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DEVELOPING-COUNTRY DEBT: A MIDDLE WAY

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INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

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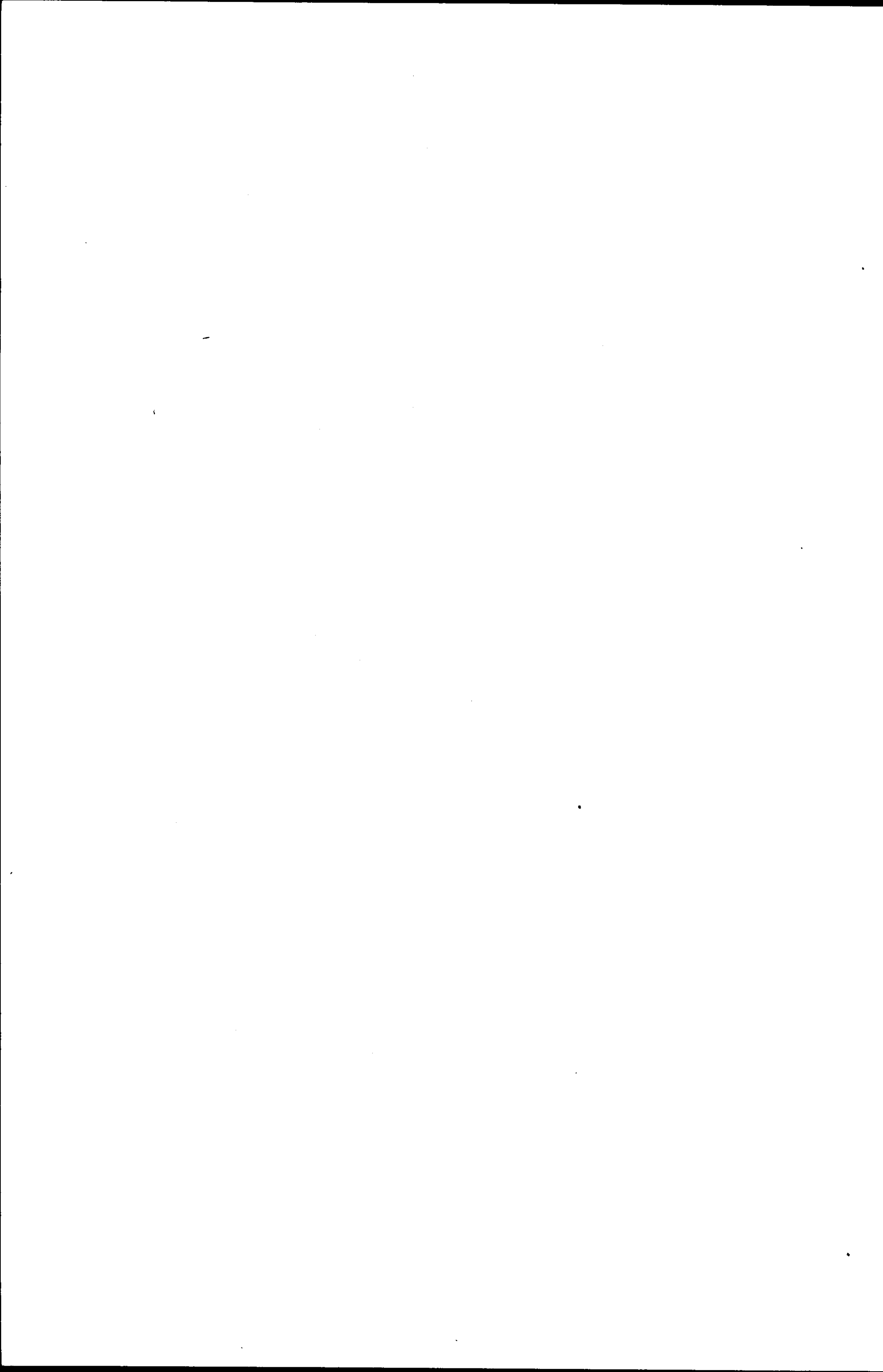

DEVELOPING-COUNTRY DEBT: A MIDDLE WAY

1 Introduction

More than half a decade after Mexico's dramatic financial collapse in the summer of 1982, the debt problem of developing countries remains as intractable as ever. The good news is that the threat of a global banking crisis appears to have been successfully contained—at least until now—by the multilateral strategy quickly put together under U.S. leadership in the first months after the Mexican rescue. The bad news is that many third-world countries continue to stagnate, frustrated and resentful, under the burden of their outstanding contractual obligations. It is now widely acknowledged by scholars and practitioners alike that the LDC debt dilemma will not be truly resolved until the severe cash-flow strains on debtors can be durably eased in a context of renewed economic development. And that, everyone seems increasingly prepared to agree, will require reform of the prevailing strategy to reduce in some way the large sums now owed to creditors. At the International Monetary Fund's most recent meeting in Berlin in September 1988, even as authoritative a body as the Fund's Interim Committee "expressed concern that many countries continue to face severe financing and adjustment difficulties" and called for "more forceful actions . . . to reduce the stock of debt" (Interim Committee, 1988, par. 4). The core question is: how can reform of the prevailing strategy best be accomplished?

Among advocates of debt reform, two main schools of thought have emerged over time. On one side are the "evolutionists," who argue that reform can best be promoted through extension and refinement, rather than replacement, of the prevailing case-by-case strategy, retaining in particular its emphasis on initiatives that are both voluntary and market-oriented. The original 1982 strategy has already evolved substantially, they point out, first with the celebrated Baker Plan of 1985, then with the so-called "menu approach" initially introduced in 1987. A smorgasbord of imaginative schemes for debt reduction has already been developed through direct negotiations between creditors and individual debtors and, in selected instances, implemented. These schemes may or may not include elements of outright debt relief, which is understood here to entail measures that effectively reduce not only the nominal stock of conventional debt in the present but also the discounted value of total contractual obligations in the future. They

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encompass direct or indirect conversions of various kinds (debt-for-equity, debt-for-debt, even debt-for-nature), as in the major package negotiated with Brazil in 1988, as well as straight debt buybacks, as in the deal worked out for Bolivia in 1987. The evolutionist approach, not surprisingly, attracts most bankers and public officials. It was commended by the Interim Committee in September 1988. It has also been endorsed by such scholars as William Cline (1987) and John Williamson (1988), as well as by blue-ribbon panels such as the Economic Policy Council of the United Nations Association of the United States (1988) and the Inter-American Dialogue (1989). And it forms the basis for the debt program of the new Bush administration, first outlined by Treasury Secretary Nicholas Brady in March 1989 (Kilborn, 1989).

On the other side are the "creationists," who by contrast plead for more comprehensive and if necessary mandatory solutions, usually involving establishment or designation of some public institution to implement a concerted approach to the problem. Creationists do not believe that serious progress on debt is likely to occur in the absence of organized collective action. Creationists also put more emphasis than do evolutionists on measures of outright relief rather than merely conventional reduction of debt. The school originated after 1982 with the early plans of Peter Kenen (1983) and Felix Rohatyn (1983), each proposing the launching of a new multilateral facility to aid in consolidating LDC obligations. More recently, there has been a flood of ideas along this line—not just from scholars and academics (e.g., Sachs and Huizinga, 1987; Islam, 1988), as might be expected, but also from present and former international officials (Sengupta, 1988; Rotberg, 1988), members of the U.S. Congress (LaFalce, 1987; Pease, 1988), commercial bankers (Robinson, 1988), and even the finance ministry of Japan (Sumita, 1988). Few of these schemes, with their emphasis on institutional innovation by the public sector, have much in common with the laissez-faire tone of the private-market initiatives favored by evolutionists.

Is there any middle ground between these two contending schools of thought?[1] The purpose of this essay is to suggest that there is indeed a middle way to debt reform—a practical approach that retains the creationists' stress on the need for collective action while not abandoning the evolutionists' preference for voluntary and market-oriented solutions. Like other advocates of reform, I start from the premise that creditor-debtor relations today amount to something akin to a non–zero-sum game—a strategic interaction among many players with an unexploited opportunity for joint gain. The now stand-

[1] The distinction drawn here between these two schools of thought is a practical one, based on the state of current debate rather than derived from formal economic logic. In principle, voluntary and market-oriented solutions are not necessarily synonymous, nor (as we shall see) are they necessarily inconsistent with approaches that are comprehensive and involve a degree of collective action. But that tends to be the way the choice is framed in public discussion today (see, e.g., Williamson, 1988; Krugman, 1988).

ard argument for this premise is summarized briefly in section 2. The remainder of the essay is concerned with the question of how to realize that joint gain.

Section 3 opens the discussion with an explanation for the unsatisfactory outcome of the current strategy, contending that it is a direct result of underlying configurations of economic and political power in creditor-debtor relations. Section 4 suggests reasons why creationists are correct in insisting that no significant change in the current outcome can be expected without organized collective action to promote revision of the prevailing approach. Imaginative institutional innovation does appear to be required to achieve genuine debt reform. Yet a concerted approach need not be inconsistent with differentiated solutions that remain voluntary and market-oriented, as advocated by evolutionists. Section 5 spells out what a reformed strategy might look like, arguing that a middle way between the evolutionists and the creationists can best be found in an international mechanism for debt relief organized on the model of Chapter 11 of the U.S. Bankruptcy Code. The essential feature would be a new agency—the International Debt Restructuring Agency—established to provide a framework for the negotiated resolution of LDC debt-service difficulties on a flexible case-by-case basis consistent with the interests of all the parties concerned. The approach would be comprehensive, but individual arrangements would remain to be worked out through direct bargaining by creditors and debtors.

2 An Unexploited Opportunity for Joint Gain

The argument that there is an unexploited opportunity for joint gain proceeds from the obviously skewed distribution of the burden of adjustment that has resulted from creditor-debtor bargaining until now. For the most part, debtors rather than creditors have borne the bulk of losses under the prevailing strategy, through stunted growth and reverse resource transfers. While in principle all parties involved are supposed to share the burden, in practice most attention has been given to IMF-sponsored or -monitored domestic "stabilization" programs for the debtor nations, complete with tough policy conditionality and rigorous enforcement of internal and external performance criteria. The capital-market countries have done little to ease developing-country debt-service burdens, apart from agreeing at the June 1988 Group of 7 economic summit to consider some mild relief measures for the poor countries of sub-Saharan Africa, where most debts are owed to official creditors. Nor have commercial banks yet made many direct concessions of any significance to the middle-income debtors in Latin America or elsewhere, apart from frequent reschedulings of maturities as they come due, occasionally accompanied by limited amounts of so-called "concerted" (involuntary) new lending and some modest reductions of interest margins. A

number of smaller banks, it is true, have formally accepted losses via write-offs or sales at discount in the growing secondary market for LDC paper. In most cases, however, bankers still insist on holding debtors to their full contractual obligations while continuing to carry loans on their books at 100 percent of face value.

It can be argued that the banks have paid a price indirectly: the financial markets have effectively discounted their LDC paper for them by bidding down the value of bank equity instead. The persistently low quotations for the shares of America's big money-center institutions—despite a five-year boom in the stock market up to October 1987—have been widely attributed to their heavy third-world exposure, especially in Latin America (Makin, 1987; Sachs and Huizinga, 1987). That price was finally implicitly acknowledged in the spring of 1987 when U.S. banks, led by Citicorp, began a massive buildup of their previously meager loan-loss reserves. But it must be remembered that, even with these additional provisions (mostly created via transfers from bank equity), there has been no substantial forgiveness of third-world debts. As David Rockefeller wrote in the summer of 1987, "This transfer of funds—and that is all it is—has not cost the banks a penny. It does not reduce the obligations of the debtor nations, nor will it diminish the efforts by the banks to recover all the interest and principal represented by their current loans." Developing countries are still expected to do most of the adjusting, whatever the prospects for their future debt-service capacity.

