 year bonds (eight years' grace) at 0.81% over LIBOR. Like Mexico, the bonds are to be exempt from future reschedulings and new money requirements. In January 1990 the country effected the mentioned buyback. There has been, however, much difficulty in completing the new money provision in the agreement. In January the country had commitments of only US$600 million, and reportedly had scaled back the targetted size of the loan to US$700 million.

3. The IMF and financing assurances

In another positive development of the Brady Plan during 1989 the IMF has also demonstrated its willingness to sponsor adjustment programmes even in the absence of financing assurances from the commercial banks. The Fund actually had already been experimenting with this strategy earlier on in Costa Rica and Bolivia: two countries that successfully negotiated IMF support even while in a state of protracted arrears with the commercial banks and other creditors. But during 1989 the IMF also disbursed loans for adjustment programmes in Ecuador, Venezuela, Mexico and Argentina, before any of these countries had reached agreement with their banks on the management of their debt service problems. Since the latter three countries are among the largest debtors in the Third World, the IMF policy stance is an important development in the implementation of the Brady Plan.

4. Incentives for debt reduction

A major catalyst behind the Brady Plan agreements in Mexico, and to a lesser extent Costa Rica, was some very strong moral suasion applied to the banks by the creditor governments and the IMF. With regard to the question of financing assurances mentioned above, IMF pressure was far from discreet. Indeed, early in 1989 the IMF's Managing Director publicly made it clear to the commercial banks that the IMF was prepared to disburse on programmes with major debtors before financing assurances were in place. As the Managing Director stated:

"This means that, when justified, the Fund must be prepared to give up one prerogative that the international community had come to accept: namely, to withhold making its first disbursement until all other financing conditions are in place. In the future, we will be prepared to proceed differently. In order to help generate confidence, we stand ready, when the situation warrants, to be the first party to disburse financing."[13]

The United States government also put unusually strong pressure on the banks to reach the agreement with Mexico. The United States Federal Reserve reportedly hinted to the United States banks that should they fail to embrace the spirit of the Brady Plan, it could result in their being forced to increase their reserves.[14] Meanwhile, senior authorities in the United States Treasury and Federal Reserve took the unusual initiative of "inviting" top-level negotiators of the banks (including the Chairmen of two major United States lending institutions) to Washington, D.C. to negotiate a debt reduction agreement with the Mexican authorities. Significantly, the meetings were held in a conference room of the United States Treasury building.[15] As for the Costa Rican agreement, it too had high-level support in the United States Treasury.

As for tax and accounting incentives, some favourable developments materialized during 1989:

United Kingdom. In August 1989 regulatory authorities ruled that the Mexican discounted bond option will initially not require provisioning for losses, while the fixed-rate bonds and new loans will. Thus there is a clear incentive for English banks to participate in the debt reduction exercise.

United States. In September 1989 regulators indicated that banks will not have to automatically write-down to market value debtor country loans restructured under the Brady Plan. In effect, debt-for-bond swaps in which principal or interest is reduced will be treated as modifications of existing loan contracts. Thus banks will have to recognize a capital loss only if the total nominal future receipts under the new terms are less than the nominal book value of the loans. This ruling effectively makes participation in bond exchanges less onerous for the banks and thereby encourages debt and debt service reduction.

Japan. In October 1989 the Ministry of Finance ruled that Japanese banks will be

[13] "Remarks by M. Camdessus, Managing Director of the International Monetary Fund, before L'Institut d'Etudes Financières et Bancaires", Paris, 31 May 1989, p. 6. Also see Hobart Rowen, "Camdessus Assails Banks on Debt Talks", *Washington Post,* 1 November 1989.

[14] Erik Ipsen, "The Embattled Debt Negotiators", *Institutional Investor,* September 1989, p. 87.

[15] See Peter Kilborn, "How the Mexican Debt Pact was Achieved", *New York Times,* 31 July 1989 and *Latin Finance,* November 1989, p. 11.

entitled to tax benefits for losses incurred by participation in the Mexican government's bond exchange.

France. French authorities ruled that par bonds will not require a write-down of assets, nor will they require provisioning if kept in the bank's investment account. Likewise tax liabilities on loan loss reserves in excess of those required by debt reduction can be paid over the life of the restructured debt.

In sum, the Brady initiative has made progress in a brief period of time. Nevertheless, for it to be truly effective in its stated goals much more needs to be done.

C. SOME LIMITATIONS OF THE BRADY PLAN

The expectations of possible debt reduction in Latin America and the Caribbean raised by the Brady initiative must be tempered by the signs that the Brady Plan suffers from underfunding, underco-ordination and other difficulties.

1. Underfunding

There are some 39 developing countries which have been mentioned as possible candidates for Brady-style debt reduction. As mentioned, the existing pool of public resources to support debt reduction is US$30 billion. This type of public commitment can be expected to induce only a rather modest reduction of debt and debt service in Latin America and the Caribbean. Indeed, a simple illustration of the deployment of the US$30 billion to eligible developing countries suggests that the Brady Plan could finance only a 13%-14% net reduction of debt and interest payments in Latin America and the Caribbean (see annex 2).

The relatively modest potential for debt reduction is suggestive of at least two serious shortcomings. First, under current funding levels of the Brady Plan, the 50%-75% reduction of bank debt that most debtor countries of the region estimate they need (an evaluation backed up by the situation on the secondary markets) to eliminate the debt overhang would be impossible to achieve in a voluntary framework.[16] Thus, unless a country won disproportionate access to the limited pool of public resources, debt reduction agreements could generally be expected to foster only a very partial reduction of the debt overhang. Second, the Brady Plan's debt reduction scheme acts only on bank debt. Hence, countries of Latin America and the Caribbean with only modest amounts of commercial bank obligations will find that the Brady Plan can only marginally alter their overall debt burdens.

It is important to point out that a partial reduction of the debt overhang that could evolve out of an underfunded Brady Plan would have very ambiguous benefits and potential inefficiencies for all the major participants involved in the management of the debt problem, i.e., the debtor countries, multilateral lenders, commercial banks and creditor governments.

a) *The debtor countries*

The partial reduction of the debt overhang that is suggested by the current level of official funding of the Brady Plan offers unambiguous benefits only for debtor countries with no real debt overhang, or for those which, although they have a debt overhang, intend to remain current on their contractual debt service at whatever social cost that might entail. These countries would essentially perceive the real value of their debt as equal to its face value; hence, any opportunity to redeem debt at a significant discount would represent substantial real savings. The incentive to use available official funding for debt reduction would moreover be strong, since the discounts on the bank debt signal the market's inability to discriminate between such a debtor country and its insolvent, or recalcitrant, neighbours. In these circumstances, new bank loans may be difficult to secure, and debt reduction may

[16] The debt overhang is that part of the debt that cannot be served on a sustained basis if the country is to attain adequate rates of investment and growth. The indicated range of debt reduction on bank obligations required to eliminate the debt overhang is also suggested by recent empirical simulations of the effect of debt reduction on economic growth. See ECLAC, *Crecimiento económico y endeudamiento externo en América Latina: las propuestas de reducción de la deuda en contraste con un financiamiento externo restringido* (LC/R.871), Santiago, Chile, January 1990.

therefore be the best way to maximize resource flows from the private markets. In other words, if faced with systemic failure in the private credit market, it could even benefit the solvent debtor country to behave like an insolvent one and seek debt reduction through the Brady Plan.

On the other hand, for a country with an unserviceable debt overhang, a partial buyback of that overhang, or its securitization, is not obviously the best alternative use of scarce foreign exchange. On the one hand, the debt being reduced at the margin has a very low expected value and therefore has a high probability of being forgiven in one form or another.[17] On the other hand, after the partial reduction of the debt overhang, a serious debt problem still remains, as do large discounts on outstanding obligations. The remaining critical mass of debt overhang, and the associated market discounts, telegraph to potential investors an uncertainty about financial claims and foreign exchange availability. This situation will in turn perpetuate the adverse incentives regarding adjustment, the repatriation of capital flight, new lending, and new private sector investment.

There are, of course, circumstances in which a partial reduction of a debt overhang could have an obviously significant payback.[18] However, this is not the general case. The traditionally difficult enforcement of payment demands on a sovereign government, coupled with the very complex links between the debt overhang and economic performance, make the social rate of return on a loan for a small reduction of that overhang necessarily problematic. Moreover, given the objectively high social rate of discount on a dollar in a foreign-exchange-constrained developing country, the uncertain social rate of return on the marginal debt reduction must compete with the relatively more tangible returns that can generally be expected from channelling official loans to their original purpose: support of economic reforms, imports, investment and growth. Indeed, allocation of official resources for securitization and repurchase of the debt overhang makes unambiguous sense only to the extent that it forms part of a definitive settlement of the existing problem of indebtedness and excessive outward transfer of resources. This serious resource allocation problem will plague the debtors as long as the Brady Plan remains underfunded.

An underfinanced Brady Plan also creates another serious potential problem for the debtors: greater rigidity in the administration of debt overhang itself. In the Brady Plan, commercial bank debt is reduced by increasing multilateral obligations. However, multilateral institutions consider themselves preferential creditors and do not reschedule their loans. Additional rigidity is created when the particular technique is a debt-for-bond exchange. If the trade only partially eliminates the overhang, the remaining debt continues to be a very problematical claim, while the remaining old claims have been transformed into securities which traditionally are not easily rescheduled. Thus, should the new securities prove impossible to service at their face value, the country funds itself faced with the uncomfortable option of defaulting on bonds secured with borrowed IMF-World Bank resources. The default moreover would have the unfortunate consequence of i) spoiling the Latin American and Caribbean debtors' impeccable performance in international bond markets over the last 40 years and ii) stimulating retaliatory measures by traditionally sensitive bondholders.

b) *Multilateral lenders*

A partial reduction of the debt overhang financed by multilateral loans also creates serious potential problems for the multilateral lenders. As public development and balance of payments financing institutions, the multilateral lenders must also confront the aforementioned resource allocation questions raised by an underfunded Brady Plan. In addition, however, they face a potential gratuitous passing of risk onto them that could ultimately deteriorate their loan portfolio.

In effect, the multilateral lenders are being asked to accelerate the growth of their

[17] The low or negligible marginal value of a piecemeal debt reduction in sovereign countries is analytically demonstrated in Jeremy Bulow and Kenneth Rogoff, "The Buyback Boondoggle", *Brookings Papers on Economic Activity,* No. 2, 1988, pp. 675-704.

[18] For example, a partial reduction of the debt overhang could generate substantial benefits in a situation where it decisively eliminates seriously destabilizing tensions surrounding a country's restriction of debt service payments.

exposure in the problem debtor countries to assist the withdrawal of the private banks. In a definitive solution to the debt problem, this would be a reasonable arrangement. However, multilateral financing of a partial reduction of the debt overhang means that these institutions are increasing their participation in the debt servicing problem rather than resolving it. The consequent potential for adverse risk selection by these valuable creditors is clear. Indeed, Moody's – a major Wall Street credit rating agency – has already expressed concern about the effects of debt reduction programmes on the triple A rating of one multilateral development bank.[19]

c) *The commercial banks*

An underfunded Brady Plan will also do little to restore the international credit system's confidence in Latin America and the Caribbean. Much has been made in banking circles of the Brady Plan's supposedly negative effects on new lending by the commercial banks.[20] However, this problem is somewhat exaggerated since significant net bank lending to the problem debtors had already become a rare event long before the emergence of the Brady Plan. Indeed, with secondary market prices displaying large discounts on old debt, and most banks now well reserved against possible loan losses, new lending – voluntary or involuntary – is unlikely to be a major force in the management of the current stage of the debt problem.[21]

For the immediate future, then, debt reduction will likely be a primary vehicle for private finance of the problem debtor countries. Although secondary markets already confirm that the real value of the bank loans lent during the 1970s is much less than its face value, recognition of the real value of an asset is always a painful and costly experience for banks, which are traditionally very leveraged and operate in highly competitive markets.[22] But the sooner a loss is formalized and an overvalued claim settled, the sooner banks, and the private credit market in general, will be able to put the current debt problem behind them. Furthermore, once the market is formally cleared of the debt overhang, renewed growth and profit opportunities in the debtor countries, coupled with fading memories of the past, will create objective circumstances for a gradual return of foreign private investors to Latin America and the Caribbean. This is at least the historical experience with credit cycles.

Unfortunately, an underfunded Brady Plan will not greatly accelerate the process of renewal. Underfinanced debt reduction will leave much of the overhang outstanding; this in turn will cause the debt problem to fester for years to come. Moreover, the securitization of the debt that will occur in an underfunded Brady Plan could in fact magnify the market's

[19] See Thomas Kampffmeyer, "The Brady Plan: A Way Out of the Debt Crisis?", Berlin, German Development Institute, July 1989, p. 26.

[20] See for instance William Orme Jr., "Mexico Makes a Deal", *Latin Finance*, September, 1989, p. 24.

[21] There is less incentive for involuntary lending when the banks have reduced their vulnerability to default. Of course, improved capital and provisioning could in principle increase willingness to lend due to reduced risk constraints, but this would occur only over the long run. Moreover, even over the long run Latin America's access to bank loans may be restricted by the changing portfolio strategy of these lenders. For the effect of capital and provisioning on bank lending see Jack Guttentag and Richard Herring, "Accounting Losses on Sovereign Debt: Implications for New Lending", Princeton, New Jersey, University of Princeton, Department of Economics, Essays, in *International Finance*, No. 172, May 1989. For the long-term prospects of bank lending to the region see Alfred Watkins, "Latin America's prospects in the financial markets", *CEPAL Review*, No. 37, April 1989, pp. 51-72.

[22] This is because every dollar of capital supports up to 18 times its value in assets; hence a one dollar capital loss will reduce the maximum value of interest earning assets. See Michel Bouchet and Jonathan Hay, "Overview of Banking Regulation in OECD Countries and the Potential Accounting and Fiscal Obstacles to Negotiated Market-Based Debt Restructuring", Washington, D.C., World Bank, 1989, p. 7.

perception of problems in Latin America and the Caribbean and postpone even more the return to creditworthiness.

By most estimates, the so-called "Brady bonds" emitted in debt exchanges will be resisted by the market. Since the World Bank and IMF have purposely avoided direct entanglement in the debt-for-bond exchanges, the main factor which distinguishes the new bond from the old debt is the amount of cash guarantees behind it. But the full guarantee on the principal of a bond that characterizes a Brady-type exchange operation offers relatively small compensation to investors; for instance, such a guarantee on a 30-year, single-maturity bond might represent only 20% of the discounted present value of the instrument.[23] Thus, it is the stream of interest payments that makes up the bulk of the value of a long-term obligation of this type.

The funding of the Brady Plan, however, is now expected to be able to offer only rolling guarantees on one or two years of interest payments. Bond markets apparently find this type of guarantee awkward and difficult to value, because it is practically impossible to know when the non-renewable guarantee option will be called. Hence, its value to investors is relatively small.[24] It is also an inefficient arrangement, since in present-value terms the cost to the borrower of paying collateral immediately up front to cover interest payments from year one of the bond exceeds the likely benefit to the bondholder, who may value the guarantee on any one of the subsequent years' interest payments.[25]

The limited value of the guarantees on the Brady bonds, coupled with their complex structure, is likely to make them inefficient financial instruments.[26] First, the typical Brady bond which the banks receive from the debtor country at a discount is expected itself to trade in the market at a very large discount. Indeed, depending on how negatively the market views the bonds, the total value given up on the debt-for-bond exchange could be greater than that which would have occurred in a cash sale of the original loan in the secondary market.[27] Thus, on a debt-for-bond exchange at, for example, a 35% discount, the economic loss perceived by the bank will be considerably greater than the debt reduction received by the country.[28]

Second, some bond analysts expect the Brady bonds to be illiquid even relative to existing loans, which would defeat one of the major attractions for the banks of securitizing the debt. Given the awkward structure of the bonds these same analysts expect it to take a number of years for investor resistance to the Brady bonds to break down and for a real market to develop in the instruments. If this proves true, then in the immediate future Brady bonds will trade mostly among banks, thereby delaying the broadening of Latin America's investor base.[29]

d) *Creditor governments*

An underfunded Brady Plan also creates problems for the creditor governments which sponsor it. Since they are the major shareholders of multilateral financial institutions, all official lending is ultimately at their risk. As noted earlier, increasing official lending without resolving the underlying problem of debt is merely a gratuitous transfer of risk to the public sector. Furthermore, since the composition of creditor government shares in the multilateral lending organizations is quite different from the geographical

[23] This is only a rough order of magnitude, since the actual relative value of the guaranteed principal depends on the discount rates applied. For estimates of the value of the Mexican-Brady bonds, see Michael Pettis, "Putting a Price on Mexico's Brady Bonds", *Latin Finance,* September 1989, p. 23.

[24] *Ibid.*, and "Banking on the Future", *Euromoney,* September 1989, pp. 251-153.

[25] For an excellent analysis of this point see Kenneth Telljohann, "Implementing the Brady Plan: Rolling Interest Guarantees", New York, Salomon Brothers, 28 June 1989, pp. 4-6. The way to overcome this efficiency is to create a general fund for interest guarantees.

[26] Some investors have in fact nicknamed the Brady Bonds "Frankenbonds" after the well-known movie monster created by Dr. Frankenstein. See *Euromoney, op. cit.*

[27] Analysts expect that discounts on the Mexican bonds could be quite large, e.g., around 40%-45% for the discounted bond and 60% for the fixed rate bond. *Ibid.*, Telljohann, *op. cit.*, and Pettis, *op. cit.* It also should be noted that given the thinness of secondary markets not all the banks could sell out at the prevailing cash prices for LDC loans.

[28] Whether the market discount on the bond must be recognized or not depends on regulators and accountants.

