

ESSAYS IN INTERNATIONAL FINANCE

No. 174, July 1989

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NEW APPROACHES TO THE  
LATIN AMERICAN DEBT CRISIS

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JEFFREY D. SACHS



INTERNATIONAL FINANCE SECTION

DEPARTMENT OF ECONOMICS

PRINCETON UNIVERSITY

PRINCETON, NEW JERSEY

## ESSAYS IN INTERNATIONAL FINANCE

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The author of this Essay, Jeffrey D. Sachs, is Professor of Economics at Harvard University and a Research Associate of the National Bureau of Economic Research. He is currently serving as economic advisor to several governments in Latin America and Asia and has been a consultant to the major international financial agencies. Professor Sachs is the author and editor of several books and many scholarly articles. The results of a large-scale study he directed for the NBER are contained in *Developing Country Debt and the World Economy*, four volumes edited by Professor Sachs and published by the University of Chicago in 1989. This is his second contribution to the publications of the International Finance Section.

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## NEW APPROACHES TO THE LATIN AMERICAN DEBT CRISIS

### 1 Introduction

Despite many years of emergency treatment, Latin America's debt crisis continues to deepen. Throughout Latin America, the debt burden grows while most economies deteriorate. Many countries are now suffering from an alarming mix of hyperinflation and hyperstagnation that has not been witnessed on such a wide scale since the disastrous experience of Central Europe in the 1920s. In many countries, economic instability is so acute that it is breeding political instability and threatening democratic governments. The collapse of democracy was the overwhelming legacy of Central Europe's economic crisis in the 1920s, and the same prospect looms in Latin America today.

As the crisis has deepened, we have learned that the "conventional strategy" for managing it is inadequate. When the crisis first developed, there appeared to be little room for maneuver. After world interest rates rose in the early 1980s and commodities prices collapsed, the debtor countries were caught in a financial squeeze and their creditor banks were caught in deep trouble. The creditor governments felt, perhaps rightly, that unless the debtor countries continued to pay the interest on their debts in full, the world financial system would be at risk.

Thus, full interest servicing and opposition to debt reduction became the hallmarks of the conventional strategy.<sup>1</sup> The conventional approach was also built on the hope that the crisis would prove to be a short-term liquidity

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This essay was originally presented at the Harvard Symposium on New Approaches to the Latin American Debt Crisis in September 1988. It was therefore written several months before the announcement in March 1989 of the new debt strategy of U.S. Secretary of the Treasury Nicholas F. Brady. Several of the ideas espoused in this essay, including the focus on debt reduction and negotiations, are part of the Brady Plan. No attempt was made to update the essay following the announcement of the plan. Nonetheless, the essay retains its relevance in view of the continuing uncertainties about the specific design of the plan and the very active public-policy debate surrounding Mr. Brady's proposals.

<sup>1</sup> The term "debt reduction" will be used to refer to any formula for restructuring the debt that leads to a reduction in the *present value* of payments that are due to the creditor. Thus debt reduction might mean a rescheduling with below-market interest rates, a cancellation of some part of the principal, or some combination of the two. In the conventional approach, all interest rates are kept at the market level *plus* a risk premium. Stretching out the time for repayment of principal or lending new money at market interest rates, which are the two main strategies of the conventional approach, *do not* reduce the present value of the debt that is due.

squeeze, so that the countries would readily be able to manage their debts in the intermediate term.<sup>2</sup>

Six years later, the banks are mostly out of deep trouble (a point we will see later), but the economic situation in the debtor countries continues to deteriorate. High world interest rates and low commodities prices proved to be longer lasting than was originally expected, and the management of the debt burden within the debtor countries proved to be far more intractable. The economic situation in Latin America has proved to be so serious that we can say that the current approach no longer serves the real interests of any of the parties to the crisis.

The debtor countries are clearly losing under the current approach because the debt-servicing burden is too high, but the creditors are losing too. The economic collapse and growing political polarization in the region mean that the creditors' hopes of being repaid are steadily diminishing. The commercial banks, for example, have experienced a sharp deterioration in the market value of their claims in Latin America as it has become increasingly evident in the marketplace that much of the Latin American debt will probably never be repaid.

And through various channels, many of which are not well understood by the general public, taxpayers in the United States, Europe, and Japan are providing more and more money to keep the "conventional approach" going. To an increasing extent, the creditor countries are supporting loans to the debtor countries that are then used to pay interest to the commercial banks. These loans are sometimes made directly (e.g. through the export-credit agencies of the industrial countries) and sometimes indirectly, through creditor-government contributions to the International Monetary Fund and the World Bank. In either case, we have a process by which taxpayers are picking up an increasing part of the interest-service burden of private commercial banks. But this is money spent with little evident return, since the long-promised economic recovery in Latin America has failed to materialize, while the loans from the creditor governments (and their taxpayers) continue to mount.<sup>3</sup>

<sup>2</sup> The most influential study in support of the conventional approach was Cline (1984). That study predicted a very sharp decline in the debt/export ratios of the major debtor countries by 1986, so that those ratios would be well below their 1982 levels. It also predicted a swift recovery in debtor-country growth and a quick return of the major debtor countries to market access in the international financial markets. Needless to say, all of those predictions proved to be very far from the mark.