Creditors therefore continue to treat most debtors as effectively illiquid rather than in any sense insolvent. That is, no matter how severe the debtors' present cash-flow strains may be, their longer-term ability to service debt is assumed to be fundamentally unimpaired. Debtor nations may have borne a heavy burden until now, it is argued, but that is part of the adjustment of policies and performance necessary for the improvement of their economies. The key, these countries are told, continues to be patience: ultimately their development will resume if only they keep playing by the rules. Given time, domestic-policy reforms will lead to higher levels of exports and output growth, gradually shrinking the *relative* weight of their external debt obligations and sparking, it is hoped, some "spontaneous" new foreign financing as well. With perseverance, in other words, their efforts to restore creditworthiness and reverse the net outward transfer of resources will sooner or later pay off.

More than half a decade onward, however, as even some of the most determined debtors find themselves caught in what Krueger (1987, p. 163) has labeled a "low-growth, high-debt-service trap," this argument is beginning to wear thin. The real tragedy of the prevailing strategy, as Krueger and others (Sachs, 1986; Dornbusch, 1987) have pointed out, is the extent to which it discourages investment in debtor countries, thereby depriving them

of the very means they need—an expansion of productive capacity—to help them earn their way out of their difficulties. In macroeconomic terms, the obligation to pay full debt service requires a corresponding reduction of domestic expenditures in order to release real resources for transfer abroad. In budgetary terms, the obligation requires extra public revenues in order to pay foreign interest costs. In practice, therefore, debtor governments must undertake some combination of spending cuts and tax increases, both of which fall especially hard on domestic capital formation. The result has been a cut in investment rates in highly indebted countries from above 25 percent of gross domestic product before 1982 to under 15 percent in more recent years—in some cases barely enough, at the present pace, to maintain the existing capital stock (American Express Bank, 1987, pp. 6-7). Is it any surprise, then, that the debt problem has proved so intractable? The prevailing strategy virtually condemns debtor countries—even those committed to serious policy reforms—to frustration and failure. For many if not most debtors, it may fairly be contended, we are really talking about something closer to insolvency—call it de facto insolvency—than to mere illiquidity.[2]

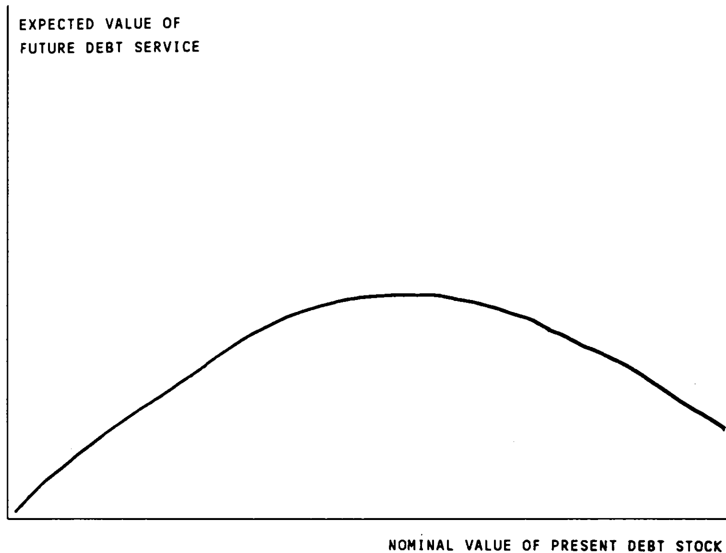
In such circumstances, a strong case can be made that at least in some situations creditors as well as debtors would be significantly better off with a cooperative strategy of debt relief. The logic of the case has been most elegantly summarized by Krugman (1988), using what he calls the "debt relief Laffer curve," which relates the expected value of a country's future debt service to the nominal value of its present foreign debt (see the accompanying figure). At relatively low levels of debt, nominal claims can be expected to be fully repaid. But as liabilities accumulate, the possibility of nonpayment is likely to grow, owing in particular to the exigencies of the low-growth, high-debt-service trap, to the point where any further additions to a country's debt stock could reduce its capacity to meet all future contractual obligations. In Krugman's words:

> Just as governments may sometimes actually increase tax revenue by reducing tax rates, creditors may sometimes increase expected payment by forgiving part of a country's debt . . . . Arguments that debt relief is in everyone's interest are, in effect, arguments that countries are on the wrong side of the debt relief Laffer curve (Krugman, 1988, pp. 11-12).

In view of the persistence of the cash-flow strains of so many LDC debtors since 1982, it seems reasonable to conclude that a good number of them are indeed on the wrong side of the debt relief Laffer curve.

[2] Other more formal and cumbersome circumlocutions have been invented to describe what I call de facto insolvency—for example, "structural indebtedness" (Bailey and Cohen, 1987, p. 2) or "hysteresis of solvency" (Islam, 1988, p. 16). I prefer to call a spade a spade.

THE DEBT RELIEF LAFFER CURVE



3 Explaining the Current Outcome

To learn how debtors can get back on the correct side of the debt relief Laffer curve, we must begin by asking what *explains* the decidedly uneven distribution of the burden of adjustment that has been evident until now. This means asking why debtors have, in effect, consented to playing the game on creditors' terms. Why have they chosen not to "defect" by repudiating their liabilities or otherwise refusing to acknowledge their outstanding contractual obligations? Most developing countries have been careful, no matter how hard-pressed, to preserve their lines of communication with other major players and, as much as possible, abide by the results of creditor-debtor negotiations, however unfavorable. Dornbusch (1987, p. 15) likens the outcome to a mugging. If so, debtors have collaborated fully with their muggers.

But collaboration is not cooperation, whatever lip service is paid on the creditor side to multilateralism in the current strategy. Collaboration implies acquiescence at best, coercion and threat at worst—hardly the same as a voluntary process of reciprocal adjustment in pursuit of mutual benefit. For this reason, I regard characterizations of the outcome that use the word "cooperation"—even with qualifiers—as misleading. For one example, see Kahler (1986, p. 26), who proposes the phrase "cooperation without reform." For another, see *The Economist* (1987, p. 46), where the debt problem,

among all international economic-policy issues, is described as "the best example of successful cooperation," albeit "of course, at the expense of the debtor countries." The point is aptly, if inadvertently, captured by the official historian of the IMF (De Vries, 1987, p. 220) when she remarks that the "cooperative" strategy adopted in 1982 "was worked out in conjunction with officials of the governments of industrial members . . . of other major institutions . . . with private commercial bankers, and *with the acceptance* of the authorities of the debtor members concerned" (emphasis supplied).

Three hypotheses, not mutually exclusive, may explain debtor behavior:

a. At the subjective level of "cognitive dynamics," an explanation might be found in the perceptions and values of key players. Debtors may share with creditors a commitment to certain essential norms (standards of behavior defined in terms of mutually accepted rights and obligations).

b. Within debtor countries, an explanation might be found in the demands of domestic politics. Home governments may acquiesce in the prevailing strategy because collaboration with creditors abroad corresponds most closely to (or conflicts least sharply with) the interests of currently dominant political elites.

c. At the international level, an explanation might be found in the distribution of bargaining power among the key players arrayed around the negotiating table. Debtors may play the game on creditors' terms because, in effect, they are coerced or bribed to do so.

Of these hypotheses, the least persuasive is the first. Clearly, belief systems are important in shaping attitudes toward transactions conducted in the marketplace, where standards of behavior and property rights are well established in practice and law. Policymakers in debtor countries, especially the more technically minded officials in the central banks and finance ministries, are undoubtedly influenced by an economic culture that puts a high premium on market-based norms—particularly sanctity of contract and nonpoliticization of commercial relations. But *how much* do such ideas matter in determining the ordering of LDC preferences? The evidence does not permit us to infer that the prevailing economic culture plays more than a marginal role in shaping debtors' perceptions of their interests.

The principal evidence is the obvious dissonance between the words and the deeds of LDC policymakers, which hardly suggests that they have been motivated by a sincere belief in the essential rightness of creditor demands for full satisfaction of contractual obligations. Quite the contrary. Virtually from the moment Mexico's crisis broke in 1982, LDC leaders have made a point of proclaiming their opposition to the prevailing rules of the game, which they clearly feel are biased against their interests. While initially there may have been inertia in at least some debtors' perceptions—much in the manner of cartoon figures who, running off a cliff, hang suspended in midair

before finally plummeting downward—it took little time for a different *gestalt* to dominate the public utterances of policymakers. Debtor governments denounce market norms as unfair or even iniquitous with such vigor and persistence that it is difficult to believe these utterances represent mere posturing for domestic or international advantage.

Yet even as debtor governments protest the rules as a matter of principle, in practice they uphold the norms of sanctity of contract and nonpoliticization of exchanges. They seek more rights, but they do not deny the fact of obligation. Established values do appear to have some operative force. The question is: how independent is that force from other, more objective factors?

One view, following the political scientist, Charles Lipson (1981), attributes genuinely independent influence to market norms, institutionalized in what amounts to an international "regime." The standard definition of a regime among international-relations scholars is a set of "implicit or explicit principles, norms, rules, and decisionmaking procedures around which actors' expectations converge in a given area of international relations" (Krasner, 1983, p. 2). Even before the Mexican crisis, according to Lipson, a distinctive and reasonably well articulated regime had evolved for dealing with LDC debt problems that embodied most of the elements of what later became known as the multilateral debt strategy. But, as Lipson (1986a, 1986b) himself concedes, most of the cooperation has taken place on the creditor side, among commercial banks and between them and public institutions. On the debtor side, a considerable amount of leverage has had to be exercised by the governments of capital-market countries and especially the IMF to gain LDC compliance with creditor terms. This does not suggest that debtors have really operated from the same premises as creditors or shared the same expectations.

The alternative view is more likely, that the influence of market norms is more instrumental than independent; it derives from other factors rather than operating separately from them. Generally, where there is no normative consensus, underlying power configurations will emerge. Norms become merely one means for the strong to legitimate their dominance over the weak—a rationale, in effect, for vested interests. The advantage to the strong of established values is that they put the burden of proof on those who would change them. For countries without the resources to alter outcomes unilaterally, the result is a Catch 22. To be persuasive they must establish credentials (a good reputation), but to establish credentials they must conform, or at least appear to conform or to wish to conform, to the very values they are committed to changing. Hence the illusion that market norms have independent operative force. The reality, it seems evident, is that they function mostly as a reflection of fundamental power relationships in the political

game at home and between debtors and creditors abroad, supporting the second and third of the hypotheses suggested above.

Studies of the politics of adjustment within debtor countries show the importance of domestic distributional struggles in determining the "will and capacity" of governments to play the game on creditors' terms (for a survey, see Haggard and Kaufman, 1989). Stabilization programs generate conflicts among societal forces. As the political scientist, Robert Kaufman (1986, p. 193), has written, "In a world composed of many interest-maximizing economic groups . . . attempts to transfer the costs of stabilization onto others will be the norm rather than the exception." The acquiescence of many developing nations to the multilateral debt strategy can be traced directly to the ability of locally dominant elites to accomplish just such transfers, thereby evading most of the pain of austerity. By insisting on upholding basic market norms in relations with creditors abroad, these nations hope to avert any radicalization of the politics of income distribution at home.