[29] See *Euromoney, op. cit.*, p. 252 and Telljohann, *op.cit.*, p. 6.

distribution of banks with exposure in Latin America and the Caribbean, any deterioration in the multilateral loan portfolio could represent a politically sensitive redistribution of the costs of the debt problem among the creditor governments.[30] Moreover, aside from the direct financial costs of an inefficient debt management strategy, creditor governments continue to suffer many other secondary repercussions: for example, lost exports and jobs, migratory pressures, and potential foreign policy problems.

In sum, well intentioned though the Brady Plan may be, when it suffers from underfunding, as is the case now, the costs of participation are clear to all parties, while the benefits are ambiguous at best. This is clearly not a propitious environment for a sustained co-operative approach to the problem. Indeed, the inefficiencies of such a scheme unnecessarily raise tensions and ultimately postpone the process of renewal of the global economic system.

2. Under co-ordination

The Brady Plan is formally a voluntary framework. However, a truly voluntary scheme will not work. Successful debt reduction will require the creditor governments to firmly co-ordinate the process.

It has been mentioned that banks naturally do not like to recognize a loss; moreover, given that they are highly leveraged institutions, there can be incentives to postpone that recognition.[31] On the other hand, banking regulations, tax considerations, as well as competitive pressures among the banks, can all induce a lender to write-off all or part of a loan.[32] An important point to be remembered, however, is that a write-off of an asset does not extinguish the bank's claim on the debtor country. From the banks' standpoint, for many borrowers (but especially sovereign ones) there is always some possibility, however faint, that the old claim can someday be recovered. That is why the banks' loan loss reserve account in the balance sheet includes an item called "recoveries".[33] Even if there were any doubt about this matter, the sanctity of claims was recently reaffirmed by an important representative of the banking community:

"Bank provisioning is reflective of prudence and conservative accounting; it does not free borrowers from their contractual obligations to service debt or banks from their fiduciary obligation to collect it. The same is true of write-downs, write-offs and other accounting valuations at less than face value."[34]

For the debtor country to receive the benefit of the reduced value of its debt, not only must the debt be written off by the creditor banks, but the lenders also must formally settle the claim at or near its market value. This is the role of debt reduction agreements. However, banks individually have very little incentive to relinquish a claim: if they do, they suffer accounting losses, or lose an option to experience windfall recoveries. Moreover, a bank knows that if it relinquishes a claim through debt reduction, it improves the chances of a competitor bank being paid. Thus as one analyst has acutely pointed out, in a debt agreement the worst option for the borrower is the best option for a single creditor: that is, to do nothing, neither to grant debt reduction nor new money but subsequently and up with an improved credit.[35] This is the "free-rider" problem that has led to the use of bankruptcy courts in domestic markets to apportion the costs/benefits of a liquidation in an organized way among the different creditors.

In sum, the individual incentive to relinquish a claim on terms the debtor can afford is not very strong. Nor will appeals to foreign policy goals or patriotism be likely to make the banks heed creditor government calls for debt reduction; bankers traditionally perceive that their first duty is to their shareholders. Thus, the commercial banks must be politely but

[30] See Kampffmeyer, *op. cit.*, p. 8.

[31] Again, one dollar of capital supports a multiple of interest earning assets. Postponing a loss that would reduce capital can therefore be profitable.

[32] A bank might want to write off questionable loans to demonstrate its capacity to bear a loss and thereby gain a competitive edge with investors in the stock market.

[33] Guttentag and Herring, "Accounting for Losses on Sovereign Debt..." *op. cit.*, p. 7.

[34] The Institute of International Finance, Inc., "The Way Forward for Middle Income Countries", Washington, D.C., January 1989, p. 15.

[35] Richard Weinert, "Comments on the Brady Plan", New York, November 1989.

firmly "pushed" into sizeable debt reduction. Only the determination of the international public sector can do this.

One positive outcome of the Brady Plan which has already been noted is that the creditor governments and multilateral lenders have clearly focussed their concern on the outward transfer of resources and excessive level of debt. It was mentioned that the official jawboning of the banks for debt reduction was impressive in the pilot cases of the Brady Plan. Indeed, such jawboning was so impressive that it is very doubtful that the creditor governments and multilateral lenders will have the time and energy to repeat that type of intensive campaign in 39 or more developing countries. In other words, making debt reduction rely mostly on the vagaries of official jawboning opens up the prospects of a debt reduction process which will be protracted, highly uncertain and asymmetric in terms of its distribution among eligible countries.

Therefore, there is no substitute for a coherent institutional framework that makes each country's offer of debt reduction – within the context of an officially supported structural adjustment programme – one that most banks cannot refuse. The framework must include incentives for good social behaviour and sanctions for anti-social free-riding. So far the Brady Plan lacks such a coherent structure.

It is well known that the regulatory, accounting, and tax practices applicable to the banks sometimes represent obstacles to quickly extinguishing debt claims in developing countries.[36] Some recent rulings on regulatory, tax and accounting matters (outlined earlier in this document) represent helpful developments, but these decisions have been *ad hoc* and related to specific transactions; bankers still face many uncertainties regarding the regulatory, accounting and tax ramifications of negotiating different types of debt reduction scenarios. Moreover, given the great resistance in the banking community to heavily discounted high-volume debt reduction, it is evident that recent advances on this front might need reinforcement through the introduction of other measures.

The Brady Plan's proposal regarding IMF financing assurances is a potentially valuable instrument in co-ordinating debt reduction. The Fund's willingness to tolerate arrears as a means for financing the balance of payments, in circumstances where the banks refuse to reduce debt in appropriate volumes, can have multiple advantages. First, the arrears would provide needed residual financing, which would allow the IMF to introduce more socially efficient conditionality into its adjustment programmes. Second, an official IMF umbrella over arrears would assuage their negative impact on private investors, particularly those who are residents of the debtor country. Third, and as mentioned earlier, the banks would be put under stronger pressure to settle their claims with the problem debtors.

While the Brady Plan's proposal regarding financing assurances is very laudable, it remains to be seen how deep the IMF Executive Board's commitment is to elimination of the debt overhang. In some recent negotiations, the IMF's initially strong commitment to disburse without a prior credit agreement has seemed to waver with time because of concern for the potential ramifications of protracted arrears. IMF policy in this area is certainly a delicate matter, but too timid an application of the Brady Plan's proposal regarding financing assurances will dilute the effectiveness of the debt management strategy.

In sum, the shortcomings of the Brady Plan in terms of underfunding and underco-ordination are very serious. They are compounded by other administrative difficulties such as uncertainty over front-loading of official finance for loan guarantees, and the artificial division of availability of this funding between principal and interest reduction. These problems in the Plan are a major factor contributing to the time-consuming negotiations and enormous delays associated with implementation of debt reduction packages. They also raise legitimate questions about the ability of the Brady Plan to eliminate the debt overhang. Indeed, these obvious shortcomings have generated frustrations that are already beginning to be echoed in declarations that the Plan is dead.[37]

[36] The best review to date on this issue is Bouchet and Hay, *op. cit.*

[37] Peter Truell, "Brady Strategy Rest in Peace", *Wall Street Journal,* 22 January 1990.

IV . TOWARDS A SUCCESSFUL BRADY PLAN: SOME PROPOSALS FOR REMEDIAL ACTION

A. SIX BASIC PROPOSALS

Notwithstanding growing skepticism about the Brady Plan, conceptually it is an important step in the right direction and contains many of the ingredients of a solution. The Plan has moreover made important advances in a relatively short period of time. However, for the new initiative to be successful in quickly eliminating the debt overhang and the excessive transfer of resources, it clearly needs to be strengthened. To this end, six basic proposals are given below which, if implemented, could contribute to a more efficient and effective debt reduction process in Latin America and the Caribbean. Given the systemic character of these proposals, their negotiation and implementation require concerted action not only of the creditors, but also of the debtor countries. The proposals constitute a general framework within which the case-by-case approach can then be successfully applied.

1. A tripling of public resources in support of debt reduction to US$90 billion

A debt reduction of 50% or more could in fact be achieved without any direct use of public resources. If the creditor governments want badly enough to achieve a predetermined level of debt reduction, they probably have the ability to coerce their commercial banks into conforming to the scheme. But there are obviously important political and economic costs in pursuing such a directly combative strategy.

Banks may not passively comply with deep debt reduction by fiat. They certainly could aggressively mobilize their political forces in the home market. Moreover, difficult and embarrassing court battles could follow. As the commercial banks' Institute of International Finance points out:

"Obviously, serious legal complications would result from any mandatory debt relief. In the United States, outright mandatory debt cancellation would be an unconstitutional taking of property unless prompt, adequate and effective consideration were afforded. Schemes designed to conceal the taking over of a property in an effort to avoid a constitutional confrontation would be contested in the courts. If such a contest revealed a taking without consideration, the scheme would be held to be unconstitutional. While not all jurisdictions provide a constitutional protection, or the same requirements of prompt, adequate and effective compensation, a taking of property without compensation is considered equally abhorrent and deserving of compensation. This being understood, any such taking requires that governments provide compensation."[1]

Aside from legal considerations, another reason banks will resist uncompensated deep discounts on developing country loans is that

[1] The Institute of International Finance, Inc., "The Way Forward for Middle Income Countries", Washington, D.C., January 1989, p. 20.

the debt reduction would complicate the management of their balance sheets. Notwithstanding the better reserve position of most banks, some national banking systems in the OECD area are undercapitalized and will be hard-pressed to meet the 1992 risk-weighted capital requirements introduced by the Basle Committee on Banking Regulations and Supervisory Practices.[2] By one estimate, if banks took a 60% write-off of their developing country debt, 17 out of 25 of the world's largest banks would fall below these minimum capital requirements. Moody's also has expressed the opinion that deep reduction of developing country debt will put stress on many banks.[3] Moreover, these types of exercises also assume that the rest of the banks' assets are sound and will not make a claim on capital. However, that may not always be the case. For instance, one recent study suggests that accounting conventions and other techniques have masked a rather general deterioration in United States banking that could rival the crisis of that country's Savings and Loan Associations.[4] Thus, while most banks are in a better position to absorb deep debt reduction, it will still be an economically painful process for many institutions. Comprehensive public guarantees on the bank debt remaining after deep reduction would at least help to strengthen the banks' portfolios and assuage the impact on capital requirements.[5]

Another consideration is the international competitive factor; a 50% or greater debt reduction would not be absorbed evenly across national banking systems because some systems are better prepared to assume the loss than others. In particular, United States banks clearly would be at a disadvantage *vis-à-vis* their European and Japanese competitors, which have had a net windfall gain through appreciating exchange rates that have diminished the weight of the region's debt in their asset portfolio.

Finally, fairness also could be a consideration. It was mentioned earlier that banks, like debtors, got involved in a systemic problem that led to market failure. Banks were clearly motivated by profit-making, but regulatory, macroeconomic and foreign policies all contributed to signals as to where and how much to lend. In other words, as has been mentioned earlier, lax regulation, complacent official attitudes on petrodollar recycling, faith in the efficiency of unregulated international capital markets, and abrupt shifts in world macroeconomic policy also contributed to the problems of the debtors and creditors.

The debtor countries may, of course, be indifferent to many of the above issues related to compensation for debt reduction. What concerns them is the elimination of the debt overhang; how the creditor governments go about doing it can be left to them and their political constituents. Nevertheless, one must be skeptical about the possibilities of creditor governments quickly forcing on the commercial banks a debt reduction of the magnitude discussed here. As is well known, in advanced democratic societies built on consensus such heavy-handed public intervention in the affairs of an entire economic sector is quite uncommon, except in states of national emergency. Thus, it is more realistic to assume that the required debt reduction will quickly emerge only if policies are applied that involve significant incentives as well as sanctions.

A major incentive for the banks is a comprehensive enhancement of the debt remaining after a deep reduction *that*

[2] By 1992 banks in Japan, North America and Europe must have primary (Tier 1) "core" capital, or shareholders equity, equal to 4% of their risk-weighted assets. Secondary capital, made up of subordinated debt, loan loss reserves and other items, will be equal to 4% of risk-weighted assets, giving an overall minimum capital coefficient of 8%. Risk weights for assets vary from 0 to 100%. At one extreme loans to the central governments of the countries in the accord carry a risk weight of zero. Unsecured foreign sector claims, including loans to developing countries, with a maturity greater than one year carry a weight of 100%. See Thomas Hanley, Aaron Gurwitz, and Jay Weintraub, "International Bank Capital Adequacy Proposals: Our Initial Thoughts", New York, Salomon Brothers, January 1989.

[3] See James McDermott Jr., "Banks and Debt Reduction: Legal, Regulatory, Accounting and Tax Issues", New York, Keefe Bruyette and Woods, Inc., October 1989, table 2, and Moody's "The LDC Debt Problem", New York, 30 August 1989.

[4] See R. Dan Brumbaugh *et al.*, "Cleaning Up the Depository Institutions Mess", *Brooking Papers on Economic Activity,* No. 1, 1989, pp. 250-258, and *The Economist,* "The Once-Welcome Properties of America's Banks", 9 December 1989, p. 83, and Michael Quint, "Banks are expected to have difficult years", *New York Times,* 5 February 1990.

[5] This is because the guarantees would lower the risk-weights on the remaining assets.

eliminates the debt overhang in co-operating developing countries. Bonds having comprehensive principal and interest guarantees would allow bank directors to better justify to their shareholders the debt forgiveness implied by formally relinquishing a claim. This is because banks would receive a very tangible and visible benefit for agreeing to the forgiveness that their shareholders and executives traditionally abhor: a solid asset that would allow them and their accountants to forget about the debt problem once and for all. These fully secured bonds would trade easily in the market with little or no discount and thus broaden the region's investor base. Moreover, those banks wishing to preserve a long-term relationship with the region could easily keep the bonds in their investment account since risk-weights on them for purposes of capital requirements would be much lower than the 100% weight imposed on unsecured developing country debt. Also, by allowing the market to put the developing country debt problem behind it, the comprehensive guarantees would bring forward the day when normal credit relations could be re-established.

Such an arrangement would not be without major sacrifices for the banks. After all, they would be required to reduce the debt by a very large amount, so that their claims more closely reflect true market values. Moreover, in reality such guarantees would not be very costly to the public sector: as long as the debt were reduced to serviceable levels, most of the guarantees would be no more than contingent liabilities.

How much would the public guarantees for problem Third World debt cost? Using pre-Brady Plan secondary market prices as a guideline, it is estimated that US$90 billion, or an amount triple current funding levels, would be sufficient.[6] This amount would represent the critical mass of public resources that is necessary to signal to all the eligible debtor countries and market participants that serious adjustment efforts can in fact be supported by deep debt reduction which effectively eliminates the problem of the overhang. Moreover, the US$90 billion of funding would not be unduly onerous, because it would be spread out among at least 10 industrialized countries and the paid-in capital would be as low as 5%-10% of the total.[7]

In sum, if the required debt reduction could be achieved by fiat, it would not involve any direct public outlay of resources. This is an entirely acceptable way to eliminate the debt overhang of developing countries. But in consensual developed societies, it is difficult to imagine that uncompensated reductions of the required magnitude could be quickly imposed upon the banks. Public pressure is likely to be more successful in inducing deep debt reduction if it is combined with the offer of a significant incentive, in the form of a comprehensive enhancement of the debt which is adjusted to serviceable levels. The bulk of the public resources for enhancements moreover should be truly "additional" to existing development assistance, and should probably be in the form of direct guarantees, instead of official loans, which generate their own debt service burden. Assuming that the debt has been reduced to serviceable levels, the guarantees would be contingent liabilities in which the effective cost to the public sector would be relatively minor, as well as being spread out over a large number of creditor governments. Finally, the application of the guarantees would not be revolutionary, since, as shown in chapter II, it merely mirrors the policies pursued by creditor governments in their home market when there are debt problems of systemic proportions.

2. More flexibility in the deployment of official finance

It has been mentioned that guidelines have already been issued for the use of IMF-World Bank resources to finance debt reduction. However, these resources are now arbitrarily divided between loans eligible to finance guarantees for payment of principal/buybacks and loans eligible to finance interest guarantees.

[6] See annex 3.

[7] As indicated in annex 3, in a very limited number of cases there is an opportunity of economizing fiscal resources by limiting public guarantees to temporarily reduce interest payments – e.g., over a medium-term period of five years –, with no guarantees for rescheduled principal. However, this type of solution could only be successful under very special conditions (see again annex 3) and therefore it does not evade the urgency for the comprehensive funding scheme outlined above.

This arrangement hampers debt reduction operations because the compartmentization of monies constrains the configuration of any debt reduction agreement. A debtor country may want to concentrate all its available finance in a straightforward buyback or, on account of the relatively small discounted present value of bond principal, channel most of the official loans into broader interest guarantees on those bonds. Under present arrangements this might prove difficult.

It is also clear that for debt reduction to take place quickly, public resources for guarantees must be front-loaded. The multilateral lenders have shown some flexibility in the pilot debt reduction cases, but they nevertheless still restrict front-loading of all the available finance. Uncertainty over front-loading creates costly delays in negotiations because the parties must spend time coaxing official lenders to bring their resources forward and also exploring ways to bridge financing which is held back. Moreover, concerns for moral hazard may be exaggerated, since the bulk of multilateral loan disbursements are linked to development and the balance-of-payments financing, which remain contingent upon economic performance.

3. Accelerated elimination of certain legal, regulatory,accounting, and tax obstacles to debt reduction

This is an extremely complicated subject made even more complex by the fact that any comprehensive review must direct itself to the specific situation of 10 or more creditor countries. While avoiding a detailed commentary on the situation of the different creditor countries, some broad-based suggestions are outlined below.[8]

A major proposal of a legal nature has already been made by the Brady Plan itself: across-the-board waivers of the sharing and negative pledge clauses in loan contracts. The Plan has, however, apparently backed-off from the proposal due to criticism from the banks and warnings that any elimination of the clauses could encourage creditors to go to court to embargo the assets of problem debtors who are in arrears. This latter concern arises because while the sharing clause is in force banks have less incentive to absorb the costs of court action, since they might have to share any proceeds with other creditors who were mere observers of the legal proceedings.