<sup>3</sup> A recent instance in which creditor-government taxpayers indirectly financed interest payments to the commercial banks was an October 1988 "bridge loan" of \$3.5 billion from the U. S. Treasury to the government of Mexico. This loan was made in advance of the accession to office in December 1988 of the new Mexican President, Carlos Salinas de Gortari. It was intended to facilitate continued interest payments by Mexico to its creditors during the transition period, at



Under pressure from the creditor governments, the major debtor countries (Argentina, Brazil, and Mexico) have struggled against the odds to keep paying the interest bill on their bank debt, despite the obvious and profound damage that the heavy interest payments are inflicting on their economies. Why they continue to pay has been a matter of considerable speculation, though the answer is really quite simple. Centrist, reformist governments like those of President Raul Alfonsín and President Miguel de la Madrid *want to play by the rules* and to work harmoniously with the creditor governments of the United States, Europe, and Japan.

The real question is not why the debtors are trying so hard to play by the rules, but rather why the creditor governments are shaping rules that are often politically dangerous for friendly, reformist, and democratic governments. In particular, why do the creditor governments continue to oppose a reduction in Latin America's debt to realistic levels?

Fortunately, the situation is not as hopeless as it seems to many. Latin America can surely escape from the present downward spiral of political and economic instability. There are realistic solutions to the crisis, solutions in which all of the major parties to the crisis (the commercial banks, the debtor nations, and the creditor nations) can achieve a satisfactory outcome. What is needed most of all is not new technical ideas but political leadership in both the creditor and debtor countries to implement some of the good ideas that have already been developed in recent years.

Several new approaches are described in this essay. Despite the superficial differences among these proposals, almost all are based on a set of shared ideas. First, the debt-servicing obligations of Latin American countries should be reduced in a sustained and predictable manner. Second, the extent to which the debt burden is reduced should be decided on a case-by-case approach, one that recognizes, for example, that Bolivia can pay a smaller share of its debt than can Argentina, which in turn can pay less than Mexico and Brazil. Third, debt reduction should be granted only to those countries that are pursuing internationally supervised programs of economic reform. Fourth, in return for accepting a reduction in debt-service payments, the commercial banks should receive from the official creditors partial or full protection against further losses, perhaps through official guarantees on the debt that remains after a debt-reduction operation.

*This basic approach is now enshrined in U.S. legislation*, although that

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a point when Mexico was losing foreign-exchange reserves at a substantial rate. In the announcement of the loan, the U.S. Treasury declared that the money would be bridged to future lending by the international financial institutions, mainly the World Bank. Tellingly, the World Bank did not have any plans in place for lending on this scale at the time of the bridge loan, and a team from the World Bank was quickly dispatched to Mexico the following week in order to identify new projects that could "justify" the loan *ex post*.

important fact is not yet widely known. In the Omnibus Trade Act of 1988, the U.S. Secretary of the Treasury is directed to "initiate discussions with such industrialized and developing countries as the Secretary may determine to be appropriate with the intent to negotiate the establishment of the International Debt Management Authority," an agency that would restructure the developing-country debt along the lines just outlined. The Secretary must pursue such negotiations unless he determines (in a study presented to Congress) that such negotiations would have major deleterious effects on the world economy. This legislation alone would make it vital and opportune to study the options for debt reduction.<sup>4</sup> As I show in section 5, the international debt facility offers a feasible and fiscally responsible approach to the crisis.

In the first half of the essay, I document the shortcomings that have become apparent in the "conventional approach" to the debt crisis and emphasize in some detail how all of the parties to the crisis are now being hurt by the current stalemate. In the second half, I analyze the leading proposals for moving into a new management of the crisis. Considerable attention is directed to the various proposals for an international debt facility along the lines of the new trade law. The discussion is not comprehensive; rather, the focus is on the handful of current proposals that most realistically meet the needs of the debtor countries, the commercial banks, and the creditor nations.

## **2 The Debt Crisis after Six Years**

The Latin debt crisis has been managed since 1982 by the creditor governments, the international financial institutions (the IMF and the World Bank), and the money-center banks. From the inception of the crisis, the creditors have displayed optimism with respect to its outcome. Each debtor nation has been given the same message: if it continues to play by the rules (i.e. to make interest payments in a timely fashion, and to abide by IMF programs), it will receive new loans, promptly regain normal access to the international capital markets, and enjoy brisk economic recovery.