It is no accident that the heaviest burden of adjustment in most debtor countries has fallen on the groups that are least well positioned to influence the course of government—unorganized laborers, peasant farmers, small businessmen, civil servants, and urban or rural marginals. They lack the options usually available to more powerful domestic interests. Private industrialists, large landowners, managers of parastatal enterprises, and the military can often use their influential voices to extract special treatment from policymakers at home or to win exemption from taxation or repressive economic policies. Many are also able, *in extremis*, to take their movable assets elsewhere—otherwise known as capital flight. The more successful the elites have been in exercising these options, the less pressure they have put on debtor governments to seek a change in the rules of the game.

At the international level, too, the practical importance of power has been abundantly clear. Ever since the third world's recent debt difficulties began, commercial bankers (often backed by their home governments and the IMF) have not hesitated whenever possible to exploit the potential for side payments or sanctions to shape outcomes to their advantage. Creditors have encouraged LDC acquiescence in the multilateral strategy by holding out the prospect of more generous rescheduling terms (e.g., longer grace periods, lower interest margins, relaxed policy conditions) and perhaps even "spontaneous" new financing somewhere down the road. They have discouraged defection by implicitly or explicitly threatening retaliation. Penalties might include not just a cessation of medium- or long-term lending or an interruption of shorter-term trade credits but also the seizure of exports or even the attachment of a debtor's foreign assets, such as commercial airliners, ships, and bank accounts. In Mexico in 1982, creditors used the offer

of emergency assistance quite skillfully to strengthen the hand of those in the Mexican government who were opposed to outright default, an option then under serious consideration (Kraft, 1984, p. 4). By 1985, a coherent strategy of "divide and rule" had unashamedly taken hold in the banking community. Carrots, such as multiyear reschedulings or liberalized terms, were dangled before debtor countries as a reward for good behavior; the stick of tough bargaining (or, in the background, damaging punishments) was held over the heads of stubborn recalcitrants (Cohen, 1986, pp. 221-222; Kahler, 1986, p. 29). The investment banker, Pedro-Pablo Kuczynski (1987), accurately describes this as a "containment" strategy. The more successful creditors have been in using the tactics of bribery or coercion, the more pressure there has been on debtor governments *not* to seek a change in the rules of the game.

In short, it is *realpolitik*, not cognitive dynamics, that best explains the behavior of debtor countries. Domestic politics have made it easier for most of these governments to eschew defection, while the international influence of creditors has reinforced rational fears of the consequences of defection. In other words, underlying configurations of power at the domestic and international levels have intersected to make acquiescence appear by far the least-cost choice for policymakers. Is it any wonder, then, that debtors have collaborated so fully with their muggers? As refracted through the lens of power relationships, collaboration has appeared to be in their best interests, frustrated though they may be.

4 The Need for Collective Action

Can LDC frustrations be relieved without the organized collective action that creationists advocate to revise the prevailing strategy? Evolutionists argue that genuine debt reform can be attained simply by continuing to rely on direct bargaining between creditors and debtors. But this implies the possibility of a significant shift in the power relationships that have determined the outcome of creditor-debtor negotiations until now. Creditor resistance to major changes in the status quo, particularly if they involve a substantial degree of debt relief, will not be abandoned lightly. The evolutionists' faith in voluntary market solutions is justified only if a new political equation considerably more favorable to debt reform can be expected to emerge more or less naturally over time to replace previous power relationships.

In point of fact, signs of a changing political equation can be found everywhere today—within debtor countries, in the broad balance of power between debtors and creditors, and among those on the creditor side. The dynamics of the strategic interaction are apparently gradually producing "endogenous" alterations of relevant power relationships. However, in none

of these relationships do the changes underway seem sufficient on their own to fundamentally alleviate the de facto insolvency of many debtor countries. Hence a case can be made that supplementary "exogenous" efforts will be required to facilitate further progress in negotiations. There is little evidence to support the view that genuine reform can be expected to emerge spontaneously.

Domestic Politics in Debtor Countries

Within debtor countries, the possibility of a shift in power relationships looks especially good. Influential economic and social forces at home are becoming increasingly sensitive to the heavy costs of maintaining full debt service abroad. Local elites may so far have been able to evade the bulk of the burden of adjustment, but as long as domestic economic stagnation persists there are likely to be increasing pressures on debtor governments to seek a change in the rules. The debt trap acts like a pressure cooker to heat up conflicts of interest among societal forces at home, gradually eroding the political basis for continued acquiescence abroad. Privileges and exemptions that can be quietly arranged for favored groups in the short term, despite the need for extra public revenues to pay foreign interest, become steadily harder to preserve in an environment of prolonged austerity and fiscal stringency. Meanwhile, those whose living standards suffer the most from stabilization programs understandably grow more and more resistant to repeated calls for patience and perseverance. The danger of continuing economic stagnation is that the domestic political pot could reach the boiling point, as occurred in Venezuela earlier this year. The specter of disorder or worse may compel debtor governments, whether they like it or not, to look for other more radical solutions to their difficulties—up to and including a unilateral moratorium on all outstanding contractual obligations.

Thus, complacency is not in order. As Putnam (1988, pp. 438-439) has pointed out, national policymakers not otherwise disposed to "voluntary" defection in international relations may nonetheless be forced into "involuntary" defection by politics closer to home. They may not regard defiance of their foreign creditors as rational, but personal and political considerations may leave them little choice, as recent events in a number of developing countries have already demonstrated. A notable example was provided during the 1988 presidential election in Mexico, where ruling-party candidate Carlos Salinas de Gortari, despite his past record of close cooperation with foreign creditors, apparently felt impelled by the pressure of domestic opposition to adopt a strikingly tougher stand on the issue of future debt negotiations.

Nevertheless, however plausible the prospect of involuntary defection, the danger ought not be exaggerated. The pot has *not* boiled over in many

debtor countries, despite rising public dissatisfaction with prevailing policies. Debtor governments will undoubtedly continue to feel the heat from their constituents; it is even possible that a growing number will be driven to adopt a more confrontational posture vis-à-vis creditors, like Peru in 1985 and Brazil in 1987. But experience to date does not indicate that enough governments will go this route to produce an "endogenous" shift in bargaining power sufficient on its own to achieve genuine debt reform. Even in Brazil, with its considerable international negotiating leverage, domestic political discontent did not prevent an eventual return to more orthodox policies in 1988 after an eleven-month moratorium on commercial-debt service.

The Balance of Power between Debtors and Creditors

What about the broad balance of bargaining power between debtors and creditors? Until now, creditors have been remarkably successful in maneuvering most debtors into a policy of acquiescence. The main reason, obviously, is the wide range of financial and legal resources available to creditors, providing them with ample ammunition for their tactics of bribery and coercion. But debtors are not without their own resources to put to work as possible carrots or sticks. Debtors can tempt creditors into concessions by offering side payments—for example, generous debt-equity conversion programs or improved access to domestic lending markets. They can also threaten creditors with some sort of abrogation of full contractual obligations, reflecting one of the most fundamental characteristics of international financial markets: the inability of lenders to directly enforce repayment. Abrogation could mean formal repudiation of all outstanding debts—de jure default, the ultimate weapon. Or it could mean something less dramatic, such as a temporary postponement of amortization or just a short-term moratorium on some or all interest payments. These intermediate actions between full compliance and de jure default are variously described as "partial," "de facto," or, in the phrase of the financial journalist Anatole Kaletsky (1985), "conciliatory" default. As all concerned have long understood, *both* creditors and debtors are constrained to some extent by the potential negotiating leverage of the other—mutual hostages, as it were, to their strategic interaction.[3] As should also be understood, there is no reason to assume that the broad balance of leverage between the two sides will always be the same.

It can be argued that to some extent the balance of leverage has already shifted, despite the past effectiveness of the carrot-and-stick "containment" approach of creditors. The issue here is credibility. Over time, promises of

[3] A considerable literature has developed in recent years attempting to model formally the complex bargaining relationship between international creditors and debtors. For useful surveys, see Eaton, Gersovitz, and Stiglitz (1986), Glick (1986), and Crawford (1987).

rewards or threats of punishment will almost certainly become less and less persuasive to debtors. Strenuous LDC exertions to improve trade balances have yet to earn a renewal of spontaneous lending by the markets. Even Colombia, the one nation in Latin America that since 1982 has never requested a rescheduling, has experienced great difficulties arranging fresh financing from Western banks. Meanwhile, recent involuntary—or even voluntary—defections by several LDC governments have failed to provoke many damaging penalties from creditors. Not even Peru, which under its Socialist president Alan Garcia has been perhaps the most confrontational of third-world debtors, has seen its exports seized or its foreign assets attached. While there has been a sizable falloff of short-term trade credits for Peru, it began as early as 1982 and was largely completed by the time Garcia took office in mid-1985 (Alexander, 1987, p. 46). Reportedly, the Peruvians can still raise enough trade financing when needed simply by paying slightly more than standard market rates. Many debtors are becoming increasingly skeptical that they have much to fear from creditors.

Two major factors appear to be responsible. One is juridical uncertainty: the limited, not to say dubious, basis in law for the usual list of legal sanctions threatened by creditors against recalcitrant debtors. There are few court precedents establishing the right of international lenders to seize exports or attach the assets of a sovereign borrower. Despite much discussion in recent years, lawyers are still unable to agree on what forms of legal redress, if any, are applicable, or even on whether court judgments could actually be enforced.[4] Awareness has grown, therefore, that the range of resources truly available to creditors may be more restricted than first thought, justifying increasing skepticism on the part of many debtors.

The second factor is the sheer number of debtors that must be induced or pressured into acquiescence in order to preserve the credibility of creditors. When only one or two countries appear to be on the verge of defection—whether involuntary or voluntary—it is not difficult for creditors to make believable promises of rewards or threats of sanctions. Indeed, it is plainly to their advantage to do all they can to cultivate a reputation for toughness. But neither bribery nor coercion is without cost. As the ranks of potential defaulters grow, so too do the potential losses for creditors, should push come to shove. Just as in the so-called "chain-store paradox" of game theory,

[4] Central to the debate among lawyers are two traditional tenets of international law—the principle of foreign sovereign immunity and the act of state doctrine—and the extent to which either, or both, may constrain the legal remedies available to lenders to foreign sovereigns. Neither recent legislation (e.g., the U.S. Foreign Sovereign Immunities Act of 1976) nor court rulings (involving countries as diverse as Costa Rica, Cuba, and Iran) have succeeded in clarifying the juridical issues or risks involved. For a sample of opinion, see Nichols (1984), McCormick (1984), and Alexander (1987, Chap. 2).

the benefits of investing in a reputation for toughness may disappear altogether in a scenario of many simultaneous defections (see, e.g., Ordeshook, 1986, p. 453). The historical record, as Lindert and Morton (1989) recently noted, demonstrates an inverse relationship between the number of countries that have been in trouble at any given moment and the willingness of creditors in effect to put their money where their mouth is. Prior to World War I, the only debtors ever subjected to sanctions were those that defaulted more or less in isolation. During global crises, by contrast, in the nineteenth century and in the interwar period, most nonpayers escaped significant retribution by creditors. Debtor countries today may be forgiven for seeing in this experience a lesson for their own time.

The trouble with bribery is its "demonstration effect." Each debtor country keeps a close watch on creditor negotiations with all other debtors, and any concessions made to one are soon demanded by all. Thus creditors understandably hesitate to spark the process by making concessions in the first place. The trouble with coercion, conversely, is a kind of reverse demonstration effect: to be credible, sanctions imposed on one recalcitrant debtor must be imposed on all. Otherwise, individual debtors will always hope to be treated as the exception rather than the rule, and incentives to defect may actually increase rather than fall. Creditors are not eager to spark this process either, given the number of potential defaulters to be kept in line.