A waiver of these clauses certainly has some merit. Given the disparate financial conditions of the banks, and their different regulatory, accounting and tax (RAT) environments, a debtor's ability to pursue bilateral negotiations could accelerate the debt reduction process. On the other hand there is also justifiable concern for what might happen if the clauses were suspended. Nevertheless, it is important to point out that the potential legal difficulties that the banks could cause a debtor would perhaps be minimized if arrears were protected under an official umbrella. This is a subject that will be returned to in the fourth basic proposal outlined below.

One key general need in the RAT area is greater transparency. Regulatory, accounting, and to some extent tax rules all tend to be so broadly defined that their application involves a considerable amount of discretion by creditor government authorities. While this situation permits flexibility in the day-to-day overseeing of the financial system, it also generates uncertainty in the negotiations concerning debt reduction. Unless banks have a fairly clear idea of what the RAT implications of different debt reduction scenarios are, they will be constrained in their ability to quickly negotiate innovative agreements. Authorities now tend to make their pronouncements on a transaction-by-transaction basis. It would be helpful if the relevant government authorities could make advance pronouncements on the probable RAT implications of the range of debt reduction techniques that are likely to emerge in current negotiations.

There could also be more co-ordination among the regulatory and accounting

[8] Recently some studies have emerged on the regulatory accounting and tax obstacles to debt reduction. The most comprehensive study is Bouchet and Hay, "Overview of Banking Regulations in OECD Countries and the Potential Accounting and Fiscal Obstacles to Negotiated Market-Based Debt Restructuring", Washington, D.C., World Bank, 1989. Also see Stephany Griffin-Jones, "European Banking Regulations and Third World Debt: The Technical, Political and Institutional Issues", Brighton, England, Institute of Development Studies, September 1989, and Mary Williamson, "The Role of Banking Regulations in Third World Debt Strategies", Washington, D.C., Overseas Development Council, May 1988.

authorities in the Group of Ten, along the lines of the recent Basle Agreement on regulatory capital. Some harmonization of tax codes could also be considered, although this is admittedly a much more difficult task because tax laws represent a tight-knit system rather than a collection of isolated rules. In any event, harmonization of rules – at least for problem developing country debt – is important for at least a minimum of three reasons. First, in face of the inability to negotiate debt reduction bilaterally, disparate RAT codes make it difficult to design debt reduction packages that are accommodating to all banks. Accommodation now is achieved through a proliferation of options for the banks that are difficult and time-consuming to negotiate, and not very transparent in terms of their cost to the debtor country. Second, individual governments will be reluctant to liberalize their interpretation of RAT codes for purposes of achieving developing country debt reduction if they believe that other governments will free-ride by leaving their less generous systems intact. Third, the disparate RAT frameworks mean that debt reduction does not take place among equals, i.e., some banks may receive more favourable treatment than others, thus giving them a competitive advantage. A bank's concern for the competitive repercussions of an agreement also slows the negotiations.

In the regulatory arena, one clear need is to officially pressure the banks to quickly and uniformly raise their loan-loss provisions on medium-term debt to levels equivalent to secondary market discounts, i.e., 65-70%. In the last quarter of 1989 only the German and Swiss banks broadly conformed to this criterion. Moreover, to increase the incentives to participate in debt reduction, loan loss reserves could be excluded from primary capital; that way the cost of carrying problem loans is higher and the capital cost of recognizing a loss is lower. Currently French and United States banks can count reserves as capital, although their ability to do this will diminish as the Basle Agreement's capital requirement rules are phased in during the early 1990s.

Also in the regulatory area, authorities could liberate banks from provisioning assets received in officially-sanctioned debt-for-bond exchanges. This, of course, is more feasible in a regulatory context when debt reduction eliminates the debt overhang and the value of the new assets is protected by comprehensive public guarantees.

Some forbearance in the accounting area could also encourage debt reduction. For instance, authorities could avoid accounting interpretations which cause losses accruing in officially sanctioned reduction programmes to contaminate the value of the rest of the loan portfolio.[9] Since delaying recognition of a loss can be valuable to a bank, authorities might also consider permitting banks to amortize over a number of years those losses realized on assets offered to official debt reduction programmes.[10] In addition, assets received in exchanges could be valued at their face value until time and experience dictated that another lower value was justified. Finally, while liberalizing accounting treatment for officially sanctioned debt reduction, authorities might simultaneously tighten accounting rules for sales of debt to third parties that do not reduce the claim on the debtor country.

As far as tax codes are concerned, it is clear that the cost of debt reduction for a bank is less – and the incentive for reduction greater – if the loss brings favourable tax treatment. Loan-loss reserves are tax-deductible in most European countries. This explains why their banks tend to have the highest loan-loss reserves. However, since the tax advantages are already accrued upon the creation of the

[9] For instance, in early 1988 United States authorities ruled that any debt tendered in the Mexican-Morgan Guaranty debt-bond exchange must be marked down to the tendered price even if the discount was not accepted by the Mexican authorities. This obviously discouraged the participation of many United States banks.

[10] In 1987 United States authorities allowed banks to amortize losses on their agriculture loans over a period of seven years. See United States Comptroller of the Currency, United States Federal Reserve System and United States Federal Deposit Insurance Corporation, "Study on Accounting and Regulatory Policies Affecting Debt Restructuring", Washington, D.C., 1989.

loan-loss reserves, there is no incentive altogether to recognize the loss in a formal debt reduction agreement.[11] Indeed, if a bank has reserved in excess of the discount on the debt reduction agreement, it will owe money to its government. In effect, by reserving in excess of expected losses a bank receives an interest-free loan from its government.

On the other hand, another possible objective is to have the banks increase their reserves to a level compatible with secondary market discounts, and tax allowances have been shown to be an effective incentive in this regard. Perhaps one way around the dilemma is to limit the tax-deductible reserve level to that which is justified by secondary market quotations, and make the benefit contingent upon participation in an officially-sanctioned debt reduction exercise. Thus, if the bank refused to reduce debt when the official opportunity arose, the tax allowance – with the corresponding interest – would revert to the creditor government.

Other tax considerations might include more flexibility in allowing banks to benefit from eligible tax deductions. A bank's ability to secure benefits depends on its overall state of profitability and accumulated tax benefits from other operations in the bank's network. Care could thus be taken to ensure that tax benefits from official debt reduction exercises do not prejudice access to other available tax allowances. A liberal attitude could also be taken with regard to allowing banks to protect their tax benefits by carrying them forward and backward over an extended number of tax years.[12]

While it is clear that innovation in the application of RAT codes could accelerate the debt reduction process in developing countries, one must be cautious about the possibilities for dramatic advances in this area. As is often the case, creditor government policy has been out of phase with the debtor countries' objective requirements. During the 1970s, when finance was abundant, the RAT structure was extremely permissive; consequently, with the crisis of the 1980s there has been a decisive shift towards tightening regulations rather than loosening them still further. Thus, modification of the RAT environment for developing country debt reduction must compete with the North's broader objective of a systematic tightening of rules and a reduction of exceptions to them. Furthermore, some innovations in the regulatory and tax area may also require changes in domestic legislation, which is known to be an uncertain and time-consuming process.

4. More assertive and transparent IMF policy on financing assurances

As was stated earlier, a key to the success of the Brady Plan is achievement of debt reduction that truly eliminates the debt overhang. This is where the IMF can play a vital role.

The first order of priority is that the IMF, in conjunction with a co-operating debtor country, should make a professional estimate of what the *ex ante* annual payments capacity of the debtor country is over an extended period of structural adjustment, say five years.[13] In estimating that capacity, explicit account should be taken of the need for reasonable growth rates, and room should be made for an urgent recovery of investment in human and physical capital. Moreover, an adequate cushion should be built into the calculation of payments capacity so as to leave little uncertainty in the private sector about the defined level of payments being achieved; tolerance of razor-thin margins of error will merely debilitate the structural adjustment programme by restraining private sector

[11] French banks are particularly insulated from incentives for debt reduction because their loan loss reserves are both tax deductible and included in capital. Moreover, French authorities have stated that they will allow their banks to take advantage of a temporary exception in the Basle Agreement which allows banks to have loan loss reserves included in capital in excess of the 1.25% limit established for 1992. See Bouchet and Hay, "Overview of Banking Regulations in OECD Countries...", *op. cit.*, p. 117.

[12] An example of a controversial decision occurred in the United States in May 1989 when authorities ruled that for the purpose of applying foreign tax credits, loan-losses must be distributed proportionally to the split between foreign and domestic assets. This will restrict United States banks' ability to assign foreign loan losses to domestic income, which in turn could cause them to lose available foreign tax credits. See David Wessel and Robert Guenther, "IRS Ruling Limits the Tax Advantages Banks Get on Foreign-Loan Write-Offs", *Wall Street Journal*, 4 May 1989.

[13] Five years exceeds the time horizon of a Fund programme. But since the programmes are renewable, there is nothing harmful in looking five years ahead.

activity and postponing the return of domestic capital flight.

The IMF pronouncement on payments capacity must be the basis for determining the required debt and debt service reduction by private creditors. If clearly justified on the *technical* grounds of the debtor's future capacity to pay, new bank lending could also be an option in the agreement. Thus, the IMF would clarify and validate a required volume of debt relief; how the banks achieved that volume would be a matter of negotiation between the creditor and debtor. Since the IMF would explicitly build a large financing cushion into its calculations, debt reduction agreements obviously should also have generous recapture clauses that allow banks to participate in any *ex post* capacity to pay that exceeds the official *ex ante* estimates.

The IMF should also, if necessary, defend its calculations by indefinitely tolerating arrears owed to private creditors who did not accept to adjust payments to the officially determined level of the capacity to pay. Ideally, the Fund could formally protect the debtor country from unruly creditor behaviour by sanctioning arrears as an exchange restriction under Article VIII(2)(b) of its Articles of Agreement. Some legal experts think that arrears –in the context of an officially monitored adjustment programme– can be interpreted as a legitimate exchange restriction that can be temporarily approved by the Fund.[14] While the use of Article VIII(2)(b) could, and probably would, be contested, banks nevertheless might think twice about harassing a country in arrears if it is successfully adjusting its economy with the unqualified backing of the IMF's Executive Board and management.[15]

A very assertive IMF policy of the type described is extremely important as long as the Brady Plan is underfunded. This is because it could serve as an "escape valve" that lowers the transfer of resources even though debt claims have not been formally reduced by the required amount. In effect, then, a bolder IMF policy could serve to temporarily delink the question of efficient adjustment, growth and their financing from the longer-term problem of the reduction of the debt overhang.

5. Reduction of Paris Club debt

There are inconveniences in reducing only commercial bank debt. On the one hand, the amount of debt reduction that the banks must grant to eliminate the debt overhang is bigger when other claims are not subject to adjustment. On the other, as mentioned earlier, a relief programme which concentrates on reduction of bank debt has relatively minor benefits for many small and medium-sized countries which have relied mostly on official sources of finance. Finally, the pain of debt reduction is certainly magnified for the banks when they are the only lenders granting it.

The Toronto Summit of June 1988 adopted an interesting policy to reduce official Paris Club debt in low income countries. The options of the creditor governments are to i) write-off one-third of the debt and reschedule the rest over 14 years (eight years' grace); ii) reschedule over 25 years (14 years' grace); or iii) reschedule debt over 14 years, with interest rates reduced by up to 3.5 points. As of June 1989, 13 sub-Saharan African countries have benefited from one of these options.[16] At the very least it would be advisable for the OECD governments to extend this programme –or variants of it– to low and middle-income developing countries in other developing regions which have problems in the service of their official debt.[17]

[14] See Whitney Debevoise, "Exchange Controls and External Indebtedness: A Modest Proposal for a Deferral Mechanism Employing Bretton Woods Concepts", *Houston Journal of International Law*, vol. 7, No. 1, Autumn 1984, pp. 157-168.

[15] Note that IMF protection of arrears would not formally question the ultimate value of the claim and hence would not be an imposed reduction of debt; rather it could be interpreted simply as a temporary restriction.

[16] See UNCTAD, *Trade and Development Report, 1989,* New York, United Nations publication, Sales No. E.89.II.D.14, p. 53.

[17] The amount of reduction of bilateral debt required to restore growth will depend on adequate external conditions and the strength of the positive externalities derived from a dramatic concerted programme to eliminate the debt overhang. If external conditions are adverse and/or positive externalities weak, a debt reduction more ambitious than that contemplated in the Toronto Summit accord would be required. For a review of this more pessimistic scenario see ECLAC, *Crecimiento económico y endeudamiento externo en América Latina": las propuestas de reducción de la deuda en contraste con un financiamiento externo restringido* (LC/R.871), Santiago, Chile, January 1990.

6. New mechanisms to assuage the burden of debt service owed to multilateral lenders

In recent years lending by multilateral agencies has grown much faster than lending from all other sources of financing. Consequently their participation in the total debt of the region has risen from 6% in 1982 to more than 15% in recent years (figure 6). The 15% participation of the multilateral lenders might suggest that they are at the margin of the region's debt problem. This is not entirely correct, however.

On the one hand, the regional average masks a situation in which some countries are deeply indebted with the multilateral lenders: Saint Lucia (68%), Dominica (60%), Haiti (59%), Guyana (53%), Honduras (44%), Jamaica (43%), Grenada and El Salvador (42%), Paraguay (39%) and Colombia (36%). On the other hand, the weight of debt service to the multilateral agencies has been aggravated by the fact that in recent years many countries have experienced a persistent negative transfer of resources from these lenders. The outward transfer manifests itself in the regional aggregates: the IMF's transfer was negative in 1986-1988, while the World Bank and IDB registered negative transfers in 1987-1988 (table 10). Moreover, preliminary information suggests that the transfer was again negative for all three institutions in 1989. Finally, the retreat of private banks from the region, coupled with the reluctance of export credit agencies to renew their lending, has made the multilateral financial institutions the only elastic source of financing for Latin America and the Caribbean. Thus the share of multilateral debt in total debt can be expected to continue to rise in the years ahead.

The growth of multilateral obligations in a situation where the overall problem of the debt overhang remains unresolved creates its own difficulties for the region. This is because these lenders traditionally consider that their debt enjoys preferential status and that therefore repayment schedules should remain unaltered. Consequently, as already noted, the increased participation of these obligations in the total stock of debt creates rigidities which can complicate debt service problems. Indeed, the preferential status of these organizations is already being breached by the weight of the global debt problem. During 1989 11 developing member countries of the IMF were in serious arrears with that institution, while nine members of the World Bank and four members of the Inter-American Development Bank were in arrears due to their general debt servicing problems. It is clear, then, that as part of an overall solution to the debt problem, ways must be found, if only transitorily, to lighten the weight of debt payments to the multilateral agencies.

One way to relieve the burden of multilateral debt may be to have these agencies more aggressively exploit existing lending capacity.

It would appear that multilateral lenders have the capability to disburse more resources than they have recently been programming. Indeed, this was demonstrated when the World Bank and IMF suddenly announced that they would each be able to disburse "additional" resources of US$6 billion out of existing capital in support of debt reduction. It has already been pointed out that disbursement of loans for debt reduction that only partially eliminates the debt overhang could be an inefficient allocation of resources. Thus, in situations where it is not feasible to achieve debt reduction agreements that represent a definitive settlement of the overhang, the World Bank and IMF might consider gradually freeing-up some of the so-called "additional" resources for project lending and balance-of-payments support. A policy which in principle would allow multilateral lenders to gradually shift funds earmarked for debt reduction into conventional loan programmes might also serve to pressure the banks into a final settlement of their claims.

The International Monetary Fund is exceptionally liquid. Of the US$80 billion available in convertible currencies, roughly half was uncommitted in 1989.[18] In view of the weight of the negative transfer to the Fund and the foreign exchange constraints of the developing countries, efforts could be made to channel more of these liquid resources to borrowers.

One potential way to do this is to liberalize the Fund's newly created Compensatory and

[18] See Arturo O'Connell, "La Deuda de los Países de América Latina y los Organismos Internacionales de Financiamiento", Buenos Aires, November 1989.

Table 10

LATIN AMERICA AND THE CARIBBEAN: NET TRANSFER OF RESOURCES WITH MULTILATERAL LENDERS

(Billions of dollars)

	1983	1984	1985	1986	1987	1988
Total	**7.5**	**5.2**	**2.5**	**1.1**	**-2.3**	**-2.9**
IMF	5.7	2.7	0.6	-0.8	-1.7	-2.1
World Bank	0.8	1.1	0.7	1.4	-0.5	-0.7
IDB	1.0	1.4	1.2	0.5	-0.1	-0.1

Source: ECLAC, on the basis of data from the three institutions.

Contingency Financing Facility, which extends financing for, among other things, the impact of rising interest rates. Conceptually the Facility is a major advance that gives realization to a long-standing proposal of developing countries. Yet the effectiveness of this new window at the Fund has been hampered by having its availability linked to a formal adjustment programme, with the concomitant conditionality, and a series of tight ceilings through the quota system. For the new window to effectively compensate exogenous shocks outside the control of the member country, access should perhaps be linked to low-level conditionality like that applied to the old Compensatory Financing Facility. Moreover, resources at the disposal of a country could also be more objectively determined by the magnitude of the exogenous shock.