Despite six years of contrary evidence, the official optimism remains.<sup>5</sup> But

<sup>4</sup> The U.S. Secretary of the Treasury must submit a progress report concerning the International Debt Management Authority to the Congress within six months after the enactment of the Act (i.e. no later than February 1989), and a final report after twelve months of the enactment of the Omnibus Trade Act (i.e. by August 1989).

<sup>5</sup> The communiqué of the Group of 7 nations at the Toronto Summit is a case in point. The leaders of the Group of 7 affirmed that the current "market-oriented, growth-led strategy based on the case-by-case approach remains the only viable approach for overcoming [the] external debt problems [of the highly indebted middle-income developing countries]."

after approximately \$150 billion of net resource transfers from Latin America to the creditor world since 1981, the promised benefits of faithful adherence to the creditor rules of the game have yet to materialize. The very procedure for debt management seems to have broken down. Contrary to creditor-government rhetoric, *most* Latin American governments do not receive *any* new loans from the commercial banks. The new loans they do receive are too small, too late, and too unpredictable to support economic recovery. No Latin American government has yet regained "normal access" to the capital markets. And almost no country in Latin America has enjoyed an economic recovery.

Outside observers of the crisis may be excused for believing much of the official optimism, for it is often conveyed in the press. Consider, as an example, this excerpt from the *Wall Street Journal* (Aug. 17, 1988):

But many bankers and government officials reject gloom about the international debt outlook. While they concede a lack of leadership in the U.S. and in some debtor countries, they counter that in the two most important debtor countries—Mexico and Brazil—there have been substantial economic reforms, and that Mexico has had considerable success in building non-oil exports, to reduce reliance on a single export.

This point of view is doubly remarkable. First, the allegedly favorable situation in Brazil and Mexico is enough to dispel "gloom about the international debt outlook" for these bankers and officials even though Brazil and Mexico are only two of forty or so countries in the world in acute debt difficulties. Second, the optimism about Brazil and Mexico somehow neglects Brazil's current inflation, which hit 938 percent for 1988, as well as Mexico's deep political crisis, which is in part centered on widespread public opposition to continued payments on the foreign debt.

A bleaker assessment of Latin America's situation is conveyed by the data in the sections below, where I examine the economic situation of the debtor countries, the status of the Baker Plan, and the politicization of the debt issue in Latin America.

### *Economic Indicators*

Table 1 shows recent changes in GDP and inflation in several important debtor countries, as well as the change in their per capita GDP since 1980. A first conclusion is inescapable: the economic crisis of Latin America is intensifying rather than diminishing. Argentina, Brazil, and Peru are on the brink of a hyperinflation; Ecuador is also in sharp crisis, with a rapidly rising inflation rate and falling output.<sup>6</sup> Mexico has recently stabilized its inflation

<sup>6</sup> Inflation rates in these four countries from June to August 1988 were much higher than even those in the table, with annual inflation rates reaching nearly 1,000 percent per year in Brazil and Peru, and 700 percent in Argentina.

TABLE 1  
CHANGE IN PER CAPITA GDP AND INFLATION RATES FOR  
SELECTED LATIN AMERICAN COUNTRIES

Country	% Change in GDP (1986-87)	Growth in Inflation <sup>a</sup> (Dec. 1987-June 1988)	% Change in GDP (1980-87)
Argentina	-0.3	386	-14.7
Brazil	0.7	640	3.8
Ecuador	-6.2	77	-7.3
Mexico	-0.8	99	-9.1
Peru	3.8	363	-4.2
Venezuela	-1.0	9 <sup>b</sup>	-20.4

<sup>a</sup> Rates of price increase expressed at an annual rate.

<sup>b</sup> Nov. 1987 to May 1988.

SOURCE: GDP per capita from CEPAL (1988).

rate (down from 200 percent in 1987), but the success of that stabilization program remains fragile in view of a deepening recession, political uncertainty, the sharp cuts in real wages in the past few years, and the intense and rising demands of people whose living standards have plummeted in the past decade.

Most of the major debtor countries are in the throes of a deep recession, and GDP per capita in many countries is expected to continue to decline. According to outside forecasts in the fall of 1988, per capita GDP in Brazil was expected to fall by about 2 percent in 1988, in Mexico by 4 percent, in Peru by 10 percent, and in Venezuela by 2 percent. In Argentina, per capita income, which was expected to fall sharply, might in the end rise slightly because of the rise in Argentina's export prices as a result of the U.S. drought in the summer of 1988. These widespread declines follow nearly a decade of continuous economic decline. Throughout Latin America, per capita GDP is now far below the levels of 1980. In Bolivia, the most extreme case of collapse, per capita income at the end of 1987 had fallen to the level of about 1965.