Creditors are not unaware of the erosion of their credibility, and to the extent possible have acted decisively to maintain or reinforce their leverage vis-à-vis debtors. Almost from the first moments following Mexico's crisis in 1982, banks have sought to reduce their vulnerability by gradually bolstering general capital ratios. Even more dramatic was the sudden and massive buildup of loan-loss reserves in the spring of 1987 by banks in the United States, Canada, and Great Britain, triggered by Citicorp, America's biggest bank. Citicorp set a new standard for American lenders, a minimum provision of 25 percent against overall LDC exposure. Subsequently, even higher levels were established by a number of important U.S. intermediaries.

Whatever Citicorp's motivations in triggering this historic round of reserve increases,[5] and whatever the ultimate results of the initiative, the immediate

[5] Various commentators have suggested at least four motivations for Citicorp's action in addition to a desire to strengthen its bargaining position vis-à-vis debtors: (a) to position the bank to "reliquify" its LDC portfolio by enabling it to take future selective charges against its new reserves; (b) to improve its competitive position in relation to less profitable or more heavily exposed commercial-banking rivals; (c) to exploit certain tax advantages before their termination under the tax-reform law passed in 1986; or (d) to provide its recently appointed chairman, John Reed, with a dramatic opportunity to distinguish his leadership of the bank from the policies of his well-known predecessor and patron, Walter Wriston. The five motivations are not mutually exclusive, of course.

effect in the opinion of many observers was to improve the banking community's strategic position in negotiations with debtors. The fact that the provisions had to be deducted from current earnings under U.S. accounting conventions gave the appearance of record losses for many banks in their 1987 income statements. But these were paper losses only, as indicated earlier, since most of the reserves were created by setting aside a portion of already-existing shareholder equity. In bargaining terms, the main importance of the provisions was that they further insulated future earnings from the impact of possible LDC defections, signaling to debtors that banks could now afford to take some hits, if necessary.

In the opinion of other observers, however, the effect was less salutory for banks, for several reasons. In the first place, a 25 percent provision is still considerably smaller than the discounts that have recently prevailed in the secondary market for LDC debts, suggesting that yet more reserves will be required to fully insulate future bank earnings against all possible losses.[6] Furthermore, even though future *earnings* may now be better protected, bank *capital* is not. Charges against the banks' new reserves will automatically reduce their capital, as currently measured, requiring them either to market additional equity and sell off existing loans or to apply to the regulators for an exemption from minimum capital requirements. Finally, the possible impact on debtor incentives must be considered. Plainly, one consequence of the 1987 provisions will be to discourage banks from future third-world financing. A higher standard for reserves acts as a tax on new lending by requiring a larger charge against current earnings for each additional credit extended. It will now be harder for bank managers to justify new LDC loans to their shareholders. This, in turn, removes one of the most important bribes that creditors have traditionally dangled before debtors. If the carrot of new money is taken away, LDC policymakers may become even more intransigent.

It is therefore not at all clear that creditors have really been successful in their efforts to reverse the erosion of their bargaining power. Indeed, the ambiguity inherent in this already complex setting is probably becoming greater, not less. Can debtor countries seize the opportunity afforded by this

[6] This does not apply to banks in Continental European countries such as Germany or Switzerland, where loan-loss reserves have customarily been maintained at levels well above the 25 percent figure; it does apply to banks in Britain and Canada as well as the United States, and above all to banks in Japan, where provisions still amount to less than 5 percent of LDC exposure.

Many bankers object to the use of quotations in the secondary market as a guide to the true long-term value of LDC paper: it is an extremely thin market where discounts in effect reflect fire-sale prices. The secondary market is, however, the best guide available and is certainly a better indicator of true value than the bankers' formal valuation of most of these loans on their books at 100 cents on the dollar.

increased ambiguity to gain the upper hand? Do they now have the power to diminish or overcome creditor resistance to major debt reform?

Most potent, of course, would be some form of *collective action* by LDC governments to extract concessions from creditors—some variant of the long-dreaded debtors' cartel. A common front would certainly improve the debtor side's capacity to proffer credible carrots or sticks of its own in future negotiations. If the creditor side did not have to worry about competition among debtors for the most favorable treatment (the demonstration effect), attractive new money packages could more easily be agreed upon. These might include generous exit options or debt-conversion schemes for banks that want "out," or flexible "onlending" or "relending" arrangements for those willing to stay in.[7] Even more to the point, any threat of de jure or de facto default would be far more persuasive if made jointly rather than individually.

Potent as a debtors' cartel might be, however, its likelihood is still remote. Recent experience, particularly in Latin America, demonstrates that serious obstacles block effective coordination among debtors, whatever the rhetoric. The two most fundamental obstacles are (a) the extraordinary diversity of economic conditions and prospects among debtors, which tends to overshadow their common interest in debt relief, and (b) the fact of national sovereignty, which encourages each government to seek the best possible deal for itself. Differences in the timing of financial crises, in foreign strategic relationships, in domestic political systems, and even in the personalities and values of key decisionmakers have presented additional obstacles.

Perhaps the most important obstacle to a debtors' cartel is that from the debtors' point of view formal coordination may not even be necessary and could well be counterproductive. As Kaletsky (1985, p. 63) has written, "The main objection to a debtors' cartel is the same as the one against flagrant repudiation: it would needlessly provoke governmental and public opinion in creditor countries." The cumulative effect of a series of individual initiatives by troubled debtors would be far less provocative but might be almost as potent. Just this has occurred lately, for one reason or another, in both Latin America and sub-Saharan Africa. One by one, more than a dozen governments, including eight of the fifteen classified by the IMF as "heavily indebted," have unilaterally ceased debt service or fallen into serious arrears, thereby saving valuable foreign exchange. Moreover, once in arrears, few of these debtors have managed to find both the will and the means to catch up on their interest payments. Yet creditors have become increasingly reluctant to engage in costly reprisals because of the considerable number of countries involved. Who needs a debtors' cartel when much

[7] For more on these and other possible technical innovations, see Cline (1987) and Regling (1988).

the same impact can be achieved without the difficulties and risks of formal coordination?

Perhaps the most likely scenario, therefore, at least for the near term, is a continuation of the trend already discernible—collective *inaction* (nonpayment) rather than collective action. And the more the trend persists, *ceteris paribus*, the greater will be the ultimate erosion in the bargaining power of creditors. To that extent, momentum would appear to be flowing to the debtor side. The political equation does seem to be changing.

But is it changing enough? The answer remains in considerable doubt. An ebbing of creditor leverage is one thing; momentum sufficient to compel a fundamental reform of the prevailing containment strategy is quite another. The outcome will depend in good part on which, if any, debtor countries choose to join the ranks of nonpayers. Sustained defaults by three or four of the largest debtor nations would do more to concentrate minds on the creditor side than several times that many individual initiatives by smaller countries. But since we cannot foresee who among the debtors will in time defect, and who not, we cannot be sure that this trend will suffice to alter the broad balance of power in creditor-debtor relations. Realistically, we must admit that the probabilities involved are simply too low to inspire confidence in such a spontaneous solution to the problem. The odds in favor of debtors may now have shortened somewhat, but hardly enough for us to be able to declare *les jeux sont faits*.

The Dynamics of Creditor Preference Formation

The scenario of collective inaction affects only the debtor side of the political equation. Much also depends on the creditor side. Can concurrent endogenous changes be expected in creditor perceptions of their interests? If so, are these likely to complement or counteract the accumulating tide of pressures from debtor nations? To answer these questions, we must take a closer look at the internal dynamics of preference formation on the part of creditors. Specifically, we must look at alignments among creditor groups—among banks and between banks and public institutions—and at how these shape or alter the collective strategic interaction of creditors and debtors. How are creditor alignments likely to evolve, given current and prospective developments in broader creditor-debtor relations?

The creditor side is not a monolith. On the contrary, there is tremendous heterogeneity among the hundreds of creditors. Nevertheless, lenders have been remarkably successful in maintaining enough solidarity in debt negotiations to shape outcomes largely to their advantage. What accounts for their success?

At first glance, the answer seems obvious: an instinct for self-preservation. Had LDC debtors not been held to their full contractual obligations back in

1982, widespread defaults might have triggered a wave of bank failures, possibly even a repetition of the financial collapse of the 1930s. But a closer look raises doubt about this simple explanation, since it is evident that not all creditors have been equally threatened by the debt problem. Public creditors can certainly survive a hit on their third-world loans. The viability of national governments is a matter of politics, not mere financial profit and loss, and the same is ultimately true of the IMF and multilateral development banks because of their legal backing by the "full faith and credit" of their respective sovereign members. Only private creditors have been directly at risk, and of these the only truly threatened institutions have been those whose exposure was and continues to be high relative to their capital—which means only the biggest of the commercial banks active in LDC lending. For the large number of smaller institutions with loans well below the level of their own capital, widespread defaults would be painful but not disastrous. For the major international commercial lenders, however—the two or three dozen giants at the peak of the global banking industry—the result could be technical insolvency (unless abridged by a modification of traditional accounting regulations). In reality, then, only these giants have had any serious reason to worry about self-preservation.

This suggests that there is more at work here than appears at first glance. Since it is the giants that have stood to lose the most from concessions to debtors, it is their interests that have been served most directly by the containment strategy in force since 1982. In effect, they have called the tune, even when other creditors with other interests might have preferred a different drummer. Creditor solidarity has been maintained by a decision-making process dominated, however imperfectly, by the needs and preferences of the biggest commercial lenders.

By exploiting two features of their institutional environment, the giants have been strikingly effective. One feature is the oligopolistic and hierarchical structure of the international banking community, which gives larger intermediaries in the banking industry disproportionate influence over their smaller rivals. The other feature is the fragmented and dispersed structure of policy assignments within the governments of the capital-market countries, which generally gives banks disproportionate influence over official attitudes on debt matters. Coordination problems have been suppressed to the extent possible by forming informal transnational coalitions. Diversity of interests has been accommodated, again to the extent possible, by the usual tactics of side payments or sanctions.

Diversity of interests within the industry is only to be expected, given the nature of the LDC loan market. There are differences among banks not only in terms of exposure (absolute or relative to capital) but in a variety of other key respects. They differ, for example, in their commitment to foreign busi-

ness in general, in the extent of their commercial ties to developing nations in particular, and in the geographic distribution of their third-world activity. As numerous studies have shown (see especially Lipson, 1986a, 1986b; Aggarwal, 1987, Chap. 3), gaining the cooperation of all these contenders, with their diverse interests, on a common strategy vis-à-vis debtors has by no means been easy. For the most part, the industry's giants have successfully suppressed divergences by exploiting competitive advantages. They negotiate terms with each other and with debtors and then seek the ratification of smaller institutions, exploiting the latter's dependence on their bigger brethren for correspondent relationships or other financial services. In effect, bankers play a parallel game among themselves, employing their own separate side payments and sanctions to accommodate industry differences. Local and regional banks can be bribed, for example, by offers of privileged access to interbank credit lines or possible participation in lucrative new lending syndicates. They can be coerced by threats of exclusion from traditional industry networks—"peer pressure," as it is politely known in the trade.

The banking giants' dominance has been reinforced by the fragmented nature of governmental policy assignments in the capital-market countries, which biases official attitudes toward debt in their favor. In all the capital-market countries, primary responsibility for LDC debt issues has been entrusted to finance ministries or central banks rather than to foreign ministries or industry- or trade-oriented agencies. As a result, not surprisingly, highest priority has been accorded to the purely financial aspects of the problem rather than to diplomatic or commercial implications. Relatively little weight has been attached to threats of political disruption or to lost export opportunities in the third world. Public policy has been conditioned most directly by concerns for the safety and soundness of financial institutions; since the largest institutions have been most at risk, their interests have received the most attention. There is no need to invoke conspiracy theory to account for the tacit alliances that have been formed between the big international lenders and their home governments.