More generally, the Fund's resources might be exploited better if countries became less inhibited about signing onto Fund programmes. Among the ways that this could be achieved would be for the Fund to make its conditionality more flexible and more directly lined to growth. The Extended Fund Facility, in principle, is a vehicle for achieving this goal. It encompasses a three-year (or, exceptionally, four-year) time horizon. Yet to date it has not been a popular facility in the Fund: indeed, in October 1989 only four countries were participating in this programme.

The Fund has recently expressed a willingness to consider the use of six-monthly performance criteria instead of the traditional quarterly review. The Fund's Extended Facility would perhaps become a more widely used programme if six-monthly reviews became a standard operational practice. Indeed, in some areas of policy annual reviews might even be more appropriate. Another possible way to induce a greater medium-term commitment to adjustment is to explore a recommendation made in 1987 by the Group of 24 which pointed to the need to complement the Fund's traditional "adjustment" exercises with explicit "growth" exercises.[19] If the Fund's facilities had a more vivid identification with economic growth, it would undoubtedly find greater demand for a medium-term commitment to adjustment programmes.

[19] Group of Twenty-Four, "The Role of the IMF in Adjustment and Growth", Washington, D.C., March 1987.

All this being said, the Fund, as a keystone of the international lender-of-last-resort system, undoubtedly needs the credibility of an impeccable liquidity position with which to confront unforeseen contingencies in the world currency. Thus the Fund might be more disposed to liberalize access to existing liquid resources if it could be assured of an imminent major quota increase. This consideration, coupled with the legitimate need to strengthen the ILLR, lends much importance to the IMF Managing Director's call for a 100% increase in Fund quotas.

While the burden of multilateral debt service during this difficult period of adjustment would be assuaged through the more agile disbursement of existing resources, temporary relief could also be effected through softer repayment schedules on regular loans.

In view of the fact that the World Bank is a public development bank, it might be justified in extending the current repayment schedules, which allow for a grace period of five years and an overall repayment schedule of 15-17 years, for even private commercial banks now routinely award problem debtors seven years of grace and overall repayment schedules of 15 or more years. Another way to reduce rigidity in repayment schedules would be for the World Bank to generalize the system of repayment in fixed quotas, which is now made available only to low-income countries. The Inter-American Development Bank also might explore ways to extend repayment periods on its regular loans.

The Fund has the statutory capability to lengthen its repayment periods. Currently repayment schedules vary from 3 1/4 to 10 years, depending on the facility used. In view of the great difficulty many countries are having with their debt service, and the degree of liquidity in the Fund, a temporary lengthening of repayment schedules may be warranted.

Finally, special arrangements must be found for countries which have fallen into protracted arrears with multilateral lenders and wish to restore their creditworthiness. The IMF has experimented with the establishment of special international support groups, in which a creditor government mobilizes resources for the problem debtor that in turn can be used to liquidate arrears with the Fund. The new mechanism shows promise and is already being employed in one Caribbean country (Guyana). Similar rescue plans might be explored at the World Bank.

B. A PROPOSED AMENDMENT TO THE PLAN: A BRADY DEBT FACILITY

Secretary of the Treasury Nicholas Brady's proposal has emerged as the new official debt management strategy. There are many other legitimate ideas, however, on how the debt problem can best be dealt with in a concerted way. Indeed, the failure to resolve the problem has not been due to a lack of innovative ideas for concerted solutions. One recent study which reviews proposals for resolving debt service difficulties counts the number of schemes since 1983 at no less than 81, including Secretary Brady's Plan.[20] This is even an underestimate, since the study's list does not pretend to be exhaustive; it excludes, *inter alia*, the revised proposal by the Permanent Secretariat of the Sistema Económico Latinoamericano (SELA), which involves debt and debt service reduction of 75%.[21]

The Brady Plan is still largely a piecemeal, *ad hoc* programme. This type of strategy has serious inefficiencies. The precise direction of the Plan is always in doubt, which raises uncertainties for both debtors and creditors. In the environment of finance, where confidence plays an unusually important role, these uncertainties curtail private sector activity and the sustained repatriation of capital flight, thereby diluting the effects of any positive incentives that the Plan may introduce into the management of the adjustment problem. Moreover, given that systemic problems are

[20] Morris Miller, "Resolving the Global Debt Crisis", New York, United Nations Development Programme, UNDP Policy Discussion Paper, 1989, pp. 132-144. United Nations publication, Sales No. E.89.III.B.3.

[21] See SELA, "Proyecto Revisado. Propuesta Latinoamericana y Caribeña sobre deuda externa", Caracas, 15 December 1989.

characterized by externalities that link the fate of the individual economic agents, an *ad hoc* approach foregoes the potential gains in efficiency that can be achieved by simultaneously and comprehensively acting on a number of fronts.[22] Another way of looking at this is that a dollar of public money spent on a comprehensive programme should yield more benefits in terms of resolving the problem than a dollar spent in a piecemeal, *ad hoc* fashion.

It is precisely because of this consideration that since the beginning of the crisis there has been a continuous flow of proposals for establishing a special international facility to assist in the reduction of the debt overhang. Indeed, since 1982 more than a quarter of all proposals for an international concerted solution have involved an international facility of some type.[23] The proponents of a special facility range from distinguished academics, bankers, and Latin American and Caribbean governments, to even a president of a major creditor country.[24]

While the exact configuration of an international debt facility is subject to variation, the basic idea is simple enough.[25] A special facility, either as an independent entity, or as an affiliate of the World Bank, IMF, or both, would purchase the debt from the banks at an established discount that took into account the sustained capacity to pay of the debtors. The purchase would be effected by issuing to the banks long-term bonds with market interest rates, perhaps with caps. The facility would then pass part of the discount on to the debtors by negotiating lower debt and debt service payments by them. Importantly, the debt relief would be contingent on progress in completing officially-sponsored structural adjustment programmes.[26] Capital backing for the facility would come from direct contributions of the creditor governments, drawings on existing idle multilateral funds,[27] a new issue of SDRs,[28] or some combination of all of the above. Paid-in capital could be only 5%-10% of the total commitment, while voting in the facility would be weighted by the capital contributions of the donors. Sometimes the proposals also suggest that the facility should have an advisory board made up of representatives from the banks and the debtor countries.

The official managers of the debt problem have always objected to the establishment of a facility. Arguments vary, but the central reservations are that a facility would i) be more expensive than the Brady Plan and shift risk to creditor governments; ii) lower secondary market price quotations; iii) create mandatory

[22] For example, given that capital markets have difficulty discriminating among borrowing countries in the area of crisis, it is possible that often a critical mass of countries must restore their creditworthiness before any one country can gain significant access to voluntary credit markets.

[23] Calculated from Morris Miller, "Resolving the Global Debt Crisis", New York, United Nations Development Programme, UNDP Policy Discussion Paper, 1989, pp. 132-144. United Nations publication, Sales No. E.89.III.B.3.

[24] A selected list would be as follows. Distinguished academics: Peter Kenen, "A Bailout For the Banks", *New York Times*, 6 March 1982 and Jeffrey Sachs, "New Approaches to the Latin American Debt Crisis", Cambridge, Mass., Harvard University, Department of Economics, 1988. Bankers: James Robinson, "A Comprehensive Agenda for LDC Debt and World Trade Growth", London, the Amex Bank Review Special Papers, No. 13, March 1988. Latin American governments: Carlos Andrés Pérez, Speech to a Symposium on International Economics, Davos, Switzerland, 26 January-1 February, 1989; David Coore, Minister of Foreign Affairs and Foreign Trade of Jamaica, speech delivered at the forty-fourth regular session of the United Nations General Assembly, New York, 4 October 1989, p. 9, and the Group of Eight, "Hacia Una Solución Para el Problema de la Deuda Externa de América Latina", Rio de Janeiro, December 1988. President of a creditor country: François Mitterrand, Speech before the General Assembly of the United Nations, 29 September 1989. ECLAC has also supported this approach. See ECLAC, *The evolution of the external debt problem in Latin America and the Caribbean* (LC/G.1487/Rev.2-P), Estudios e Informes de la CEPAL series, No. 72, Santiago, Chile, 1988, chapter III.

[25] For a good overview of the different options for establishment of an international debt facility, see United States Congress, House of Representatives, "Report on an International Debt Management Authority", *op. cit.*

[26] In many of these proposals only the debtor's debt service is reduced; the original claim remains unaltered. The facility would forgive part of the debt only in time and then after the country had established a track record of policy reform and good economic performance.

[27] The principal focus has been on profits from sale of IMF gold reserves. See John LaFalce, Congressman, United States House of Representatives, "Third World Debt Crisis: The Urgent Need to Confront Reality", *Congressional Record*, vol. 133, No. 34, 5 March 1987.

[28] The use of SDRs is a central feature of the Mitterrand Proposal.

prices for debt reduction, and iv) violate a market-oriented approach to debt reduction.[29]

It may be that all these problems are exaggerated. A facility would certainly raise demands for public funding above current levels. However, it was shown earlier that the Brady Plan, even to work effectively on its own terms, will itself require a much larger resource commitment from the creditor governments. Indeed, the total amount of resources that the Brady Plan would ultimately need to fulfill its objectives would – because of the inefficiencies of an *ad hoc* approach – probably be greater than that required by a facility. Since most of the facility's capital commitment would be truly additional, rather than draining away current funding for development, it would make fiscal demands on the creditor governments. But then again, any meaningful increase in the US$30 billion already assigned to Brady Plan debt reduction would also probably have to come mostly from truly additional sources of funding.

As for the shift of risk to the public sector, it has already been shown that this has been occurring anyway at an accelerated pace as the private-oriented market solutions have failed to halt the deterioration in the debtors' economies and creditworthiness. It has been pointed out, moreover, that an underfunded Brady Plan promises to shift risk to the public sector even more rapidly than before. Indeed, one of the lessons of the systemic Savings and Loan Association crisis in the United States is that piecemeal public intervention at the beginning of a crisis can lead to much larger public costs later on, as the problem expands in scope and difficulty.

It is true that a facility would very likely establish mandatory prices for debt exchanges. The important point to note, however, is that they would not be arbitrary prices, but would be based on professional estimates, worked out in conjunction with the IMF and World Bank, about the sustained capacity of the debtor to service his obligations. Moreover, discrepancies with these estimates could be worked out through the use of equity-type participation of the banks in the facility, which is similar in effect to a recapture clause.

The present study has already pointed out that a truly voluntary market-oriented approach to debt reduction cannot possibly eliminate the debt overhang in any reasonable timeframe. The Brady Plan has discovered in its initial pilot cases that agreements involving significant debt reduction require enormous direct pressure from the creditor government authorities. A debt facility would not be any less "market-oriented".

Finally, regarding secondary market prices, they have been seen to be plunging without the presence of a debt facility. Moreover, debt exchanges with a facility would be based on informed multilateral estimates of the debtors' capacity to sustain a certain level of debt service. That estimate would in turn be empirically founded on the conditions of the country and not blindly based on secondary prices as such. Indeed, if those prices incorporated a large element of "unwillingness to pay", there would be differences between the price of the instrument which is offered to the banks and the quotations in secondary markets.

All this suggests that the objections to a debt facility may be overstated if the underlying goal is a management strategy that can effectively eliminate the debt problem. Indeed, to fulfill its own stated objectives, the Brady Plan would be more effective and cost-efficient if it quickly evolved into a Brady debt facility. This is because a facility has many advantages over such an *ad hoc* scheme.

First, a facility would represent a dramatic shift to a comprehensive approach after eight years of ineffective, piecemeal strategies. By establishing the facility and granting it an initial capital authorization sufficient to deal with the global problem, the creditor governments would be providing a very visible symbol of their full commitment and determination regarding the resolution of the problem of the debt overhang and the outward transfer of resources. The enhanced credibility of the debt reduction programme could, moreover, create positive externalities. On the one hand, debtor governments would have more incentive to adjust because the creditor governments' irrevocable commitment to debt reduction would leave little doubt about the reward for "good behaviour". On the other hand, the

[29] See United States Department of the Treasury, "Interim Report to the Congress Concerning International Discussions on an International Debt Facility", Washington, D.C., March 1989.

facility could represent the critical mass of assistance that the private market needs to reverse its negative expectations about Latin America and the Caribbean; this would not only raise entrepreneurial spirits, but also contribute to a more permanent return of capital flight.

Second, a facility would enhance accountability in the management of the debt problem. A decentralized *ad hoc* programme such as the Brady Plan makes it difficult to evaluate performance because debt reduction is a secondary or tertiary responsibility of several entities with very different primary mandates. As a consequence, the worst of both worlds is often encountered: managers cannot pay sufficient attention either to their primary mandates or to debt reduction, with the result that both suffer. A special facility, in contrast, would have a single mandate of debt reduction and the effectiveness of policy could be more easily evaluated. Moreover, the facility, by centralizing information, could allow for a better evaluation of the performance of the different creditors and debtors involved in negotiations for debt reduction. The facility would also allow creditor government ministries and international organizations now closely engaged in debt reduction processes to become more detached and thereby give greater attention to their primary mandates.

Third, the facility would give more flexibility to debt reduction exercises. The World Bank, IMF and other official lenders were not originally established to be debt reduction agencies. Given their particular Articles of Agreement, the modalities of debt reduction must conform to the constitutional guidelines on what these organizations are allowed and not allowed to do. Moreover, the Group of Ten shareholders are, quite correctly, ambivalent about any major changes in these organizations' behaviour, because in their own words "the fundamental nature of the two institutions must be preserved".[30] By setting up a facility from scratch, it would be unencumbered by tradition and existing statutes and therefore could be given an operational structure specifically designed to accelerate the debt reduction process. For instance, there would be no restriction on direct entanglement through guarantees (as is the case now for the IMF), and the capital which backs guarantees could be leveraged.[31] There would also be no need to give preferential status to the facility; hence it could subordinate its debt to new lending, which presumably would accelerate the debtors' reintegration into capital markets.[32] Moreover, voting in the facility would conform not to the distribution of existing shares in the multilateral lenders, but rather to the weight of the new and specific financial commitments of creditor governments to the debt reduction process. Thus with more voting power in terms of how debt reduction funds are used, countries with balance-of-payments surpluses (including those in developing areas) might be more inclined to become involved in the debt reduction process.[33]

Fourth, the institutional flexibility of a facility would allow it to control moral hazard problems more efficiently than the current framework, since the facility would have the capacity to provide problem debtors with immediate debt service reduction, but at the same time it could grant debt forgiveness in a more measured way, based on progress in economic policy reform.

Finally, a facility should provide for more evenness in the debt reduction exercises. The experience with the ad hoc approach is that debt relief tends to reach those countries which are of special political significance to the creditor countries. A new facility, of course, would not be insulated from this type of pressure. But by being a centralized and transparent agent of debt reduction, it certainly might be feasible to check this tendency and distribute relief more quickly to a broader range of debtor countries.

[30] Group of Ten, "The Role of the IMF and the World Bank in the Context of the Debt Strategy", a Report to the Ministers and Governors by the Group of Deputies, June 1989, paragraph 26.

[31] This should not greatly weaken the guarantees because investors would probably estimate that in practice the facility was backed by the full faith and credit of its shareholders. This is at least the experience in the domestic markets of the creditor countries when their governments establish special financing agents for public bailouts.

[32] Robinson, *op. cit.,* proposed subordination of his facility's claims.

[33] It should be noted that if the debt reduction process is successful in returning the developing countries to growth, the facility will return a profit to its shareholders.

In sum, the proposals presented above would clearly require the international public sector to assume a much larger share of the risk of resolving the debt overhang of the developing countries. However, as long as banks are required to reduce debt to levels compatible with renewed investment and growth in the debtor countries, the public sector's assumption of more risk would not be a "bail out of the banks". Rather, it would be a "bail in" of the international public sector which has been exceedingly reluctant to assume responsibilities that are proper to its domain when there is a major systemic problem such as that observed in the excessively indebted developing countries. It has been shown, moreover, that socialization of a systemic problem is a frequent practice in the domestic markets of the creditor countries; indeed, experience demonstrates that the public sector's tardiness in comprehensively intervening in a systemic problem and socializing its costs only deepens the problem and raises the eventual cost for taxpayers. It must also not be forgotten that OECD governments are partly to blame for the creation of the debt overhang in developing countries, due to the very lax regulation of the banks during the 1970s, their insistence that private lenders should take primary responsibility for recycling petrodollars, and their macroeconomic policies which caused interest rates to skyrocket and commodity prices to fall in the 1980s. Thus, co-responsibility and burden sharing are also compelling reasons for more ambitious public management of the debt problem.

On the other hand, these basic proposals constitute a general framework within which case-by-case agreements can be reached. Negotiating their implementation is a task that can only be undertaken by debtors and creditors in a concerted fashion. Some negotiating mechanisms are already in place but could be improved upon, or else new mechanisms could be created, for example, within the United Nations. The lack of a forum should not prove to be an unsurmountable obstacle. If it were, debtor countries would probably be pushed further into payments restrictions, delaying a definite solution of the crisis and increasing its cost.

V. THE OPTION OF A UNILATERAL PAYMENTS RESTRICTION

The international debt facility is clearly a good idea, which best expresses the principle that systemic public problems demand public solutions. Perhaps this explains why the proposal for a facility has constantly re-emerged in the eight years of debate about how to resolve the debt burden and the excessive transfer of resources. But being a good idea is obviously not enough; without political support the idea will not evolve beyond being just one more of the many debt proposals on record. In this regard, the current Brady Plan is today the only operative strategy in the realm of concerted solutions.

Most observers would agree that a concerted solution is clearly the first best option for resolving the problem of debt and the excessive transfer of resources. However, emphasis must be placed on the word *solution:* a concerted strategy which does not constitute a solution is not necessarily optimal for debtors, creditors, or society-at-large. Indeed, it has already been seen that the concerted approach of the first three phases of the international debt management strategy has been incapable of avoiding stagnation in the debtor countries' growth and socioeconomic development. Indeed, it may even have helped to increase the burden of the debt overhang.