Thus, despite differences and coordination problems within the banking industry, creditor solidarity has been maintained by a singular alignment of political forces. Power has centered on the joint preferences of a small number of large banks backed by an equally small number of public institutions. And within this configuration of power, no players have been more influential in shaping creditors' collective behavior than those of the United States—the major money-center banks of New York, Chicago, and California, together with the Federal Reserve and, most important, the Department of the Treasury. Other players on the creditor side generally defer to U.S. leadership in dealing with third-world debt problems (Aggarwal, 1987,

Chap. 3). This reflects not only the key role of the dollar as the currency in which most LDC paper is denominated (making the Federal Reserve the de facto lender of last resort in the event of a debt-induced banking crisis) but, even more to the point, the dominant market share of U.S. lenders in the most prominent of the troubled debtor nations, Latin American countries and the Philippines. The bank advisory committees that negotiate with LDC governments traditionally comprise no more than a dozen of a country's largest creditors. This has given America's big money-center intermediaries, backed by the Federal Reserve and Treasury, by far the greatest influence in formulating and managing the prevailing containment strategy (Holley, 1987, pp. 25-26). It is no accident that the strategy was first developed at the Federal Reserve and Treasury Department back in 1982. Nor is it an accident that all the major adjustments in the strategy since then—including especially the Baker Plan, the menu approach, and the new Brady program—have also emanated from Washington. The tune that has been called since 1982 has had a distinctly American ring to it.

The key question is: will other players on the creditor side continue to follow this tune, or could there be changes in political alignments that will significantly revise the ordering of creditor preferences? The answer is not immediately apparent. On the one hand, growing distributional struggles among banks and between them and other interested parties in the capital-market countries are exacerbating strains and coordination problems within the banking industry. Creditor-side alignments are becoming more fluid. On the other hand, it is not clear that this increased fluidity will lead soon to a powerful new coalition that will challenge the dominance of the largest commercial lenders, led by the United States. Here too, as on the debtor side of the equation, change is indeed occurring—but, once again, not necessarily enough to cause fundamental alterations in the rules of the game.

The signs of increasing strains on the creditor side are everywhere. Consider first relations between the big banks and their smaller brethren in the capital-market countries. Local and regional banks have always resented the strong-arm tactics of the giants of the industry. They have been compelled to go along with each successive rescheduling of outstanding syndicated loans and even to participate on a pro rata basis in concerted new credits to troubled debtors. But, as the prospect of de facto insolvency rises for many of these debtors, more and more smaller creditors seem prepared to ignore peer pressure and break ranks. Many, especially those with limited third-world exposure and few other commercial ties to developing countries, are simply getting out. They are selling off their paper in the secondary market or refusing to participate in new reschedulings, forcing larger banks to take over their shares. Others, more dramatically, are writing off substantial portions of their portfolios or working out separate deals with debtor govern-

ments. The ability of the major banks to suppress intra-industry differences is clearly in decline.

Even among the majors themselves, disparities in interests and priorities appear to be widening. The Continental European banks have long chafed under the current strategy of rescheduling-plus-concerted-lending favored by the big U.S. banks and the Federal Reserve and Treasury. Under their different regulations, the Europeans would find it less costly to capitalize interest arrears than to keep lending debtors new money with which to service old debt. With their more substantial provisions (mostly well hidden), the Europeans are also more willing to contemplate the idea of outright debt relief. More and more, they too seem prepared to break ranks with the Americans, or at least to talk publicly about the possibility of new approaches. American leadership no longer receives quite the degree of deference that it once did.

Furthermore, divergences are evident in the ranks of the major banks *within* the United States. Citicorp's dramatic, unilateral, and unexpected decision to add to its loan-loss reserves in 1987 provides one example. While other U.S. lenders soon emulated Citicorp, its action was resented by money-center banks less well positioned (because of either lower profitability or greater exposure) to meet what from that time became the 25 percent minimum standard for provisions. Tensions over the issue were exacerbated near the end of 1987 when the Bank of Boston and some other large regionals initiated a second round of increases in reserves to an even higher standard of 50 percent or more of exposure. By early 1988, a distinct cleavage had developed between the big New York institutions (together with the Bank of America), which refused to add yet again to their LDC provisions and the remaining money-center banks of California and Chicago, as well as most regional institutions, which opted for the new higher standard. There is evidence that at least some of big New York banks would have been extremely hard-pressed to find the requisite resources had they tried to go along.

Another example of divergence within the American ranks was the deal Morgan Guaranty Bank negotiated secretly with the Mexican government and announced at the end of December 1987. Under that proposal, Mexico hoped to swap a sizable portion of its bank debt at a discount for newly issued marketable Mexican securities, which were to be backed by U.S. Treasury bonds bought with cash reserves by the Mexican government. Initially, many hailed the deal as a breakthrough in coping with third-world debt problems, because it enabled Mexico (and possibly other countries) to retire some of its bank credits at less than par—in effect "capturing the discount" prevailing in the secondary market. For precisely that reason, however, Morgan Guaranty's plan was greeted with little enthusiasm by most other U.S. money-center institutions, still reluctant to accept formal losses on their

LDC portfolios. When the plan was implemented two months later, none of them chose to participate, and the final results fell far short of aspirations. Increasingly, relations among America's major banks appear to be dominated less by thoughts of preserving industry solidarity than by sentiments of *sauve qui peut*.

Finally, sectors *outside* the financial community with their own interests in debtor countries are beginning to express opposition to the prevailing containment strategy. This is especially true of key constituencies in the export sector in the United States and elsewhere as they realize the extent to which the debt trap has cut traditional sales to developing nations. Exporters have had their consciousness raised in recent years. Their anger is directed particularly at the Federal Reserve and Treasury for their apparent bias in favor of financial interests. More and more, exporters are asking that framers of public policy on LDC debt accord higher priority to commercial and even diplomatic considerations, instead of focusing mainly on financial concerns. Pressures are clearly growing to loosen the close, albeit tacit, bank-government alliances that have previously dominated decisionmaking in this area.

Despite all these signs of strain on the creditor side, however, no change can be expected in the effective ordering of creditor preferences unless existing coalitions in the capital-market countries are supplanted by new and even stronger alignments, whether implicit or explicit. Increased fluidity among the players is not enough to alter the political equation significantly: resentments and frustrations must be translated into practical action. The big banks, backed by finance ministries and central banks, are unlikely to abandon their resistance to the idea of major debt reform without a struggle, since it is they who stand to lose the most. In the absence of sufficient leverage on the debtor side, their resistance can be diminished or overcome only with superior use of power from within the creditor side, by means of new tactics of side payments or sanctions to replace those exercised at present by the industry giants. Since such organization is unlikely to occur spontaneously, it can be accomplished only by deliberate political organization among other players inside or outside the financial community.

Unfortunately, efforts along these lines to date have not been very fruitful. An early case in point was the so-called Bradley Plan, the well-publicized debt-relief scheme proposed by Senator Bill Bradley of New Jersey in 1986. Under the Bradley Plan, all outstanding loans to eligible countries would have been written down by 3 percent a year for three years, and interest rates would have been reduced by 3 percentage points (300 basis points) over the same period. Eligibility would have been tied to a debtor government's commitment to a program of trade liberalization designed to promote imports from the United States and other industrialized nations (Bradley, 1986). By linking trade and debt so explicitly, Senator Bradley plainly hoped

to draw export interests into the policymaking process as a counterweight to the influence of the money-center banks. Despite some initially favorable reactions, however (see e.g., AFL-CIO, 1986), his plan soon faded into oblivion under the persistent and determined opposition of the Treasury and Federal Reserve. Much the same fate has awaited similar proposals promoted more recently by other members of Congress, such as Representatives John LaFalce of New York (1987) or Don Pease of Ohio (1988).

Nor is the failure of such efforts surprising, given the considerable difficulties involved. Inside the financial community, barriers to alternative alignments are high and undoubtedly will remain so as long as the industry remains as oligopolistic and hierarchical as it is. Outside, other interested parties will continue to have difficulty influencing official attitudes as long as finance ministries and central banks retain primary policy responsibility for the debt issue. And any forging of links between selected elements of the financial community and other parties, for example between the smaller banks and exporters, will continue to be hampered by the absence of either a tradition or an institutional base for effective joint political action. We must therefore admit that here too, as on the debtor side, the probabilities are simply too low to inspire confidence in such an endogenous solution to the problem. Again, the odds are unlikely to shorten sufficiently for us to declare categorically *les jeux sont faits*.

Correcting for Market Failure

If it is unrealistic to expect an endogenous change in power relationships sufficient to alleviate the de facto insolvency of many developing countries, it follows that supplementary exogenous efforts will be required to promote genuine debt reform. This means that effective collective action will have to be organized in order to bring about appropriate agreements among all the parties concerned. Serious progress on the debt front is simply not likely to be achieved if we continue to rely solely on the laissez-faire approach favored by evolutionists.

The point can be put more formally. Earlier, the strategic interaction between creditors and debtors was likened to a multiplayer game with an unexploited opportunity for joint gain. Alternatively, the situation can be described as an example of market failure caused by the unwillingness of any player or group of players to take responsibility for the needed "collective good" of a genuinely durable solution. All recognize their common interest in easing the severe cash-flow strains on debtors, but none wants to pay any of the costs if they can be avoided. Everyone, in short, would like to be a "free rider." And so there is a tendency for each player to concentrate principally on avoiding losses or deflecting them as much as possible onto others—equivalent, in game-theoretic terms, to saying that any potential for

joint gain tends to be lost because of the individual temptation to defect. Reliance solely on the market in such circumstances will not achieve the optimal outcome.

This free-rider problem is by now widely recognized, especially as it affects relations within the banking industry. As scholars like Williamson (1988) and Krugman (1988) have noted, broad agreement on significant debt-reform measures is difficult to achieve, particularly if these measures contain some degree of outright relief, because of the ever-present risk of widespread nonparticipation. Most individual lenders have an incentive to avoid any share of the costs of concessions while hoping to reap the benefit of any ensuing gain in the value of their claims. Hence the signs of increasing strains on the creditor side come as no surprise. Collective market failure derives directly from the myopia of individual self-interest.

It is precisely in such circumstances that economic theory recommends concerted action to correct for market failures. As Sachs (1988, pp. 22-23) has commented:

> Fundamentally, we face here the so-called collective action problem: each individual bank sees its self-interest in getting the best possible terms, while it would be in the collective interest of all banks to moderate the terms. It's very hard to maintain the collective interest in this world when nobody is managing the overall strategy properly . . . . It's a myth to believe that the market can do this on its own.

What is needed instead is deliberate organization of the common effort to exploit opportunities for joint gain.

5 Toward Genuine Debt Reform

The creationists press for active institutional innovation to achieve genuine debt reform. Institutional innovation, however, does not have to mean imposed or mandatory solutions to the debt problem. To say that markets may fail is not to say that they must be replaced. It might be enough simply to provide a third party to facilitate mutually beneficial agreements that will help participants avoid the costs of their own imperfections. Accords may continue to be negotiated on a case-by-case basis. The point has been put most succinctly by Krugman (1989):

> The costs incurred by a failure to reach agreement represent a real social cost (e.g., through disruption of trade, financial flows, political stability, etc.). It may be worthwhile for the [debtors] and their bankers to accept this cost in order to demonstrate their toughness, but it is preferable from the world's point of view, and possibly from the point of view of the parties themselves, if agreement can be reached more quickly. Thus there is a potential albeit problematic role for [third parties] as facilitators of agreement.

Who should that third party be and how would its role be defined? Can a middle way to debt reform be found that retains the creationists' stress on collective action without abandoning the evolutionists' preference for voluntary and market-oriented solutions?

Creditor Objections to Debt Relief

If large commercial lenders are to be persuaded to abandon the status quo, they will have to be offered sufficient incentives. No collective approach that is not genuinely responsive to their legitimate concerns could possibly work. What might such incentives look like? What concessions from others would be most likely to draw these creditors into voluntary concessions of their own?

Clues are provided by what large creditors themselves have to say about the idea of comprehensive debt reform, and in particular about the possibility of debt relief. Mostly they object. In spite of the evidence of changing attitudes in the financial community, large creditors' resistance to any substantial reduction of obligations remains strong and vocal. But an analysis of *why* they object can help us understand what safeguards or side payments might make the idea of debt reform more palatable. In this way, we can learn what revisions of the prevailing strategy they might realistically regard as a fair price to be paid for their cooperation. The goal is to identify a set of practical working principles for a new concerted approach to the debt problem.

Creditor objections to debt relief encompass a wide range of arguments of varying degrees of intellectual sophistication and rigor. For analytical purposes, it is convenient to group them under six major headings: (a) contagion, (b) loss of creditworthiness, (c) weakening of discipline, (d) moral hazard, (e) legal problems, and (f) politicization. All of these arguments have self-serving elements: lenders are not disinterested bystanders, after all. But all the objections are legitimate and, when placed in perspective and shorn of exaggeration, deserve to be taken seriously for what they can tell us about the perceptions and motivations of creditors.

a. Contagion. Perhaps the most self-serving of all these arguments stresses the possible "contagion effects" of a widespread markdown of third-world debt obligations. Heavily exposed creditors express concern not only about what such a step might mean for their own safety and soundness but, more broadly, what it could do to the banking industry and world financial markets in general. Given the manifold links among lending institutions, they say, even a single major insolvency could produce potentially disastrous ripples and feedbacks. At a minimum, a good number of intermediaries could be seriously weakened. At worst, a full-blown financial crisis might occur.

Contentions of this kind are bound to exaggerate to some extent the dangers involved. Vulnerable though they may be, banks have been remarkably

successful in reinforcing their defenses against any threat of loss on their third-world exposure. Moreover, talk of a possible financial crisis discounts the effectiveness of present prudential supervisory practices, as well as the powerful role of central banks as lenders of last resort. And it overlooks the positive impact that debt relief might have on the equity prices and credit ratings of major banks. In fact, the risk of contagion effects is just not as serious as is sometimes suggested.

Nonetheless, some residual risk undoubtedly remains. The question is whether safeguards can be developed to help ease the legitimate concerns expressed by creditors on this score. At least two safeguards can be imagined. One possibility would be to insist on *selectivity*: make debt relief selective rather than general, limiting reductions of contractual obligations to those countries that, by objective analysis, really do appear to face something approximating insolvency rather than mere illiquidity. A differentiated, case-by-case approach is already employed as part of the debt strategy. An equivalent approach to debt relief would substantially diminish potential hits to bank earnings and balance sheets.

A second possibility would involve greater *flexibility* in accounting for all such hits: design regulatory changes or reinterpetations to permit banks to avoid an immediate write-down of existing capital assets when obligations are reduced. Such reforms are within the scope of supervisors' present authority in most of the capital-market countries. In the United States, for instance, ample precedent exists under current accounting rules for stretching out lenders' capital losses in selected instances. One example is the system of so-called Allocated Transfer Risk Reserves for LDC loans that have been classified as "value impaired." Why not authorize banks to spread out the costs of debt relief in the same way? Neither of these safeguards would remove all the pain for creditors, of course. But they would certainly help to reduce discomfort levels significantly,[8] and so contain the threat of contagion spreading through the interbank market from one financial institution to another.

b. Loss of creditworthiness. The second line of argument, also somewhat self-serving, stresses possible consequences for debtors rather than creditors —specifically, the damage debt relief could do to the long-term credit standing of developing nations. Like any bankrupt enterprise or individual, we are told, debtor countries could find access to market financing severely curtailed, perhaps even totally blocked, for an indefinite period should their

[8] According to one estimate based on financial results in recent years (Pease, 1988, p. 101), a five-year write-down cumulating to 25 percent of third-world exposure (beyond the write-down that would already be permitted by previous loan-loss provisions) would require America's large money-center banks, on average, to allocate no more than half their annual pre-tax earnings—painful, clearly, but hardly devastating.

creditors be obliged to cancel some fraction of outstanding contractual obligations. The result could be an even longer delay in the return to healthy economic growth.

This argument might be persuasive but for a simple fact: troubled countries already have suffered severe damage to their credit standing. No new money is going to debtors even now, apart from occasional concerted lending agreements. Even in those instances, a perverse relationship has developed between debtor performance and credit availability, as Krugman (1989) has noted. Any improvement in a debtor's economic health tends to be reflected in a reduction rather than an increase in capital inflows as concerted lending is cut back; in effect, success in complying with the prevailing debt strategy is punished rather than rewarded by creditors. The pattern amounts to a tax on a country's efforts to adjust its economy. Seen in this light, creditor expressions of concern for LDC creditworthiness seem disingenuous at best.

Indeed, the logic of the argument could be stood on its head: debt relief might actually enhance the capacity of these countries to service their remaining obligations—the debt relief Laffer curve again. Foreign earnings currently absorbed by interest payments abroad could instead be used to promote accelerated investment and economic reforms at home, and creditworthiness might ultimately improve as a result. Much depends, of course, on what debtor governments do with their new-found degrees of freedom. From the creditors' point of view, the pain associated with debt relief would surely seem more tolerable if they could be assured that developing countries would not waste the additional resources made available to them.[9] This suggests yet a third, rather obvious safeguard, *conditionality*, which is also already well established in the prevailing debt strategy. To lower the risks of an alternative approach, relief could be made contingent upon pursuit of appropriate policies by debtor governments. That leads directly to the third line of argument traditionally advanced by creditors to oppose any reduction of debtors' contractual obligations.

c. Weakening of discipline. The third line of argument stresses possible deleterious effects on the policies pursued by debtors—the risk that debt relief will remove incentives to adopt tough domestic adjustment measures and reforms. The advantage of the prevailing strategy, creditors insist, is that it encourages responsible economic management; the disadvantage of an alternative approach, that it would weaken discipline over future policy and performance.

Here, too, the logic of the argument could be stood on its head: incentives are already diluted by the perverse relationship that has developed between

[9] As one New York banker said to me in private conversation in September 1987, "Banks are not opposed to pain, but to pain with no purpose."

debtor performance and credit availability. The effective tax on successful adjustment actually discourages rather than encourages a continued commitment to the current strategy. Moreover, there is the reverse question of incentives for banks, which until now have been obliged to pay little direct price for their own past imprudence. By some measures, commercial lending to developing countries was excessive in the period up to 1982. Lacking an explicit loss on the resulting claims, what discipline are banks under to ensure appropriate caution on their part in the future?

Nonetheless, given the intense distributional struggles that underlie economic policymaking in any country, it must be conceded that the discipline argument makes a point. Any government—debtor or not—is apt to act like an irresponsible child if presented with a free good. But why should we assume that debt relief must be granted with no strings attached? To the contrary, the discipline argument reinforces the case for retaining conditionality as an integral part of such an approach. Incentives for responsible management could actually be increased if linked to a reduction of outstanding contractual obligations.

d. Moral hazard. Parallel to the discipline argument is the so-called "moral hazard" issue—the risk that some developing nations might deliberately take steps to lower their economic performance in order to qualify for debt relief. Any compromise of the prevailing strategy, we are told, would appear to reward wasteful or inefficient policies at the expense of debtor countries that have done everything possible to keep up with their contractual obligations, making a mockery of their sacrifices. The danger is that these well-managed countries will therefore be tempted to relax their domestic discipline.

The answer to this argument, plainly, is the same as before: continue to make any approach contingent upon pursuit of appropriate policies. Moral hazard might indeed be a problem if the strings attached to debt relief were too loose or flimsy. With a real price to be paid, however, governments would be deterred to the extent that the costs of qualifying for relief appeared to exceed the benefits. The trick, of course, would be to determine just how high that price should be. It would have to be high enough to be effective as a deterrent to moral hazard, yet not too high to drive away those truly in need. We return to this point below.

e. Legal problems. The fifth line of argument stresses the many legal issues that would have to be surmounted by any plan for debt relief. These issues would involve everything from the definition of obligations and the identity of obligors to be covered in each country to the relationships and priorities to be established among various foreign claimants. Underlying all these issues is an even more fundamental objection concerning sanctity of contract: the fear that any abrogation of contracts voluntarily entered into in the past

would severely, if not permanently, undermine the basis for further commercial lending in the future. Why should creditors ever again put money into the third world if full repayment cannot be assured?

These are not inconsequential issues and clearly must be confronted head on. It is also clear that they are within the wit of humans to resolve, as most nations have already demonstrated in their domestic arrangements for dealing with the challenge of insolvency. Basic legal theory has long held that there may be occasions when contracts should not be enforced but instead rewritten, particularly when unforeseen low-probability contingencies place extreme and unexpected burdens on debtors (see, e.g., Posner and Rosenfield, 1977). The issue is whether rigid insistence by creditors on full adherence to contractual obligations could so endanger a debtor's capacity to pay that both sides would be better off with some form of relief. The means for resolving the issue at the national level are already well developed in mechanisms such as Chapter 11 of the U.S. Bankruptcy Code or analogous regulations elsewhere. There seems to be little reason in principle why such mechanisms could not be used as a model for resolving the relevant legal issues at the international level as well. From the creditors' point of view, the key safeguard here would appear to be a need for *mutuality*: explicit recognition of rights and obligations on both sides. We return to this point as well.

f. Politicization. The final line of argument is that any scheme for debt relief would surely inject politics into the creditor-debtor relationship. But is this necessarily so? One could argue just the opposite, that the issue is obviously already highly politicized and could actually be defused by an orderly procedure that promises to ease the cash-flow strains of debtor countries in a context of renewed development and continued stability in financial markets. Much depends on the degree to which a third party would be directly interposed between creditors and debtors in setting the terms of relief. Commercial lenders, understandably, are happiest with a minimum of political intervention, preferring to preserve to the extent possible the formally voluntary and market-oriented character of today's negotiating framework. A final safeguard, therefore, would be to reaffirm the basic *autonomy* of participants on both sides. Indeed, in practical terms this could prove to be the most important incentive of all from the creditors' point of view.

A New Design

This analysis of creditor objections has suggested five crucial safeguards that could reduce creditor resistance to the idea of debt reform, with or without outright relief:

a. *Selectivity*: a differentiated case-by-case approach.
b. *Flexibility*: rules changes to stretch out costs to creditors.

c. *Conditionality*: a direct link between creditor concessions and appropriate policy commitments by debtors.
d. *Mutuality*: explicit recognition of rights and obligations on both sides.
e. *Autonomy*: preservation of an essentially voluntary and market-oriented negotiating framework.

These five safeguards can be understood as the working principles needed for a new concerted approach to the debt problem. The challenge is to translate them into a practical and effective design for reform.