The Brady Plan has the basic ingredients of a long-term solution. Yet it was illustrated in the previous section that the Plan suffers from serious underfunding and underco-ordination, which raises the spectre that the international debt management strategy could once again fall short of the objective requirements for resolving the problem of the region's debt overhang. Moreover, making the Plan more robust will not be an easy task. The driving force behind the Plan is the United States government. However, its capacity to finance ambitious international initiatives is now hampered by a serious fiscal disequilibrium, and it remains to be seen to what degree the European and Japanese governments will be willing and able to pick up the slack in the management of the problem.

Given this difficult panorama, it could certainly be a costly matter for the Latin American and Caribbean countries to wait for a global solution to the debt and transfer problems to emerge from the developed world. Of course, given the objective differences among the countries in the region, some will undoubtedly find advantages in managing their debt problem within the confines of orthodoxy. Other countries, however, faced with the destabilizing effect of an excessive outward transfer of resources, have been obliged to opt for a unilateral restriction of debt service payments.

The purpose of the unilateral restrictions on debt service observed so far has been to lower the transfer of resources to levels below that which would probably be demanded by the creditors. On the one hand, the arrears can buy time and provide financing to efficiently undertake necessary economic adjustments. On the other, the arrears force markets to adjust their expectations about the value of the debt and thereby put downward pressure on prices in secondary markets. This in turn sets the stage for the eventual negotiation of a settlement of the claim at less than its face value. Thus, arrears can – albeit at the cost of running some risks – forcibly extract financing from a closed-down private credit market and serve as a bargaining tool for settlement of an overvalued claim.

A. PAYMENT RESTRICTIONS IN LATIN AMERICA AND THE CARIBBEAN

Unilateral restrictions on the payment of debt can be viewed as the other side of the coin of a flawed concerted debt management strategy. It is therefore not surprising that the number of countries with arrears in their debt service payments has been on the rise since 1985. Indeed, by 1987 the phenomenon of arrears

had become rather generalized. Excluding Colombia, which has never had a debt overhang as such, among the problem debtors in Latin America only Mexico, El Salvador, Chile, and Uruguay avoided running into serious arrears with one or more of their foreign creditors during 1989[1] (see table 11).

In the context of the current crisis, the first protracted unnegotiated restrictions on payments in Latin America and the Caribbean appeared in 1981-1982 in Costa Rica, Bolivia and Nicaragua.[2] The most extended restrictions on payments have been recorded in Bolivia and Nicaragua (unbroken since the above-mentioned period),[3] Peru (since 1984) and Honduras, Cuba and Costa Rica (since 1986).[4] Most of the restrictions have been in the form of a quiet, informal accumulation of arrears. However, unnegotiated moratoria were called by Costa Rica in 1981 and Brazil in early 1987.[5] Meanwhile, as is known, in mid-1985 Peru converted its informal restriction into a formal limit by asserting that service of public medium-term debt would be limited to 10% of the country's export earnings.[6]

In general, arrears have, more often than not, emerged as part of an overall deterioration in the economic (and sometimes political) management of a debtor country. Because of this, payments restrictions have often been discredited as a viable alternative to the official debt management strategy. However, it is important to point out that the adjustment programmes of two internationally acclaimed "success stories" regarding adjustment –Bolivia and Costa Rica– have been partly financed by unnegotiated restrictions on the payment of debt to private commercial banks.[7] In the light of the very limited number of "success stories" that can be pointed to over the last eight years, it can be concluded that at least under certain circumstances payments restrictions can be part of an orderly process of structural adjustment.

B. THE COSTS OF A UNILATERAL RESTRICTION ON PAYMENTS

Default on debt service has conventionally been viewed as an extremely risky venture for a debtor country. On the one hand, a delinquent debtor country will anger its creditors and lose access to new loans. On the other, it could induce serious retaliation. As

[1] Venezuela had arrears with the commercial banks until October 1989 when it arranged a US$600 bridging loan from banks to help eliminate US$900 million of arrears.

[2] For analysis of the events leading up to the Costa Rican restriction see Adrian Rodríguez, "La Deuda Pública Externa de Costa Rica: Crecimiento, Moratoria, y Renegociación", *Revista Ciencias Económicas,* vol. VII, No. 2, 1987, pp. 13-35, and Juan Alberto Fuentes, "Deuda Externa y Ajuste en Costa Rica, 1982-1987", San José, 1988. For Bolivia see ECLAC, *Los Bancos Transnacionales, el Estado y el Endeudamiento Externo en Bolivia,* Estudios e Informes de la CEPAL series, No. 26, Santiago, Chile, 1983, chapter 2, United Nations publication, Sales No. S.83.II.G.22.

[3] However, in 1988 Bolivia, using donor resources, bought back about one-half of its commercial bank debt. For details on the operation, see Ruben Lamdany, "Voluntary Debt Reduction Operations: Bolivia, Mexico and Beyond...", Washington, D.C., World Bank, June 1988.

[4] Costa Rica's 1981 restriction ended in 1983 when it joined most other Latin American countries in the first round of reschedulings of bank debt. See A. Rodríguez, *op. cit.* The country fell back into protracted arrears in 1986. However, as mentioned in chapter III, in late 1989 Costa Rica reached an agreement in principle with its Steering Committee to buy back up to nearly 60% of the bank debt (including arrears) in the secondary market and convert the remainder into long-term bonds.

[5] The moratorium ended in 1988. However, the country slipped back into informal arrears in late 1989.

[6] The restriction applied to debt contracted prior to July 1985. It moreover excluded all short-term debt, private sector medium-term debt, and debt paid in goods. In July 1986 private sector medium-term debt was incorporated into the 10% limit. For data on serviced and unserviced debt in Peru see ECLAC, *Economic Survey of Latin America and the Caribbean, 1988,* Santiago, Chile, United Nations, 1989 (chapter IX), table 21 of the chapter on Perú.

[7] For a review of the Costa Rican experience see Ennio Rodríguez, "A Path in the Maze: Costa Rica, Cross-Conditionality and Development", a paper prepared for the IDRC Workshop on Cross-Conditionality, Washington, D.C., 5-7 September 1989, and Juan Cariaga, "Bolivia's Structural Adjustment Programme 1985-1989", paper presented to the Institute for International Economics Conference on Latin American Adjustment, Washington, D.C., 6-7 November 1989.

Table 11

LATIN AMERICA AND THE CARIBBEAN: COUNTRIES IN ARREARS WITH ONE OR MORE CREDITORS [a]

	1986	1987	1988	1989
Oil-exporters				
Bolivia	x	x	x	x
Ecuador	-	x	x	x
Mexico	-	-	-	-
Peru	x	x	x	x
Venezuela	-	-	-	x [b]
Non-oil-exporters				
Argentina	-	-	x	x
Brazil	-	x	-	x
Colombia	-	-	-	-
Costa Rica	x	x	x	x
Chile	-	-	-	-
Cuba	x	x	x	x
El Salvador	-	-	-	-
Guatemala	n.a.	x	x	x
Haiti	n.a.	n.a.	x	x
Honduras	x	x	x	x
Nicaragua	x	x	x	x
Panama	-	-	x	x
Paraguay	-	x	x	x
Dominican Republic	x	x	x	x
Uruguay	-	-	-	-
Total	**7**	**11**	**13**	**15**

Source: ECLAC.

[a] *"x" indicates the existence of protracted arrears, that is, during several months in the corresponding year.* [b] Arrears were eliminated in October by an interim agreement with the banks that included a short-term bridging loan of US$600 million.

one study commented in 1984 concerning the consequences of default:

"Beyond difficulties with access to long-term and short-term credit, defaulting countries could face reprisals. Foreign creditors could attach any of the foreign assets of a defaulting country, as well as its exports abroad (commercial airlines, ships, bank accounts, shipments of commodities, and so forth).... To be sure, in this event the private concerns with truly large interests (especially the major banks) would first seek to reestablish a payment schedule through negotiation before attempting to attach assets, because any assets they could attach would be small relative to their claims on the country. But in the event of extended inability to reestablish negotiations, these private concerns might eventually join in the action of other private creditors to seize assets and shipments.

Under more aggressive circumstances, moreover, such as a moratorium declaration coupled with internal government changes... announced in terms laying the blame on Western nations, international official reaction might reinforce private reprisals. At the extreme, Western nations might impose trade embargoes on the defaulting country. Such a step would complete the process of moving toward autarky that a country would risk when it first decided on an extended moratorium."[8]

The picture drawn by the above description of the costs of default is indeed dire. Moreover, the image of massive retaliation for default which it conjures up was undoubtedly a contributing factor to the co-operative attitude of most Latin American and Caribbean governments in the early phases of the official management of the crisis.[9]

The conventional notion of the costs of default of course contains an element of truth, for otherwise it would not appear in a serious discussion of the debt problem. In effect, a default conceivably could have dire consequences in terms of a massive external retaliation. However, historical experience has demonstrated that the conventional picture greatly exaggerates the costs that are most likely to emerge from a policy involving a unilateral restriction of debt payments, for when massive retaliation of the type described above has occurred, it was not because of default as such, but rather because of a broader political confrontation between a debtor government and one or more of its creditor governments.[10] Indeed, in the few contemporary examples of such sanctions being applied, the driving force behind the phenomenon was the executive branch of the creditor government. Thus, it appears that commercial retaliation was in fact part of a broader foreign policy initiative *vis-à-vis* a debtor country government that for any number of reasons had developed a serious diplomatic problem with an industrialized country. As far as the co-ordinated retaliation of the commercial banks is concerned, experience has shown that default was only an incidental element in a bilateral foreign policy conflict.[11]

In the context of the current debt problem, Latin American and Caribbean countries have so far found that as long as they have generally amicable relations with the creditor

[8] Cline, *International Debt*, Washington, D.C., Institute for International Economics, pp. 90-91.

[9] Nevertheless, the prime motive for co-operation was the shared values of financial orthodoxy and a rational calculation of how best to maximize resource flows. See ECLAC, *The evolution of the external debt problem in Latin America and the Caribbean* (LC/G.1487/Rev.2-P), Estudios e Informes de la CEPAL series, No. 72, Santiago, Chile, 1988, United Nations publication, Sales No. E.88.II.G.10.

[10] This point was raised originally by a financial writer of the *Financial Times*, Anatole Kaletsky, in *The Costs of Default*, New York, Priority Press, 1985.

[11] Commercial banks frequently act as instruments of the industrialized countries' foreign policy. See J. Andrew Spindler, *The Politics of International Credit*, Washington, D.C., Brookings Institution, 1984.

governments, the major banks have not had reason to contemplate a systematic destabilization of the debtor's economy. This is even more so the case now that arrears have become a general fact of life in the debt problem. Moreover, since the emergence of the Brady Plan there is even more of an official disposition to tolerate arrears as a transitory component of an adjustment programme.

Experience has also shown that commercial banks do not necessarily have all that much to gain from retaliatory action. This is because the tangible return on an attempted embargo of assets is usually small relative to the costs involved. First, court proceedings are expensive, and when the defendant is a sovereign government, the outcome of a judgement is always extremely uncertain.[12] Second, the amount of the debtor's assets that are within the reach of a creditor are usually small relative to the size of the disputed claim. Third, sharing clauses in loan contracts imply that a bank must often share any gains from court proceedings with its competitors which may not even have joined it in the financing of the lawsuit. Fourth, banks with investments and collateral business in the debtor country's home market must weigh the problematical gains from a lawsuit against the potential losses that economic disruption or retaliation can have on that domestic business.[13] Fifth, a debtor government which is prepared for potential retaliation has had numerous practical ways to protect itself from aggressive behaviour; this in turn has lowered the pecuniary benefits and raised the costs of any aggressive policy initiated by a lender.

In sum, the major motive that a bank has had to aggressively pursue legal harassment of a debtor is to impress shareholders and/or create a "demonstration effect" that might dissuade other countries from copying the strategy. Even then, however, banks have had to weigh this benefit against other considerations. On the one hand, massive retaliation also risks creating a "martyr" which would galvanize the debtor countries into a co-ordinated initiative. On the other, such action calls undue attention to the problem loans and could induce regulatory and accounting authorities to employ a stricter interpretation of the value of the bank's assets.

Nevertheless, restrictions on debt service payments have proved to have important costs, too. The restrictions have indeed tightened access to new credit, although, since banks are better reserved against loan losses, in many cases net medium-term lending by them was unlikely to be voluminous in any event. Official export credits have also tended to collapse during the crisis.[14] Thus the payments restriction's practical impact on loans has been largely felt in more difficult access to short-term lines of credit. There has also been a slowdown in multilateral lending, when creditor governments have shown a low tolerance for arrears to the commercial banks. However, when the low tolerance of arrears was concomitant with a higher tolerance for an excessive outward transfer of resources, efforts to keep payments current with the banks usually weighed so heavily on the country's economy that it was difficult in any event for it to comply with the targets that condition the disbursements of the multilateral lenders. Another effect of payments restrictions has been contamination: a limitation of payments by any important borrower has sometimes altered the market's behaviour *vis-à-vis* other borrowers in the region.

[12] Governments have traditionally enjoyed sovereign immunity from jurisdiction. However, post-war legal trends have moved in the direction of restricting this privilege. For instance, in the late 1970s both the United States and the United Kingdom reinterpreted immunity to exclude commercial activities of sovereign States from protection against legal enforcement. Moreover, most Latin American governments formally waived their sovereign immunity from jurisdiction and enforcement in syndicated loan contracts. However, the track record on lawsuits against sovereign governments is very limited, as has been the success in attaching sovereign assets. See Gonzalo Biggs, "Legal aspects of the Latin American public debt: relations with the commercial banks", *CEPAL Review*, No. 25, (LC/G.1338), April 1985, pp. 161-186 and Edgardo Barandarian and Felipe Larrain, "Towards Debt Reduction", Washington, D.C., August 1989.

[13] For instance, Citicorp has a large volume of business in the Brazilian market. In 1988 Brazil alone accounted for 20% of Citicorp's income world-wide. See Citicorp, *1988 Annual Report*, New York, 1989.

[14] See OECD, *Financing and External Debt of Developing Countries: 1988 Survey*, Paris, OECD, 1989. p. 37.

There has also been a high probability that a debtor country in a protracted state of arrears will encounter legal harassment from at least some creditors. Indeed, available information suggests that most debtor countries with an unnegotiated restriction on debt payments have experienced at one time or another a legal skirmish with a creditor bank. Perhaps the most celebrated case was in May 1989 when Citibank "set aside" US$80 million of deposits of the Ecuadorian government in compensation for an unpaid loan.[15] Other publicized cases appeared in 1981 when Libra Bank and Allied Bank sued some local Costa Rican banks for the default induced by the aforementioned government-sponsored moratorium.[16] Meanwhile, in 1985 Riggs Bank of Washington, D.C. "set off" a Peruvian Central Bank deposit on the grounds that it was a guarantee for a delinquent claim on a State bank; as of 1989 the case was unresolved and still in litigation. In 1986 and again in 1988 Manufacturers Hanover set off US$900 000 against Peruvian deposits. Brazil and Argentina are also known to have confronted sporadic legal action by some disgruntled banks.

Perhaps the most serious risks a debtor country has confronted, however, have not been on its external flank at all. Thus, the most negative reaction to a restriction on payments has sometimes come from sectors of the debtor country's own society. Aside from any ideological considerations, domestic banks and firms involved in trade are understandably sensitive about their operational relations with foreign banks and their access to credit. This has been especially true when the private sector itself is solvent – as is the case in some Latin American and Caribbean countries – and wants to dissociate itself from the government's debt problems. Moreover, commercial banks have often sensed the government's vulnerability with these groups and have sometimes attempted to heighten public criticism of a payments restriction. Thus when there was not a broad consensus at home that the debt overhang must be eliminated, a restriction on payments has at times set off a domestic political backlash that undermined economic performance and the position of the government, or at least of its economic team. An example of a country where the restriction on payments had considerable domestic support was Peru in July 1985. On the other hand, it appears that from its outset the February 1987 moratorium in Brazil enjoyed little internal support, which partly explains why it did not last very long.[17]

Restrictions on payments have therefore not been free of costs. But when a restriction has been administered efficiently the negative impact of arrears has been kept at tolerable levels. At all events, countries finding themselves forced into arrears must carefully consider the effects, both positive and negative, of such a move.

C. ARTICULATION WITH THE BRADY PLAN

Since the Brady Plan has formally suggested more official tolerance of arrears for countries undergoing formal adjustment programmes, the distance between a unilateral payments restriction and the official international debt management strategy has clearly narrowed. Indeed, when a country finds itself compelled to adopt such a restriction, that potentially becomes a starting point for negotiating a Brady-style debt reduction package.

When banks are receiving full and prompt service of the debt, negotiating a debt reduction that eliminates the overhang can be a very difficult task. This is because the banks will always compare any agreement, no matter how modest, with the *status quo* and feel much worse off. In contrast, the restriction of payments signals the material inability of the debtor to service his debt under the impending circumstances and the need to negotiate an adequate debt reduction agreement. In these circumstances both parties know that time can be on the side of the debtor country because a stalemate in negotiations, which preserves the *status quo,* maximizes debt service relief.

[15] "Set asides" are a dangerous tool that United States banks have at their disposal. In effect, without prejudice to possible legal action, legislation in the United States permits banks to automatically apply money deposited in checking accounts to the payment of a delinquent debt. This is clearly a more expedient method of harassment than a lawsuit.

[16] For details of the cases see Biggs, *op. cit.,* pp. 183-185.

[17] See Paulo Nogueira Batista, Jr., *Da Crise Internacional a Moratoria Brasileira,* Rio de Janeiro, Paz e Terra, 1988, pp. 83-89.