A useful model is provided by Chapter 11 of the U.S. Bankruptcy Code or analogous mechanisms established elsewhere to deal with problems of insolvency at the national level. Under Chapter 11, debtors unable to meet their contractual obligations can appeal for protection from creditors while they reorganize their affairs, under the supervision of a bankruptcy court, and work out mutually satisfactory terms for a resolution of their difficulties. Settlement terms may or may not include elements of outright debt relief. Indeed, subject to certain conditions, they may include just about anything to which debtors and a qualified majority of creditors can agree through direct negotiation—deferral of principle, reduction of interest rates, conversion of debt into alternative claims, etc. The role of the court, in the first instance, is to facilitate negotiations with creditors (e.g., by establishing representative committees for each class of claimant, setting timetables for discussions, and acting as a conduit of communication) while exercising general surveillance over the relevant managerial decisions of the debtor. More broadly, the court's responsibility is to use its adjudicatory powers to ensure that creditors receive equitable treatment at the same time that debtors are given the breathing space needed to put their affairs back in order.[10]

The attractions of a Chapter 11 procedure are obvious, in that it embodies all five of the working principles that seem appropriate to promote durable solutions to debt problems. While the approach is comprehensive, mutuality and autonomy are preserved by an essentially voluntary and market-oriented negotiating framework based on explicit recognition of respective rights and obligations. Selectivity is embodied in the right of the debtor to make the initial decision to seek protection, while flexibility is inherent in the virtually unlimited scope provided for final terms of settlement. Finally, conditionality is respected in the assignment of a supervisory role to the court over the debtor's continuing operations. Debtors benefit from the opportunity to get back on their feet without being driven to the wall, but creditors are safeguarded by the conditions attached to the assistance provided obligors. Relief does not come without a price.

Those interested in the problem of third-world debt have long lamented

[10] For a useful guide to the intricacies of Chapter 11, see Weintraub (1980).

the absence of something like Chapter 11 at the international level (see, e.g., Suratgar, 1984; Dell, 1985; Williamson, 1985; UNCTAD, 1986, Chap. 6). Until now, imaginative institutional innovation along these lines has been effectively blocked by the determined opposition of creditors. But with attitudes on LDC debt now changing in the financial community, the time may at last be ripe for serious consideration of just such an alternative approach. What shape might it take?

As a first step, it would be necessary to establish an appropriate institution—some entity authorized to play a role comparable to that of the bankruptcy court, which is the core of the Chapter 11 procedure. Negotiations between creditors and debtors may be direct and voluntary, but if the two sides are ultimately to be persuaded to take responsibility for the needed "collective good" of a durable solution, there must be some neutral intermediary capable of assuring them both that their rights and needs will be respected. A comprehensive new set of rules of the game would not be enough to overcome the misgivings over motives and commitments inherent in any such strategic interaction. Players must also be confident that the rules will be interpreted and implemented objectively, assuring creditors that moral hazard will be deterred and assuring debtors that the price paid for relief will not be punitive. In short, the two sides need a referee.

Fortunately, there are precedents for such an institution, even at the international level. One example is the Iran–U.S. Claims Tribunal established in 1981 as part of the agreement negotiated between Washington and Tehran to unblock Iran's frozen assets in exchange for the release of American hostages held since 1979 (Cohen, 1986, Chap. 4; Riesenfeld, 1982). Another is the little-known but influential International Centre for Settlement of Investment Disputes (ICSID), an affiliate of the World Bank created by a multilateral convention over two decades ago to provide a forum for resolving conflicts between national governments and foreign investors (Soley, 1985; Shihata, 1986). ICSID functions as an arbitrator for investment disputes submitted to it. The process is voluntary in that the interested parties decide whether to consent to use of the ICSID machinery; it is binding in that once consent is given it cannot be revoked and all judgments are final. Disputes covered by ICSID concern every possible type of foreign direct investment, from wholly owned or joint ventures to technical and licensing agreements. Specifically excluded are conflicts relating to purely financial transactions of the sort we are considering here.

For our purposes, however, there is one key problem with these precedents, whether at the international level or as represented in national arrangements like Chapter 11—the extent of the powers to be conferred on the referee. Alternative models for conflict resolution display a wide range in the degree of authority accorded a designated third party to fix settlement

terms between disputants (Goldman, 1985). At one extreme are procedures based on governmental fiat or its equivalent—models that are clearly incompatible with the principle of autonomy that seems needed for a new concerted approach to LDC debt. At the other extreme are procedures relying exclusively on direct negotiations between the parties involved, formally independent of explicit intervention by third parties—essentially the method embodied in the prevailing debt strategy, with all its attendant disadvantages. In between are yet other models that attempt to compromise between the two extremes, for example, adjudication or arbitration, where neutral third parties are empowered in some degree to resolve differences on the basis of settled principles, or mediation or conciliation, where the role of third parties is limited to facilitating negotiations by one means or another. Adjudication and arbitration are obviously nearer the government-fiat end of the range, and mediation and conciliation nearer the direct-negotiation end.

The problem is that all the precedents are placed closer to the government-fiat end of the range than is likely to prove acceptable to either sovereign borrowers or commercial lenders. Chapter 11 depends on the broad adjudicatory authority of the bankruptcy court; both the Iran–U.S. Tribunal and ICSID act in an arbitrational capacity. Precedents though they may be, therefore, they are not directly replicable for our purposes; they are imperfect analogies for the design of a new institution to deal specifically with the problem of third-world debt. If political intervention in the creditor-debtor relationship is to be kept to a minimum, consistent with the other working principles of a comprehensive reform strategy, the powers of the referee will have to be more restricted than in any of these arrangements. The new approach must rely most on the model of mediation or conciliated negotiation if it is to be workable in practical terms.

An effective alternative to the prevailing debt strategy might thus be designed along the following lines:

a. A new institution. An appropriate institution would be established by multilateral convention to set the framework for a negotiated resolution of LDC debt-service difficulties on a case-by-case basis consistent with the interests of both creditors and debtors. The institution could be called the International Debt Restructuring Agency (IDRA). Ideally, it would be organized as a wholly new and independent entity in order to underscore its neutrality and objectivity. In practice, it might be more feasible—and certainly would be quicker—to get IDRA started as a joint subsidiary of the two multilateral agencies most involved with the problem now, the IMF and the World Bank, relying on the expertise and experience of existing staff, who would be seconded for this specific project.

b. Basic procedures. LDC debtors would have the right to apply to IDRA if they believed their circumstances warranted some degree of debt relief.

However, by doing so they would commit themselves irrevocably to a process of conciliated negotiation with their creditors, as well as to some surveillance of their policies by IDRA. Relief would be provided only where all the parties concerned concurred that it was justified. The terms of relief would be anything to which the debtor and a qualified majority of creditors could agree. Following agreement, terms would be supervised by IDRA until such time as the country was back on its feet and, if possible, its external creditworthiness was restored.

c. Responsibilities of the new institution. The general role of IDRA would be to facilitate negotiations between creditors and debtors on a fair and equitable basis. Specifically, its functions might include the following:

(1) Creditor committees. Following application by a debtor, IDRA would establish or, where such negotiating groups already exist (as in the standard advisory committees for medium-term bank debts), certify representative committees for each class of claimant.

(2) Timetables for discussion. Once creditor committees were established or certified, IDRA would set timetables for submission of initial negotiating positions, responses, counterproposals, and so on.

(3) Conduit of communication. IDRA would investigate the policies and financial conditions of the debtor in order to provide a common factual basis for negotiators on both sides.

(4) Analysis and evaluation. More controversially, IDRA might be authorized to go beyond mere fact finding to undertake formal evaluation of the policies and financial condition of the debtor, with the aim of providing an objective analysis of its economic circumstances and prospects. The purpose would be to determine, in as neutral a manner as possible, whether the country really appears to be facing something approximating insolvency rather than mere illiquidity and, if so, to what extent.

(5) Formulas for settlement. Even more controversially, IDRA could be authorized to propose its own formulas and terms for settlement, as a means to bridge gaps between positions and identify areas of potential agreement.

(6) Breaking deadlocks. Most controversially of all, IDRA could conceivably be authorized to compel agreement in the event of deadlock, in order to suppress any remaining temptation among lenders to free ride. For example, dissenting creditors might be obliged to accept terms agreed by a qualified majority if IDRA declared the proposed settlement to be "fair and equitable" and in the best interests of all concerned.[11] Or both sides might

[11] This authority would parallel the so-called "cramdown" rule that is an integral part of the Chapter 11 procedure (Weintraub, 1980, Chap. 16). An alternative possibility, more consistent with voluntary market-oriented solutions, would be to allow dissenting creditors to reject proposed IDRA settlements—but only at a price, such as forfeiture of some or all of any ensuing gain in the value of their claims.

be obliged to accept a settlement proposed by IDRA if agreement could not be attained within the limits of a specified timetable. Obviously, this function would push IDRA's conciliator role quite distinctly into the area of arbitration and could thus prove too much for either lenders or borrowers to accept. On the other hand, if included strictly as a last-resort element in an otherwise flexible and unencumbered negotiating process, it might have some appeal to all concerned.

(7) Monitoring debtor behavior. Finally, as part of any settlement, IDRA (or another agency designated by IDRA, such as the IMF or the World Bank) would have the responsibility of monitoring the debtor's economic performance in order to ensure that all terms were being faithfully met. The specific content of conditionality would be defined by the parties themselves on the basis of an agreed understanding of the adjustments or reforms needed to restore the country's capacity to service obligations on a sustained basis. Creditors would be permitted to withdraw all concessions on such matters as interest rates if IDRA determined that a debtor was not complying with its policy commitments.

Would such a design be politically feasible? Both commercial banks and developing countries ought to find it attractive, since like the Chapter 11 procedure it embodies all five of the working principles needed to make an alternative strategy workable. The banks' home governments should also find it appealing since it puts little demand on scarce public revenues. In this respect, the design stands in stark contrast to most of the previous proposals for institutional innovation. The distinguishing characteristic of these earlier plans is usually that a sizable financial liability, outright or contingent, would have to be assumed by a public entity as part of a multilaterally negotiated program of debt reform. As Corden (1988) has pointed out, creationist schemes for an international debt facility inevitably depend on some level of funding or financial risk on the part of the governments of the capital-market countries in order to be effective. By contrast, IDRA calls for mediation, not intermediation. Hence it would entail no explicit new financial commitment beyond the comparatively trivial amounts needed for its own operating expenses. This would surely count as a plus from a political point of view.

Implicitly, to be sure, there would be some cost to taxpayers: they would be obligated to compensate for any tax deductions or credits legitimately taken by banks if LDC obligations were marked down. This could give rise to charges that public money was being used to "bail out" private lenders. But that would be true only to the extent that the loss of taxable bank earnings implied by a settlement negotiated under IDRA could otherwise be averted—a dubious proposition if the discounts in the secondary market and other signs of de facto insolvency in the third world are to be believed. In any event, the pain for taxpayers would be eased as much as for banks by regulatory changes to stretch out the costs of debt relief. Any discomfort

remaining should not be politically intolerable—a small price to be paid, really, for a durable solution to the debt problem.

One could argue that the proposed IDRA mechanism does not actually add much. After all, creditors and debtors already negotiate directly, case-by-case, on a formally voluntary and market-oriented basis, and even now many bankers seem ready to acknowledge the need for selective concessions in appropriate circumstances to help ease the plight of troubled debtors. Why interpose a new player in a game where the old players already know all the rules? The answer should be obvious: because of the unsatisfactory outcome of the prevailing strategy—the "market failure" of an unexploited opportunity for joint gain. Today's approach is costly because, by relying on the continued ability of creditors to bribe or coerce debtors into acquiescence, it inevitably generates frustration, confrontation, and conflict. The great advantage of the IDRA approach is that it would structure incentives in a far more positive way for all concerned.

In the end, of course, an IDRA mechanism would be only as effective as creditors and debtors wanted it to be. However, in a situation where both sides could benefit compared with the prevailing strategy, good will ought not be in short supply. The presence of IDRA could help greatly to reduce or eliminate existing obstacles to debt reform. With the stakes as high as they are, that would certainly be no mean accomplishment.