Moreover, any formal agreement for debt reduction that is eventually arrived at will most likely require the debt service to increase *vis-à-vis* the *status quo,* thereby improving the situation of the banks even though the formal debt reduction may be quite significant. Finally, in the case of the new agreement free-riding is less of a problem, because a bank's alternative to accepting the debt reduction accord is the *status quo* with its low or negligible payments.

A prerequisite for a Brady Plan debt reduction package is a formal adjustment programme with the multilateral lenders. In principle, thanks to the Brady Plan, even a country with a payments restriction can now arrange such an official adjustment programme and use it as a platform to begin negotiations with the banks. An alliance with the multilateral lenders can clearly be helpful in many respects. However, in certain circumstances debtor countries have preferred to avoid entering into a formal multilaterally-sponsored adjustment scheme, while other countries have been more disposed to enter into multilateral adjustment programmes, but have preferred to postpone them until their own domestic economic programme was already reasonably well consolidated.

Regarding this latter group, it can be pointed out that many debtor countries have had a poor track record regarding their economic performance. Thus, even a new economic team's credibility has often been initially suspect both domestically and externally. The shortage of credibility has made it more difficult to persuade domestic groups of the sustainability of an economic programme, and to negotiate acceptable parameters of adjustment with skeptical multilateral lenders. Moreover, a premature signing of an agreement for an adjustment programme with the multilateral lenders has sometimes been judged to have undesirable side effects.

In effect, the lack of a reassuring track record in the country has meant that the domestic private sector judges the quality of a programme not by its inherent soundness, but by the "external" standard of whether the economic team can meet the traditional quarterly (or sometimes six-monthly) performance targets typically set by the multilateral lenders. The performance targets moreover often involve parameters which the governments can only partially control.[18] This fact, coupled with the normal uncertainties of launching a comprehensive economic adjustment programme, has meant that the economic team may risk the demoralizing effects of a failed target even though the programme itself may be basically sound. The bad publicity surrounding a failed target moreover can undermine the credibility of the economic authorities and weaken their internal and external bargaining power.

In sum, when domestic economic authorities initially lack internal and external credibility, the immediate signing of a multilateral adjustment agreement has often been considered inadvisable. Negotiation of an acceptable agreement has been difficult, as the multilateral agencies were reluctant to give authorities the benefit of the doubt when disagreement arose over the nature of the programme. Moreover, the authorities have also estimated that during the delicate launch of the programme its quality will be judged "externally" by how well it completes targets that may or may not reflect the underlying strength of economic policy. The importance of external opinion has also increased the authorities' vulnerability to potential official pressure to sign a debt agreement with the banks which might be unsatisfactory.

These and other considerations have given rise to cases in Latin America and the Caribbean where domestic economic authorities have decided to pursue the alternative of introducing their economic programme without the support of a formal agreement with multilateral lenders on an adjustment programme. However, contact with the multilateral agencies has sometimes been maintained through informal discussions, as provided for under Article IV of the IMF Articles of Agreement. In any event, only when the programme was well consolidated and a successful track record established did the authorities approach official lenders with a view to agreeing on an adjustment programme. Indeed, if the adjustment programme

[18] See Richard Lynn Ground, "A Survey and Critique of IMF Adjustment Programs in Latin America", in ECLAC, *Debt Adjustment and Renegotiation in Latin America,* Boulder; Colorado, Lynne Rienner Publishers, Inc., 1986, pp. 101-158.

succeeded and gained international acceptance, the multilateral lenders were under some moral pressure to support it.

Another benefit of developing a proven track record is that it puts the authorities in a better position to gain, and enforce, a commitment from the multilateral lenders to respect the payments capacity of the successful economic programme. Indeed, as proposed in the earlier chapter, a prior condition for a formal adjustment programme should ideally be an explicit agreement between the country and the multilateral lender(s) about the appropriate amount of debt and debt service reduction that will be demanded of the banks, as well as a firm *ex ante* commitment by them to tolerate protracted arrears should the banks be unwilling to accept the agreed parameters

The successful Bolivian programme followed an approach similar to the one described above. In 1985 the economic team of the new government faced credibility problems due to a long history of poor economic performance. Hence, the government decided to initiate its own adjustment programme even though official multilateral agencies were skeptical. The economic programme itself was of an orthodox nature, except for external payments, which the new government continued to restrict despite heavy pressures from the banks and the IMF to renew debt service. It was only after a year, when the economic programme was already showing signs of consolidating itself, that the authorities sought a formal adjustment programme with the IMF. Thanks to its tenacity and bargaining power, the government won an agreement with the Fund without renewing payments to the banks: a precedent-setting situation. In 1988, from a position of arrears, it negotiated a buyback of one-half of the bank debt at 11 cents on the dollar. However, since the agreement also forgave US$150 million of arrears, the real cost to Bolivia was about 7 cents on the dollar. Moreover, the debt that the banks did not offer to sell continued to accumulate arrears. In 1989, again using donor resources, the country quietly bought back one-third of the remaining unserviced debt, at 11 cents on the dollar.

A variant of this approach also appeared in Costa Rica. Here there was a track record since 1982 of successful, but less orthodox, adjustment policies. The new government which came into power in 1986 introduced an economic programme which significantly reinforced that effort. In view of the severe burden of the debt, it had to use arrears with the creditors as a financing tool. Only after consolidating the new government's economic programme did the authorities approach the IMF and negotiate an adjustment programme. In early 1987, agreement was reached on a formal programme, but with the novel feature that arrears would be tolerated, and as already mentioned, in 1989 the country, from a position of arrears, offered to buy back its debt from the banks at about 16 cents on the dollar.

D. THE ADMINISTRATION OF PAYMENTS RESTRICTIONS

As already noted, payments restrictions are a fact of life in the debt problem, as the bulk of countries in Latin America and the Caribbean find themselves in this state of affairs. Most countries are interested in a Brady-style debt reduction package with the banks. However, since the Brady Plan has an IMF agreement as a prerequisite, it will take many debtor countries time to organize themselves for a formal multilaterally-sponsored adjustment programme. Thus in the interim, efficient administration of the existing payments restriction will be a precondition for an orderly adjustment process.

There is now long enough experience with payments restrictions in Latin America and the Caribbean to begin to describe some of the policies that countries have in fact used to minimize the costs of arrears.[19]

1. The point of departure: a coherent economic programme

There has been growing recognition in the region that a restriction on payments and a lowering of the outward transfer of resources is not an end in and of itself, but rather only an

[19] ECLAC has undertaken detailed case studies of the experience of payments restrictions in Latin America and the Caribbean during the 1980s. Many of the points raised in this section are drawn from those case studies. The country studies will be published in early 1990 as part of a special volume dealing with the administration of the restriction of debt service in the region.

instrument to achieve temporary relief and financing in support of an economic programme aimed at structural adjustment. Moreover, just as an economic programme may need the breathing space provided by a payments restriction, to be reasonably efficient the restriction itself needs the support of a successful economic programme. Indeed, experience has demonstrated that when not backed up by a coherent economic programme, payments restrictions can involve inordinately high economic and political costs which discredit them as a means for neutralizing the debt overhang and excessive outward transfer of resources.

Aside from its intrinsic value, experience shows that a coherent economic programme lends credibility to a payments restriction and makes it more effective as a tool of economic policy. First, a reasonable economic programme helps to give a more legitimate definition to a restriction on debt payments because it creates some respectable objective criterion on which to determine the capacity to pay. Second, a visibly coherent economic programme also to some degree dispels the negative connotations of the payments restriction. This is because domestic economic agents tend to be less suspicious of a restriction when it is linked to an economic programme that has their respect and raises expectations of improved domestic economic performance, with its associated opportunities for profit-making. Moreover, foreign creditors have displayed reluctance to harass a country that has been using arrears to finance a respectable economic programme. On the one hand, the programme offers them prospects of an improved capacity to service outstanding debt, while on the other, public reaction could be strongly opposed to hostile acts against a debtor government displaying serious economic intentions. Finally, creditor governments and multilateral lenders have shown themselves to be more patient with, and forthcoming to, a country which is pursuing respectable economic objectives.

What exactly is a coherent economic programme may be subject to debate. However, successful programmes have clearly tackled some basic macroeconomic issues related to international competitiveness and external adjustment (stable incentives for production of exports and import substitutes), as well as internal adjustment (inflation, fiscal disequilibrium, social disequilibria, stable rules of the game for the private sector, etc.).

Economic growth has also been an objective. However, sustainable economic programmes have also taken care to ensure that the restriction on debt payments did not become an excuse for an unsustainable populist economic boom. After all, a payments restriction can relieve an external constraint, but not eliminate it. Thus, coherent programmes have prudently managed domestic demand consistent with the maintenance, or building up, of adequate levels of international reserves. Economic programmes that have tended to exhaust reserves quickly become unsustainable and cause the domestic private sector, foreign banks and creditor governments to lose confidence. This has created an inherent vulnerability in the economic programme which has made the administration of a restriction on payments more difficult and costly.

2. Laying the political groundwork

Restrictions of payments have also usually required careful political management.

The strength and efficiency of a restriction on payments *vis-à-vis* orderly adjustment has depended very much on the emergence of a domestic political consensus in support of the view that such a policy is reasonable in the light of the limited alternatives offered by the creditors. This political project has sometimes been aided by a programme designed to inform private businesspeople, political leaders, and the public more generally, of the perverse consequences of the debt overhang and outward transfer of resources for the nation.

Since, as noted below, it is important to make conciliatory moves towards the creditors, the most effective informational campaigns have avoided hyperbole and harsh attacks on the lenders. Rather, the procedure has been to offer a continuous flow of objective information to the public on the adverse effects of the debt overhang and the inadequacies of the official debt management strategy. In one case television and newspaper commentary was complemented by public workshops which brought together the domestic business élite,

local politicians and respected national and foreign experts.[20] By highlighting the excessive costs of servicing an artificially overvalued debt –e.g., higher taxes and lower growth– the authorities provided relevant information to economic agents and helped to avoid the undesirable consequences of a loss of confidence.

In sum, since an adverse internal reaction is a major threat to a restriction on payments, a number of country authorities have tried to lay the political groundwork for such a policy. It has also proved to be strategically important to gain the support (if only passive) of important segments of the business community. In cases where a reasonable domestic consensus has not been reached on the inability to service the debt overhang, a restriction on debt payments has usually had unacceptably high political and economic costs.

3. Treatment of the different creditors

In the current crisis, indebted governments have proceeded on the assumption that conciliatory restrictions on payments run the least risk of creating problems on the external front. The approach has been to consider the restriction as a special circumstance brought on by the crushing weight of the outward transfer of resources and the imperative of financing a domestic economic programme involving efficient structural adjustment. Authorities also have been careful not to highlight the payments restriction in pronouncements about economic policy, in order to maintain flexibility to handle the issue. In effect, authorities generally did not want the payments restriction to become the political centre of attention in economic policy-making.

Barring a catastrophic situation, most debtor countries have –at least initially– been selective about the debt that has been subject to restricted service. However, there has sometimes been a notion that such selectivity could clearly isolate a certain group of creditors and thereby permit credit relations to proceed normally with other types of creditors who are unaffected by the policy. Experience has shown that with the exception of short-term revolving credit lines, this can be a miscalculation. For instance, a restriction on the debt service to the commercial banks has more often than not negatively affected the disposition of many Paris Club agencies to lend. Unless the country has enjoyed a considerable amount of goodwill with a majority of creditor governments, the boards of directors of the multilateral agencies have on occasion subtly enforced a slowdown of these organizations' disbursements as well.

The same principle has applied to individual debtor entities. Sometimes governments have granted exemptions to certain national borrowers, allowing them to service debt that otherwise was being restricted. The motive has usually been to allow this particular debtor to distinguish himself from the general situation so as to preserve normal relations with his foreign creditors. In practice, however, few foreign creditors discriminate so finely, so that the exempted debtor entity usually did not receive treatment that was much different from other borrowers who were respecting the restriction on debt payments.

Thus, it has often proved presumptuous to expect that selectivity in the application of a restriction will, in and of itself, preserve reliable access to certain types of credit. Experience has shown that when a government begins to consider a systematic restriction on the debt service to one or more groups of creditors, a realistic working assumption is that all other sources of credit will be adversely affected by that policy. Any exception to this general rule can be treated as a windfall gain and not as a pillar on which to support a decision to restrict payments. Indeed, an overly sanguine view of a country's ability to isolate certain creditors from the effects of a payments restriction has often created an unexpected shortfall in available finance that has ultimately weakened the administration of the restriction. Thus selectivity has worked effectively mostly as a tactical instrument aimed at minimizing the number of problem fronts with foreign creditors.

a) *Multilateral lenders*

In determining where to apply a restriction, most debtors have tried to avoid arrears with the multilateral agencies. This is true even if a negative net transfer has developed with them.

[20] Costa Rica deployed this strategy in 1985 and 1986.

In effect, there has been a recognition that official development institutions are the collective responsibility of all member governments. The continuation of normal service of these obligations has acted as an investment in the future. On the one hand, falling into arrears with multilateral lenders could be interpreted by third parties as an act of desperation that reflects badly on the economic authorities' overall management of the domestic adjustment process. On the other hand, these organizations are not constrained by a private evaluation of risk and therefore are potentially an elastic source of funding. Thus, while a negative transfer may currently be registered, this could quickly be converted to a positive transfer by a favourable turn of events, e.g., a credible economic programme, or a satisfactory settlement of arrears with a significant number of creditors as part of the debt workout process. However, if a country has accumulated a significant amount of arrears with the multilateral agencies, this limits the possibility of a quick response by them to changing circumstances. Indeed, since these organizations do not reschedule debts, it has proven very difficult to find expedient ways to clear unpaid balances with them.

b) *Commercial banks*

Payments restrictions have mostly been used in relation to the debt of commercial banks. In principle, the exposure of the latter in Latin America and the Caribbean developed out of the market-based calculation of "return/default risk" on their loans. While the loans have generated a return, that risk of default has materialized in the 1980s. At a time of a difficult external and internal situation, by effecting debt service at a rate much in excess of secondary market prices, the debtor country could have to pay a very high cost in terms of growth and employment. Thus if a realistic level of debt service is impossible to negotiate, a restriction on payments may become unavoidable.

Where a restriction on payments has been applied, the fewest problems have developed in those situations when it was introduced with as little fanfare as possible. It has also been demonstrated that the negative impact of the decision can be diluted by allowing market participants to anticipate the event. In the past, this has created conditions for a "soft landing" of all participants. One strategy that has been employed involved quietly informing creditors and the public that if an agreement to lower cash payments to a predetermined amount of dollars could not be negotiated by the date of an important upcoming interest payment, the country --in the context of the possibilities of its economic programme-- would not have the capacity to effect a full payment of the scheduled amounts of debt service. By avoiding surprises, the restriction became a non-event for the private sector.

In all but the most extreme circumstances the restriction on debt service to the banks has been limited to medium-term debt. Short-term lines of credit are a lucrative, nearly risk-free business for the banks and necessary to the normal development of foreign trade relations. Continued prompt service of short-term lines has generally encouraged banks to continue to operate with these loans. Also, countries that have allowed the private sector to be exempt from the payments restriction to the banks have provided some sense of movement on the debt issue. This has served to reduce tension in the private sector because those who wished to service their debt could do so. The feasibility of this latter action has depended, of course, on the total size of the private sector debt and the availability of foreign exchange.

A variant of this latter approach has recently been proposed as a temporary solution for a country where the primary constraint on debt service is of a fiscal nature. This strategy has been termed "decentralization" of the debt service problem. It involves the withdrawal of central government guarantees on the debt, while allowing any national debtor (private or public) with the will and adequate local currency to service his obligations as he sees fit.[21] In a fiscally constrained case the bulk of the debt is with public sector entities that are in a financially delicate state; hence, as long as the service of debt does not act as a cover for capital flight, it should not unduly pressure the

[21] The idea of decentralizing the debt in fiscally constrained countries is that of Carlos Eduardo de Freitas, an ex-Director of the Central Bank of Brazil. See Carlos Eduardo de Freitas, "Descentralizar a Renegociaço de Nossa Divida Externa", *Gazeta Mercantil*, 4 July 1989.

balance of payments. Again, the main purpose of this type of proposal is to provide some sense of movement on the debt issue and alleviate tensions around the restriction on payments. It has also been argued that this type of administration of a restriction on payments helps the banks to recognize that in a fiscally constrained case the capacity to pay cannot be determined by traditional analysis of a balance-of-payments gap.

In any event, some countries have tried to demonstrate goodwill, by effecting some debt service on medium-term obligations which are covered by the restriction. Partial payments have also offered a practical disincentive for retaliation; the creditor is at least receiving some return on his assets, and this could be jeopardized by hostile action.

One formula for partial payment applied in Latin America has been to establish a simple rule, such as stating that debt service is limited to a certain percentage of exports or GDP. Simple formulas like these have had the advantage of establishing an orderly basis for debt service. They have also placed creditors in a quasi-equity position in the country, i.e., the better the country performs the more debt service banks receive, and vice versa. One drawback to such an approach, however, is its formality, which has given the restriction's unilateral character a higher profile than some countries have wanted.

A less simple approach, followed by a majority of countries in the region, is the deployment of a more informal payments formula, whereby a country makes quiet periodic payments to the banks based on the cash flow availability of the economic programme. Usually such payments have not been made according to any set schedule, or in fixed amounts. That way, the countries involved have avoided creating false expectations about what is to be paid over a given period. In a sense, irregularity in payment is the cost the banks must pay for not negotiating a final settlement of the debt.

Banks have usually insisted that the partial payment be applied to arrears, while debtor countries have often resisted this by pointing out to the banks that the periodic outlays are for partial payment of currently scheduled debt service and not a partial settlement of accumulated arrears. In effect, since the arrears represent the overvalued part of the banks' claims, various countries have not wanted to recognize them during the interim of a payments restriction.[22]

Also for the purpose of maintaining a fluid position on the debt, many countries with a restriction on payments have made honest efforts to ensure an on-going dialogue and negotiations with the banks. A team close to the Minister of Finance or Central Bank President has usually been assigned to the problem in order to continuously exchange views with the creditors about ways to settle the claims. Effective negotiating teams have usually had concerted and constructive proposals for dealing with the debt service problem. Given the different financial situations of the banks and the array of possibilities that can emerge from creative financial engineering, most countries have ultimately proven to be flexible about the design of financial instruments. The only area where inflexibility has clearly been unavoidable is in the amount of debt service effected on a cash basis: most countries have tried to make it consistent with the medium-term payment capabilities of their respective economic programmes.

In pursuing negotiations it has sometimes been proposed that a debtor country should by-pass the Steering Committee in its discussions with the banks. Experience, however, has shown this to be an unproductive strategy because there is no other practical way to mediate conversations with hundreds of banks throughout the world. Indeed, attempts to hold *ad hoc* bilateral conversations with the banks outside the Steering Committee have usually failed to transmit any coherent message to the banking community at large. In fact, the

[22] This position has technical merits. Arrears are part of the overvalued claims and as such they ought to be dealt with when the opportunity arises to negotiate a final settlement of claims. Indeed, there is a precedent in history and the current crisis (as exemplified in the Bolivian buyback) to forgive all or part of the arrears accumulated before the final settlement of a debt claim. For the historical case, see Marilyn Skiles, "Latin American International Loan Defaults", Federal Reserve Bank of New York, Research Paper No. 8812, April 1988, pp. 24-34 and Barbara Stallings, *Banker to the Third World*, Berkeley, University of California Press, 1987, pp. 58-106.

Steering Committee usefully fills a vacuum in communication among banks and so far there has proven to be no practical alternative to interfacing with it. Should there be difficulty in arranging for a meeting of the Steering Committee, some countries have tried to seek informal bilateral conversations with individual members of that Committee. Moreover, this has proved more feasible today than it was a number of years ago because the Steering Committees' coherence has been weakened by the growing divergence of opinion in the banking community about how to deal with the debt problem.[23]

Experience has also shown that in negotiations banks have frequently sought to promote "interim agreements" with the borrower to eliminate arrears on the grounds that they could not hold serious conversations with debtors until delinquent payments were eliminated. While countries have reacted to this position in the light of the objective circumstances of the negotiations, as a general rule proposals for interim agreements have been treated with extreme caution, in order to avoid premature acceptance of a position which may be tilted in a direction too favourable to the banks. For reasons analogous to that outlined in the above paragraphs, some countries have legitimately argued that arrears are a consequence of the overvalued debt claim and therefore cannot be excluded from the negotiations for a final settlement of the debt service problem.

Finally, during negotiations with the banks some countries have found it helpful to make efforts to keep creditor governments and multilateral lenders fully informed of all developments with the banks, including proposals and counter-proposals. The initiative has been presented matter-of-factly as a gesture of courtesy, rather than as any form of excuse for asking favours during the negotiations.

c) *Paris Club creditors*

Many debtor countries are in arrears with Paris Club creditors. This is partly because export credit agencies have often taken a conservative view of repayment capacity and severely restricted their new credits even to problem borrowers who are current on their payments. In this case it is difficult to summarize negotiation strategies for the settlement of the arrears and excessive debt service burdens, because the parameters have largely been determined politically rather than commercially. Indeed, the bureaucratic and political dimensions of a Paris Club negotiation have induced creditors to take positions ranging all the way from extremely rigid to extremely flexible, depending on the case in question.

4. Protective measures

Since payments restrictions are an unconventional, unilateral way to limit the outward transfer of resources, some private creditors have reacted in a hostile way. Moreover, hostile reactions are now more likely than ever, since with higher loan-loss reserves banks can more easily contemplate singling out a country as an example of the costs of default. The preceding section has already pointed out the basic ways in which some countries have tried to mitigate such a reaction. A number of debtor countries, however, have deployed the following additional, or complementary, protective measures.

a) *International reserves*

Aside from their intrinsic value for economic policy, reserves have also been a key bargaining chip with the banks, because they provide more autonomy to a country that is restricting debt payments. That is why any restriction on payments has also included policies to build up reserves to comfortable levels and protect them from hostile action.

There are at least two mechanisms which banks have used to sequester a debtor country's reserves. One is to go to court to seek an attachment against an unpaid claim. The other is to exploit laws in certain countries which allow banks, without prejudice to collection by legal means, to automatically "set aside" deposits of customers who are in arrears to them. Even though there may be considerable doubt about the legality of attaching the assets of a sovereign government, the laws on sovereign immunity have become sufficiently

[23] See Erik Ipsen, "The Embattled Debt Negotiators", *Institutional Investor*, September 1989, pp. 87-88.

flexible to encourage some creditors to take action along these lines.

Hence, a number of countries contemplating a restriction on payments have discreetly drawn down their reserves held in deposit with commercial banks generally, but especially with those institutions with which there are unsettled claims. This has been done gradually, while payments for exports have been channelled through institutions which are considered secure.

The Bank for International Settlements in Basle, Switzerland, has been used by some governments for safe deposit of gold and currencies. However, the Bank pays below-market interest rates; it has also been known to pay zero interest on deposits that its Board considers to be "excessive". Thus, security has had its price, which countries have had to take into account in calculating the cost of a payments restriction. Debtor countries with very good diplomatic relations with a creditor government have also been known to deposit reserves denominated in that country's currency in its central bank for safe keeping.

Commercial banks that are outside of the potential zones of conflict and which do not have medium-term claims on the country have been known to seek debtor countries' deposits. These banks have also included subsidiaries of trusted banks located in offshore financial centres. A general practice of these banks has been to offer a "comfort letter" in which the headquarters of the subsidiary promises to back the deposit with its full faith and credit. In addition, countries have frequently asked a bank for a formal "negative pledge" not to embargo the country's deposits. The countries of the region have found the negotiation for these commitments to be protracted, however, experience has also demonstrated that a country can sometimes reach a satisfactory gentlemen's agreement with a large bank.

b) *Short-term lines of credit*

As already stated, short-term lines of credit are extremely vulnerable to being cut because they are rolled over frequently at the discretion of a bank. Some debtor countries have "captive" lines which the banks have agreed to keep outstanding as part of a global rescheduling agreement. However, in a situation of a restriction on payments, certain banks have shown a disposition not to honour these commitments.

In recent years, the debtor countries have found that there has been less pressure on their short-term lines of credit when the restriction on payments i) has been conciliatory, ii) has explicitly excluded short-term credit, and iii) has been part of a serious economic programme that does not threaten prudent levels of international reserves. In these circumstances, a bank's instincts for profit-making have worked in the debtor's favour: short-term lines of credit are lucrative and nearly risk-free as long as the country's economy is not expected to enter into a tailspin. Thus, the more a country is in control of its own economic situation, the easier the access to short-term lines of credit has been. In contrast, when there have been signs that the government is losing its grip on economic policy, short-term lines have quickly eroded.

Given the importance of short-term lines of credit in the finance of import and export trade, and hence adjustment, debtor countries have found it useful to protect them. One system employed when there has been a serious threat to short-term credit has been to "administratively freeze" outstanding lines by requiring all debt payments to be made directly to the central bank of the debtor country. The central bank, in turn, has refused to allow the commercial banks to withdraw the line, but only to recirculate it to the same or another domestic borrower. The rate charged on the line has been determined by the negotiations between the debtor and the commercial bank. However, the central bank has usually established a minimum maturity for short-term credit when it has found that banks were shortening the term to the point where this threatened fluid import and export trade. This type of policy was feasible because the central bank had quantified and monitored outstanding short-term lines of credit.

Another practice to bolster access to short-term lines of credit during a payments restriction has been to use international reserves as collateral for short-term lines with safe banks. This has proved effective when the threat to the lines did not merit an aggressive response such as an administrative freezing of outstanding credit. This practice only worked, however, as long as the country had, and could maintain, an adequate level of liquid reserves.

In sum, in an efficiently administered payments restriction countries usually did not experience undue pressure on their short-term lines of credit. However, the cost of credit typically rose by a quarter to a half point, while the term shortened. When lines became threatened by a co-ordinated external attack on them, or by a dramatic deterioration in expectations about economic performance, explicit protective measures have been required. A first line of defence has been collateral deposited with trusted banks, while in a more serious threat a temporary freezing of credit lines was required. In cases of severe crisis caused by exhaustion of international reserves and the collapse of an economic programme, the cost of lines of credit has skyrocketed to several points over LIBOR.

c) *Legal assistance*

As mentioned earlier, in certain past cases of restriction of payments one or more creditors have gone to court seeking to attach a deposit. The first line of defence has been the withdrawal of assets out of easy reach of such action. A second line of the debtor's defence has been to seek the services of a world-class international legal firm to help design protective strategies and to negotiate solutions to legal difficulties as they arose. Indeed, some international legal firms have specialized in the issue of the Third World debt problem and have many developing country clients.

When legal problems arose, it has often been of interest to both creditor and debtor to settle out of court. When doing this, some countries have pursued a principle of never settling in cash. This is because the unavailability of cash was considered a way to discourage other banks from copying the aggressive tactics of a competitor. Paper instruments, export of goods or asset swaps were deployed when compensation was merited.

In sum, a unilateral restriction on debt service payments is clearly not the first best solution to the debt problem. But in the absence of an effective concerted public solution, it may well prove to be a second best alternative for many debtor countries which are obliged to reduce the outward transfer of resources. Moreover, while a unilateral restriction of payments has costs, experience has shown that these can be minimized if the limit on payments is efficiently administered and forms part of coherent economic and political programmes.

ANNEXES

Annex 1

LATIN AMERICA AND THE CARIBBEAN: NET TRANSFER OF RESOURCES [a]

(Annual averages)

	Millions of 1987 dollars				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Latin America					
Total	-1 434	6 530	17 096	1 418	-26 236
Credit-related	919	6 505	15 108	13 083	-19 816
Foreign investments	-2 498	-1 758	720	4 596	-494
Oil-exporting countries					
Total	-2 119	241	6 425	-2 887	-14 744
Credit-related	406	2 253	7 496	6 372	-9 851
Foreign investments	-2 493	-2 187	-205	1 943	-329
Oil-exporting countries (excluding Venezuela)					
Total	403	1 425	3 240	454	-10 469
Credit-related	580	1 824	4 764	4 802	-6 840
Foreign investments	-419	-319	614	1 082	-252
Bolivia					
Total	109	-49	175	-157	57
Credit-related	56	192	286	45	-123
Foreign investments	13	-81	25	23	-35
Ecuador					
Total	54	188	304	164	-509
Credit-related	27	76	423	213	-167
Foreign investments	-14	115	-91	-45	-44
Mexico					
Total	249	1 280	2 062	161	-9 774
Credit-related	310	1 306	3 397	4 834	-6 583
Foreign investments	-189	-147	637	1 260	-105
Peru					
Total	-10	6	698	285	-244
Credit-related	187	250	658	-291	33
Foreign investments	-228	-206	44	-156	-68
Venezuela					
Total	-2 522	-1 184	3 186	-3 341	-4 274
Credit-related	-174	429	2 732	1 571	-3 011
Foreign investments	-2 074	-1 868	-820	861	-77

Annex 1 *(continued 1)*

	As a percentage of exports of goods and services				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Latin America					
Total	-4.3	12.2	20.1	0.3	-25.5
Credit-related	2.7	12.0	18.1	11.2	-19.3
Foreign investments	-7.4	-3.5	0.8	4.1	-0.5
Oil-exporting countries					
Total	-14.4	1.2	17.3	-6.0	-30.0
Credit-related	2.5	9.5	20.5	10.8	-20.8
Foreign investments	-16.6	-9.7	-0.3	3.4	-0.6
Oil-exporting countries (excluding Venezuela)					
Total	5.4	10.5	17.0	0.5	-30.1
Credit-related	8.2	12.9	25.4	12.7	-20.3
Foreign investments	-6.3	-2.4	3.3	2.9	-0.7
Bolivia					
Total	36.0	-8.3	16.9	-14.2	10.5
Credit-related	14.4	33.7	26.9	4.0	-15.1
Foreign investments	7.7	-14.2	2.7	2.0	-4.6
Ecuador					
Total	8.2	25.7	11.9	5.1	-17.1
Credit-related	4.5	9.1	16.8	6.7	-5.2
Foreign investments	-2.9	18.4	-3.5	-1.5	-1.6
Mexico					
Total	4.1	14.6	16.4	-0.3	-35.8
Credit-related	5.5	13.9	28.0	16.7	-24.8
Foreign investments	-3.7	-1.7	4.8	4.4	-0.4
Peru					
Total	-0.6	0.1	23.2	6.8	-6.4
Credit-related	7.1	8.2	22.3	-6.3	0.7
Foreign investments	-9.5	-6.6	2.6	-3.3	-1.8
Venezuela					
Total	-30.9	-12.4	20.8	-17.0	-30.0
Credit-related	-2.0	4.5	17.2	7.5	-22.1
Foreign investments	-25.5	-20.5	-4.3	4.3	-0.6

Annex 1 *(continued 2)*

	As a percentage of the gross domestic product				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Latin America					
Total	-0.5	1.3	2.5	0.0	-4.0
Credit-related	0.3	1.3	2.3	1.4	-3.0
Foreign investments	-0.9	-0.4	0.1	0.5	-0.1
Oil-exporting countries					
Total	-2.4	0.1	2.7	-1.2	-5.8
Credit-related	0.3	1.2	3.2	1.7	-4.0
Foreign investments	-2.7	-1.2	-0.1	0.6	-0.1
Oil-exporting countries (excluding Venezuela)					
Total	0.5	1.0	1.8	-0.3	-5.4
Credit-related	0.8	1.3	2.6	1.6	-3.6
Foreign investments	-0.7	-0.2	0.4	0.4	-0.1
Bolivia					
Total	6.5	-1.7	3.8	-4.2	1.9
Credit-related	2.8	6.3	6.2	0.6	-3.6
Foreign investments	1.2	-2.8	0.6	0.5	-1.0
Ecuador					
Total	1.2	3.8	2.7	1.3	-4.3
Credit-related	0.7	1.5	4.1	1.6	-1.4
Foreign investments	-0.5	2.5	-1.0	-0.3	-0.4
Mexico					
Total	0.4	1.2	1.4	-0.6	-6.3
Credit-related	0.5	1.1	2.3	1.8	-4.3
Foreign investments	-0.4	-0.1	0.5	0.5	0.0
Peru					
Total	-0.2	0.0	2.6	1.1	-1.3
Credit-related	1.1	1.1	2.5	-1.2	0.2
Foreign investments	-1.6	-1.0	0.1	-0.6	-0.3
Venezuela					
Total	-9.7	-3.2	5.4	-4.8	-7.4
Credit-related	-0.8	1.2	4.8	2.3	-5.3
Foreign investments	-7.9	-5.1	-1.5	1.2	-0.1

Annex 1 *(continued 3)*

	Millions of 1987 dollars				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Non-oil-exporting countries of Central America					
Total	353	510	1 206	1 254	1 087
Credit-related	203	347	1 107	1 315	41
Foreign investments	14	83	35	90	133
Costa Rica					
Total	92	213	358	231	42
Credit-related	39	78	243	118	-146
Foreign investments	13	45	62	93	45
El Salvador					
Total	46	-3	91	17	103
Credit-related	27	61	145	193	-7
Foreign investments	7	-6	-13	-46	-27
Guatemala					
Total	60	19	276	84	158
Credit-related	29	46	168	240	-105
Foreign investments	21	-26	52	68	84
Haiti					
Total	15	10	84	184	161
Credit-related	-2	2	49	51	22
Foreign investments	-8	-1	1	2	3
Honduras					
Total	26	31	182	62	127
Credit-related	29	72	172	117	51
Foreign investments	-18	-39	-34	-55	-30
Nicaragua					
Total	59	77	71	415	488
Credit-related	46	99	193	424	479
Foreign investments	0	-31	-29	-10	0
Dominican Republic					
Total	55	164	144	260	9
Credit-related	34	-11	138	171	-199
Foreign investments	0	142	-4	38	59

Annex 1 *(continued 4)*

	As a percentage of exports of goods and services				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Non-oil-exporting countries of Central America					
Total	9.9	10.3	15.8	17.8	17.2
Credit-related	5.8	6.7	14.3	18.3	0.9
Foreign investments	0.2	1.8	0.4	1.2	2.1
Costa Rica					
Total	19.0	25.7	28.1	17.2	3.1
Credit-related	9.0	9.0	18.5	8.6	-10.5
Foreign investments	2.9	5.5	5.0	7.1	3.5
El Salvador					
Total	7.6	-0.7	9.0	4.4	11.5
Credit-related	4.7	7.1	12.5	17.4	-0.7
Foreign investments	1.2	-0.7	-0.9	-4.6	-2.9
Guatemala					
Total	10.5	1.7	15.8	7.3	13.5
Credit-related	4.4	4.4	9.7	15.6	-8.9
Foreign investments	3.4	-2.6	2.6	4.2	7.2
Haiti					
Total	10.4	6.1	32.5	66.5	52.0
Credit-related	-1.1	1.3	20.0	17.9	7.2
Foreign investments	-4.9	-0.6	0.2	0.6	0.9
Honduras					
Total	6.4	5.3	23.6	5.9	14.0
Credit-related	7.1	12.0	21.6	11.7	6.1
Foreign investments	-4.2	-6.5	-3.8	-5.7	-3.3
Nicaragua					
Total	12.3	11.6	8.9	78.2	129.3
Credit-related	9.0	14.6	20.8	79.5	128.0
Foreign investments	0.4	-4.6	-3.0	-1.8	0.0
Dominican Republic					
Total	8.4	20.1	10.4	17.8	0.7
Credit-related	4.9	-0.7	9.7	12.4	-14.6
Foreign investments	-0.4	16.9	-0.2	2.4	4.2