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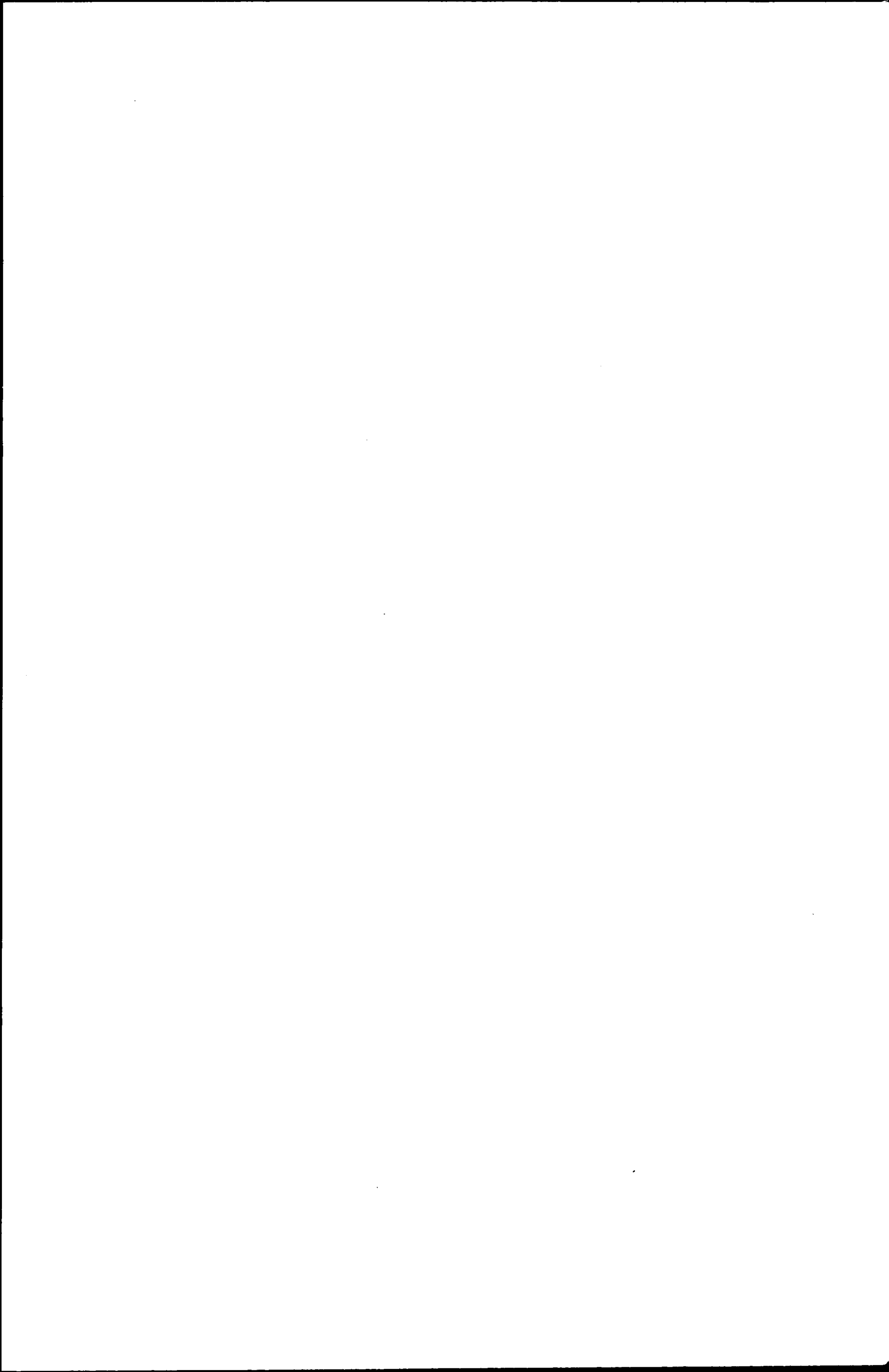

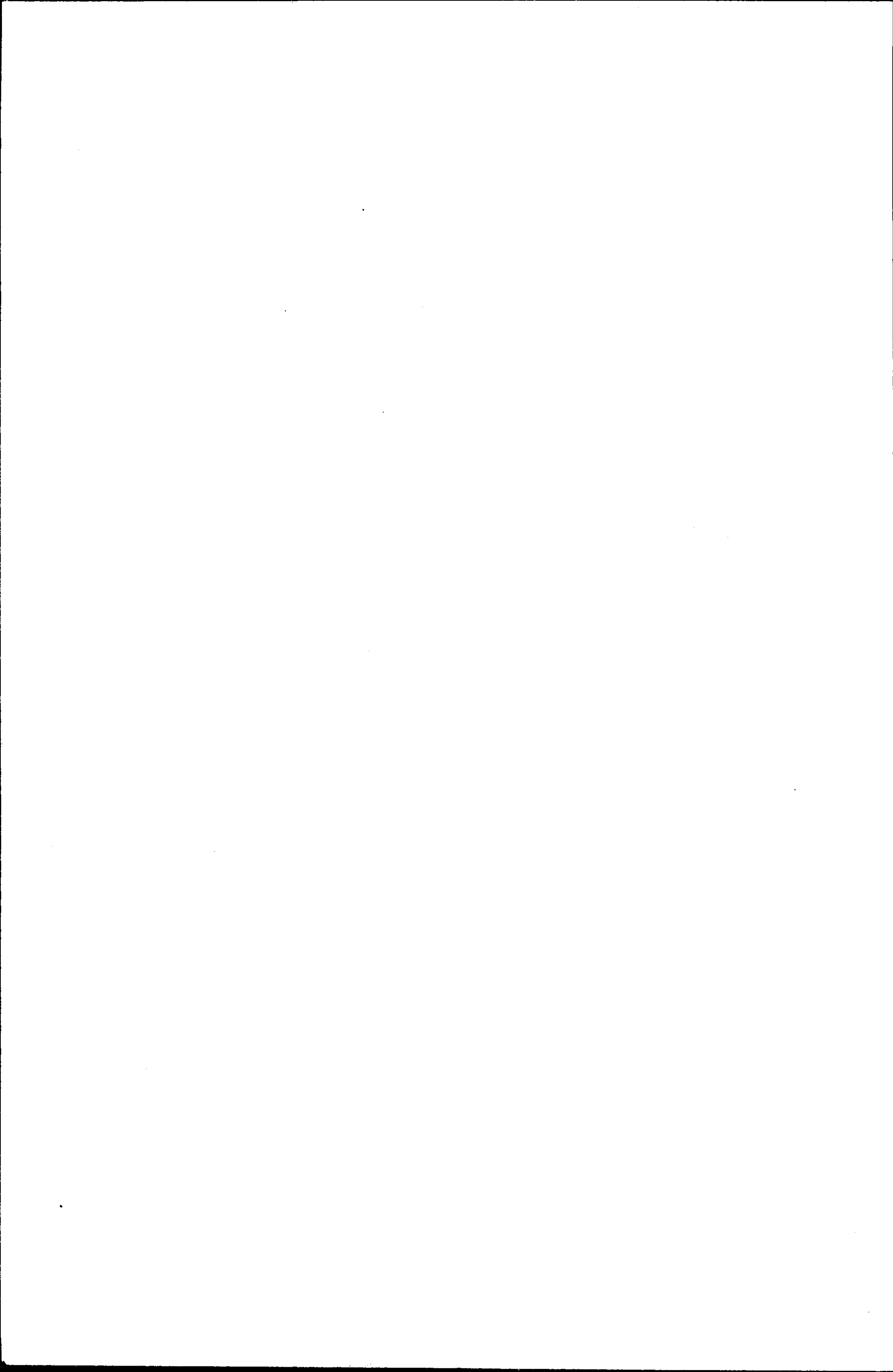

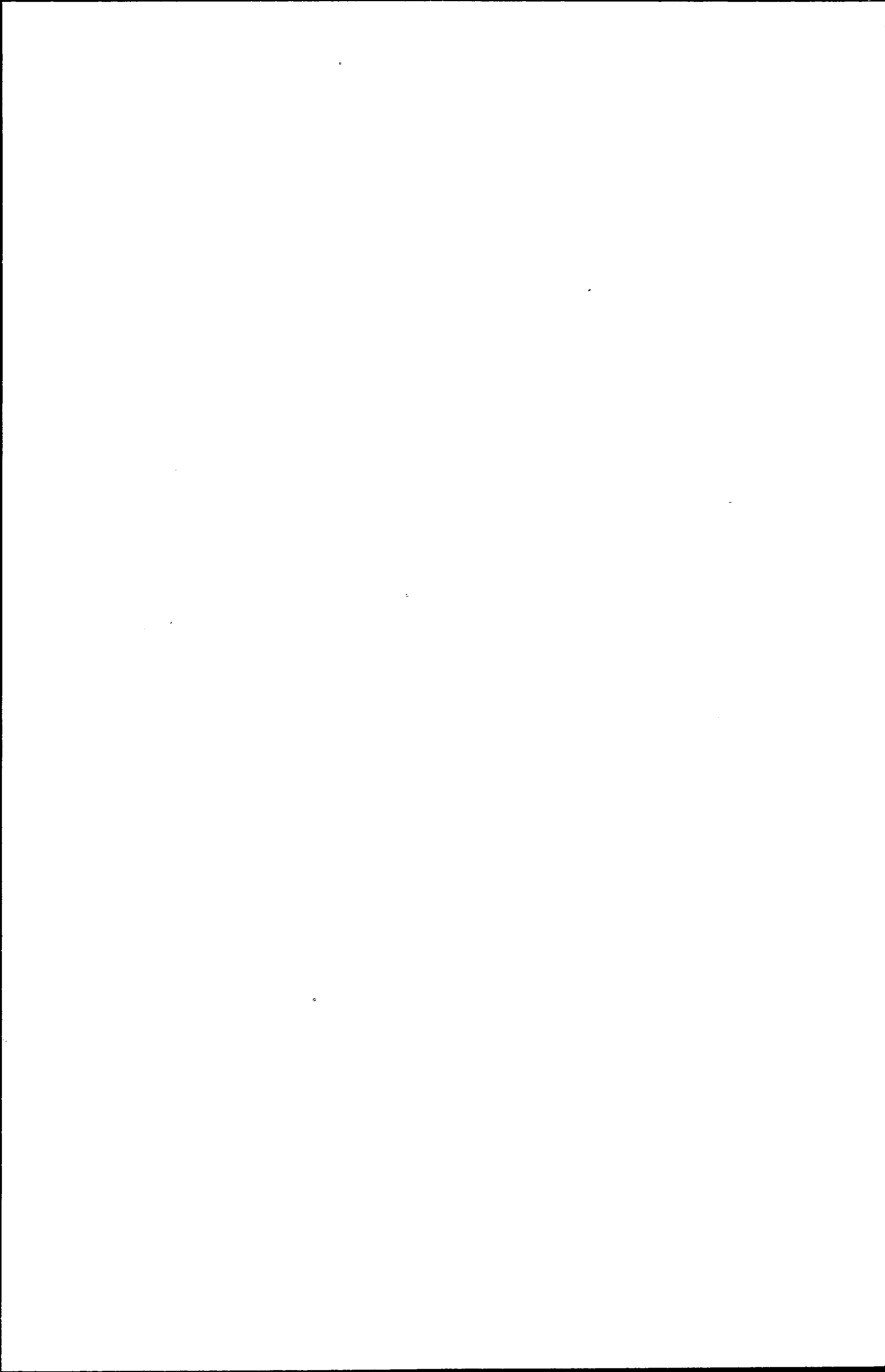

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