Annex 1 *(continued 5)*

	As a percentage of the gross domestic product				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Non-oil-exporting countries of Central America					
Total	2.1	2.4	4.3	4.4	3.9
Credit-related	1.2	1.6	3.9	4.5	0.2
Foreign investments	0.1	0.4	0.1	0.3	0.5
Costa Rica					
Total	4.6	7.4	8.4	4.9	0.9
Credit-related	2.1	2.7	5.5	2.1	-3.2
Foreign investments	0.7	1.6	1.5	2.4	1.2
El Salvador					
Total	1.9	-0.1	2.7	0.6	2.5
Credit-related	1.1	2.1	4.1	5.0	-0.1
Foreign investments	0.3	-0.2	-0.3	-1.2	-0.6
Guatemala					
Total	1.5	0.3	3.5	0.9	2.1
Credit-related	0.7	0.8	2.1	2.7	-1.6
Foreign investments	0.5	-0.5	0.6	0.8	1.2
Haiti					
Total	1.5	1.2	8.4	18.5	11.8
Credit-related	-0.1	0.3	5.0	4.9	1.7
Foreign investments	-0.8	-0.1	0.1	0.2	0.2
Honduras					
Total	1.6	1.6	7.8	2.1	3.5
Credit-related	1.8	3.5	7.2	3.9	1.5
Foreign investments	-1.1	-1.9	-1.3	-1.8	-0.8
Nicaragua					
Total	3.3	3.0	1.9	15.8	19.7
Credit-related	2.4	4.2	6.6	16.3	19.5
Foreign investments	0.1	-1.4	-1.0	-0.4	0.0
Dominican Republic					
Total	1.0	3.6	2.2	4.3	0.3
Credit-related	0.8	-0.2	2.1	2.9	-4.2
Foreign investments	-0.2	3.1	-0.1	0.6	1.2

Annex 1 *(continued 6)*

	Millions of 1987 dollars				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Non-oil-exporting countries of South America					
Total	332	5 779	9 465	3 051	-12 580
Credit-related	310	3 905	6 504	5 396	-10 005
Foreign investments	-19	346	890	2 563	-297
Argentina					
Total	-84	-458	489	-1 556	-3 309
Credit-related	-126	-380	447	2 927	-3 251
Foreign investments	105	-52	-115	1 228	108
Brazil					
Total	189	5 583	7 560	820	-8 031
Credit-related	-79	3 856	5 335	-506	-5 904
Foreign investments	146	728	1 097	1 004	-728
Colombia					
Total	171	454	210	1 262	-519
Credit-related	178	302	231	986	22
Foreign investments	-36	-100	-137	9	177
Chile					
Total	36	165	703	1 832	-652
Credit-related	274	128	349	1 331	-872
Foreign investments	-231	-232	-92	206	142
Paraguay					
Total	46	39	238	401	105
Credit-related	34	25	111	208	127
Foreign investments	4	3	2	-3	-34
Uruguay					
Total	-26	-4	265	292	-174
Credit-related	29	-25	31	449	-127
Foreign investments	-7	-1	135	119	38

Annex 1 *(continued 7)*

	As a percentage of exports of goods and services				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Non-oil-exporting countries of South America					
Total	2.8	22.8	24.2	5.4	-26.2
Credit-related	2.5	15.5	16.7	10.6	-20.8
Foreign investments	0.2	1.1	2.2	5.3	-0.6
Argentina					
Total	-0.2	-7.2	2.8	-15.5	-35.8
Credit-related	-1.6	-5.7	2.8	26.0	-34.9
Foreign investments	2.7	-0.2	-1.4	11.9	0.9
Brazil					
Total	3.2	48.8	41.3	2.7	-30.3
Credit-related	-1.4	33.0	29.2	-2.4	-22.4
Foreign investments	2.8	5.6	5.8	4.0	-2.8
Colombia					
Total	7.9	16.3	3.9	26.0	-7.9
Credit-related	8.3	10.7	5.1	20.2	1.4
Foreign investments	-2.0	-3.5	-2.9	0.3	3.8
Chile					
Total	4.7	5.9	13.9	30.2	-12.8
Credit-related	12.7	3.8	6.2	22.0	-16.9
Foreign investments	-9.1	-7.2	-2.3	3.9	2.1
Paraguay					
Total	24.7	13.6	43.4	64.8	16.6
Credit-related	17.8	8.8	21.4	33.3	23.7
Foreign investments	2.7	1.0	0.4	-0.4	-4.3
Uruguay					
Total	-1.9	0.6	20.4	15.8	-12.9
Credit-related	5.2	-2.4	1.7	27.0	-9.7
Foreign investments	-1.0	-0.2	10.7	6.7	2.7

Annex 1 *(concluded)*

	As a percentage of the gross domestic product				
	1960-1969	1970-1973	1974-1979	1980-1982	1983-1987
Non-oil-exporting countries of South America					
Total	0.2	2.0	2.3	0.6	-3.3
Credit-related	0.2	1.4	1.6	1.1	-2.6
Foreign investments	0.0	0.1	0.2	0.5	-0.1
Argentina					
Total	0.0	-0.7	0.2	-2.0	-4.7
Credit-related	-0.1	-0.5	0.3	2.3	-4.5
Foreign investments	0.3	0.0	-0.2	1.4	0.2
Brazil					
Total	0.2	3.5	3.0	0.3	-3.3
Credit-related	-0.1	2.4	2.1	-0.2	-2.4
Foreign investments	0.2	0.4	0.4	0.4	-0.3
Colombia					
Total	1.0	2.1	0.6	3.2	-1.3
Credit-related	1.0	1.4	0.7	2.5	0.2
Foreign investments	-0.3	-0.5	-0.5	0.0	0.5
Chile					
Total	0.5	0.7	2.9	5.6	-3.7
Credit-related	1.7	0.6	1.2	4.2	-5.0
Foreign investments	-1.3	-1.0	-0.4	0.7	0.8
Paraguay					
Total	3.3	2.0	7.1	8.0	2.2
Credit-related	2.3	1.3	3.5	4.1	2.5
Foreign investments	0.3	0.1	0.0	-0.1	-0.8
Uruguay					
Total	-0.6	-0.1	3.5	2.4	-3.1
Credit-related	-0.5	-0.4	0.2	3.9	-2.3
Foreign investments	-0.1	0.0	1.8	1.0	0.6

Source: ECLAC, Economic Development Division, on the basis of figures from the International Monetary Fund.

[a] The following concepts are used: Total net transfer of resources: equivalent to the net inflow of capital (official transfers, long and short-term capital and errors and omissions) minus net profits and interest. Net credit-related transfer: equivalent to the net inflow of long-term capital (except investment capital) and net inflow of short-term capital from official sources and commercial banks (therefore excludes the item "capital from other sectors") minus net payments of interest. Net foreign investments: equivalent to direct and portfolio investments minus net payments of profits.

Annex 2

CURRENT FUNDING OF THE BRADY PLAN: A SIMPLE ILLUSTRATION OF ITS EFFECTS ON DEBT REDUCTION IN LATIN AMERICA AND THE CARIBBEAN

Of the total of 39 developing countries said to be candidates for debt reduction, 17 are from Latin America and the Caribbean.[1] These latter countries have a total debt of US$400 billion. The portion of that debt with the commercial banks is about US$245 billion, of which US$213 billion has been estimated by one analyst to be publicly-held bank debt potentially eligible for the Brady Plan.[2] Assuming a 10% rate of interest on bank debt, and a 7.5% rate on other debt, annual interest payments on the total debt and the stock of bank debt would be US$36 billion and US$25 billion, respectively.

While there are complex rules of access to the pool of US$30 billion of public monies in support of debt reduction, for the sake of simplicity it can be assumed that the 17 Latin American and Caribbean countries can draw on these funds in rough proportion to their share of the eligible publicly-held bank debt in the aforementioned group of 39 countries; i.e., 76% of the total, or US$23 billion. Also for the sake of simplicity, the reduction is assumed to be effected via a buyback,[3] which uses the pre-Brady Plan secondary market price as the reference price, but to which is added a 15% premium to forestall any potential debate about undervaluation. Since the February 1989 weighted average secondary market price for the 17 countries was 33 cents,[4] the illustrated buyback will be effected at 38 cents on the dollar. Thus, the US$23 billion of finance would retire US$61 billion of the region's bank debt.

The elimination of US$61 billion of bank debt causes total bank obligations to fall by 25%. Total debt obviously falls by less (15%).

[1] The candidates are from a United States Treasury report on the Brady Plan. The 17 Latin American and Caribbean countries are Argentina, Bolivia, Brazil, Chile, Costa Rica, Dominican Republic, Ecuador, Guyana, Honduras, Jamaica, Mexico, Nicaragua, Panama, Peru, Trinidad and Tobago, Uruguay and Venezuela.

[2] The US$213 billion figure is calculated from Jeffrey Sachs, "Making the Brady Plan Work", Cambridge, Mass., Harvard University, Department of Economics, May 1989, table 1. The figure includes adjustments by Sachs for bank debt that has the guarantee of export credit agencies. The corresponding figure given for the total of 39 countries is US$279 billion.

[3] It should be noted that, all things being equal, a market-based exchange of old debt for new bonds backed by collateral of US$23 billion would give approximately the same amount of debt reduction as a direct buyback. The use of exchange instruments could provide additional leverage to the public funding of debt reduction only if there were benefits for the banks that further distinguished the new debt from the old debt. Such possibilities might include a perception by creditors that World Bank funding of guarantees in practice means official entanglement in the instrument, which would award it a quasi-preferred status. Alternatively, carrot and stick incentives derived from changes in bank accounting and tax regulations could make the creditors perceive benefits from the new bond that go beyond the collateral behind it. For an excellent treatment of the equivalence of market-based buybacks and securitization, see Michael Dooley, "Self-Financed Buy-Backs and Asset Exchanges", *IMF Staff Papers*, vol. 35, No. 4, December 1988, pp. 714-722.

[4] Calculated from data in Sachs, "New Approaches to the Latin American Debt Crisis", Cambridge Mass., Harvard University, Department of Economics, 1988. Table 1.

It must also be remembered that the buyback was financed by US$23 billion of official loans, which is new debt. Since something of the order of half of these official resources will come out of existing loan programmes that would apparently have been disbursed anyway, the strictly additional debt attributable to the buyback operation as such is US$11.5 billion. Therefore, the net reduction in total debt due to the buyback is US$50 billion (61-11.5), which represents a fall of only 13% with respect to the original outstanding balance of total debt.

What about the effect on interest payments? On account of the buyback, total interest payments on the bank debt fall by US$6 billion (0.10 x 61), or 25%. However, for reasons analogous to the above, there are "new" interest charges derived from the official loans contracted to finance the operation. Since about half of the US$23 billion of loans would have been drawn-down anyway in normal operations with the official creditors, the "additional" annual interest burden derived from the buyback is, strictly speaking, US$860 million (0.075 x 11.5). Thus the net reduction of interest payments on the total debt is US$5 billion, or 14% of the original interest bill of US$36 billion.

Cash flow relief for the balance of payments would be less than the net interest savings of US$5 billion per annum.[5] On the one hand, it must be remembered that one-half of the US$23 billion used to finance the debt reduction came from set-asides of official lending programmes originally destined to support the debtor countries' balance of payments. Since the US$5 billion per annum of the interest savings in the above example is at the cost of redirecting US$11.5 billion of loans from the balance of payments to debt reduction, the cash balance of the operation for the external accounts is initially "negative". On the other hand, since the other half of the US$23 billion of official funding represents so-called "additional", earmarked loans, it does not generate an initially negative cash balance for the external accounts. However, the resources are then an unexpected net addition to debt that must be repaid; hence when grace periods expire on these additional loans (4.5 years in the case of the IMF and 5 years in the case of the World Bank), their amortization – which cannot be rescheduled – will erode the annual cash flow benefits of the net interest savings derived from debt reduction.[6]

Since the allocation of official funding and discounts applicable in debt reduction operations will all be determined on a case-by-case basis, the above illustration of course can be only a rough guide of the potential effects of the Brady Plan.

[5] Some analysts include reduced amortization in the calculation of cash flow relief. This, however, can be a deceptive measure of the benefits of partial debt reduction in a foreign-exchange-constrained problem debtor. First, when secondary market discounts on debt are large, the expected value of principal at the margin is low or negligible. Second, in practical terms of balance-of-payments financing over the relevant time horizon of a country in crisis, the "savings" of amortization payments are more nominal than real. In effect, countries with debt problems do not, and are not expected to, amortize debts with commercial banks. These obligations are, and in practice have been, easily rescheduled. In contrast, the problem debtor does experience some pressure to keep his interest payments current.

[6] For analysis of the effect of accelerated disbursements on debt service burdens, see Alfred Watkins, "Rejoinder to Feinberg", Washington, D.C., May 1989.

Annex 3

THE PUBLIC RESOURCE COMMITMENT NEEDED FOR EFFICIENT DEBT REDUCTION IN THE THIRD WORLD

How much would the public guarantee cost? The potentially eligible bank debt of the 39 developing countries discussed as candidates for the Brady Plan has been estimated at US$279 billion. The pre-Brady Plan value of this debt at February 1989 secondary market prices, plus a 15% premium, would be US$112 billion.[1] The US$112 billion could be paid in a single 30-year maturity which bears a market interest rate, e.g., 10%. The cost of guaranteeing that debt would be no more than a zero-coupon bond with a similar maturity. For instance, the cost of a 30-year zero-coupon bond yielding 8% is 9.9% of face value; hence the guarantee of principal could be bought today for about US$11 billion.

The annual interest payments of US$11 billion on the US$112 billion of debt would also need to be guaranteed by the creditor governments. There are, of course, any number of ways to administer the guarantee.[2] The maximum loss that the guarantor would face is US$11 billion per year, which at a 10% rate of discount has a present value of slightly more than US$100 billion. However, the entire point of the debt reduction exercise is to bring the debtor countries' obligations down to serviceable levels. Hence, the probability of any guarantees being called upon would be extremely low. If the probability of default were 10% throughout the 30-year period, the expected cost of the guarantee would be just US$10 billion. *Ceteris paribus,* any probability much higher than this would indicate that debt reduction was not deep enough.

Instead of reducing the debt to its market value of 40 cents on the dollar (which includes the 15% premium), an alternative strategy would be to reduce the interest rate to 40% of its original level. Annual interest payments, and hence guarantees, would be the same as in the previous example. However, with the outstanding debt kept at par – like one of the options in the Mexican agreement –, the cost of the guarantee on principal (measured in terms of the purchase of a zero-coupon bond) would rise to US$28 billion. Thus, while this arrangement may be more attractive to some capital-constrained banks, it does significantly raise requirements for official finance.

The above calculations suggest that the public resource commitment that would ultimately be required to eliminate the debt overhang in the Third World is in the range of US$110-130 billion. However, even in the face of a real commitment to support a very dramatic debt reduction, some developing countries will undoubtedly be unable to organize themselves for a Brady-style operation. Thus, a commitment of the order of US$90 billion would probably represent the initial critical mass of public resources needed to revert negative expectations and make the Brady Plan begin to work. This amount of resources is 20% higher than the recent increase in the World Bank's capital (US$75 billion), and 20% lower than the 100% quota increase (US$115 billion) proposed for the IMF by its Managing Director.

From the standpoint of the renewal of the system, a comprehensive approach like that outlined above is clearly the appropriate strategy. However, since there is little political disposition to raise fiscal income in the industrialized countries, more modest programmes for voluntary debt reduction may

[1] The average secondary market price of the debt of the 39 countries was US$0.35 (see Jeffrey Sachs, "Making the Brady Plan Work", Cambridge, Mass., Harvard University, Department of Economics, May 1989, table 1). With a 15% premium, the debt would be honoured at the equivalent of 40% of its face value.

[2] Normally guarantees can be backed with 5%-10% of paid-in capital.

unfortunately have to be contemplated. One option would be to offer full public guarantees on interest payments that have been reduced to serviceable levels for a medium-term period, e.g., five years, without offering any guarantees for rescheduled principal or subsequent years' interest payments.

The only advantage of this latter temporary debt service reduction scheme, *vis-à-vis* a more comprehensive solution like the one outlined above, is that it does provide some breathing space for the debtors while initially economizing fiscal resources. Its major drawback is that it is much less efficient and more uncertain. The option leaves the stock of debt unaltered and the horizon very clouded by the bulge in payments in year 6, all of which could negatively affect expectations of the private sector and inhibit a return to voluntary lending by private credit markets. To be successful, this latter strategy would probably have to be deployed in the special case of a country where response to economic reform is very rapid and/or the external trading environment is expected to improve markedly in the near term. Moreover, the scheme would probably work better if it were placed within an international debt facility. On the one hand, as explained later in the main text, a facility is precisely designed to manage the debt problem by initially lowering debt service rather than debt as such. On the other, since the facility has purchased debt from the banks, there would not be uncertainty about how debt service problems would be dealt with should they materialize in year 6.

In sum, there may be limited opportunities to deploy the more economical temporary debt service reduction scheme in a few countries. But the debt picture has been clouded by uncertainty for so long, and the debtors' plight is so critical, that the comprehensive option outlined earlier is clearly the preferred course of action for the vast majority of the debtor countries in Latin America and the Caribbean.

LIBROS DE LA CEPAL

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First edition

Reprinted in United Nations — Santiago, Chile — 90-9-1529 — October 1990 — 500

ISBN 92-1-121156-5 — E.90.II.G.7 — 00600 P