Even countries sometimes termed "economic success stories," such as Chile and Uruguay, are successes only in relative terms. Between 1980 and 1987, per capita output declined by 2.4 percent in Chile and 10 percent in Uruguay.<sup>7</sup> Colombia is the lone bright spot in Latin America in terms of per capita income growth, with an increase of 9 percent between 1980 and 1987.<sup>8</sup>

Nor do the prospects look much better for the debtor countries to regain

<sup>7</sup> The data are from CEPAL (1988).

<sup>8</sup> Remarkably, despite its growth and the timely servicing of its debt throughout the entire 1980s without a single rescheduling, Colombia remains severely constrained in its access to international loans, belying the standard creditor assertion that "good behavior" is rewarded by

creditworthiness in the financial markets. The debt/export ratios have not fallen below the high 1982 levels that prompted the crisis in the first place. On the contrary, as seen in Table 2, in most countries the debt/export ratios have risen sharply since 1982 and remain far above the levels that would be compatible with a return to normal access to the international capital markets during the next five to ten years. Indeed, contrary to the early expectations that creditworthiness would be restored by 1986 or 1987, the World Bank now puts the target date for renewed creditworthiness at "within the next five to seven years."<sup>9</sup>

TABLE 2  
DEBT/EXPORT RATIOS OF SELECTED DEBTOR COUNTRIES <sup>a</sup>  
(in percent)

Country	1982	1984	1986	1987 <sup>b</sup>
Argentina	405	461	536	554
Brazil	339	322	425	471
Chile	333	402	402	370
Colombia	191	254	198	235
Ecuador	239	259	333	464
Mexico	299	292	413	366
Peru	269	356	497	551
Venezuela	84	158	322	278

<sup>a</sup> Average gross external debt as a percentage of exports of goods, services, and private transfers.

<sup>b</sup> Projections.

SOURCE: *World Financial Markets* (1987).

Debt-servicing conditions also deteriorated in 1988 because of the sharp rise in U.S. interest rates. The key LIBOR rate, on which most international bank loans are based, rose by more than 3 percentage points between January and December 1988, and each percentage-point increase in interest rates added approximately \$3 billion of interest-servicing costs.

### *The Baker Plan*

The Baker Plan for "growth-oriented adjustment," the conventional approach to debt management, has six basic components:

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a quick return to the international credit markets. During 1988, Colombia attempted to raise new loans in order to refinance about \$2.1 billion of principal falling due. The commercial banks were unwilling to refinance the maturing debt, pressing Colombia to settle for a partial refinancing instead. As of the end of 1988, the final terms of the refinancing were still in doubt, but there were indications that the bank creditors would agree to lend Colombia approximately \$1.7 billion of the amortization payments coming due.

<sup>9</sup> See World Bank (1988, par. 34).

1. Interest payments on commercial-bank debt should be made on a timely basis at full market interest rates.
2. Principal payments due on commercial-bank debt and bilateral official debt should be rescheduled.
3. New lending by the commercial banks should be undertaken to refinance a portion of the interest due.
4. Debtor countries should submit to conditionality under the supervision of the IMF and the World Bank.
5. The international financial institutions (including the World Bank, the IMF, and the Inter-American Development Bank) should extend new loans on a high-conditionality basis.
6. Innovative financing arrangements (e.g. exit bonds, debt buybacks, and debt-equity swaps) between the banks and the debtor countries may be entered into on a "voluntary basis" as part of a "menu of options."

These six components are, in principle, to be tailored to each country according to a "case-by-case" approach. In the eyes of the creditor governments, the most important element of this approach has been that the debtor countries remain current on their interest payments.

Tables 3 through 6 describe the status of the Baker Plan. As seen in Table 3, the approach has broken down almost completely for many of the smaller debtor countries. For seven Latin American debtor countries (Bolivia, Costa Rica, Dominican Republic, Ecuador, Honduras, Panama, and Peru), the process of conventional debt servicing and new lending has by now collapsed: these countries have suspended debt-servicing payments (either partially or fully) to the commercial banks for more than one year. Among the large countries, Argentina also ran up considerable arrears to the commercial banks during 1988, but it has stated its intention of clearing the arrears in a timely manner.<sup>10</sup>

A "new-money package" is the misleading name often given to the third component of the Baker Plan—the commercial-bank lending that is supposed to be available to the debtor countries. The name is misleading because, as stressed below, the amount of new loans is invariably *less* than the money the country repays to the banks in debt servicing. On top of that, the new loans, meager as they have been, in practice have been available only to the big players (Argentina, Brazil, Chile, Mexico).<sup>11</sup> New-money

<sup>10</sup> As described below, the official creditors seem intent on putting enough new money into Argentina to make it possible for Argentina to clear most of the arrears with the private banks.

<sup>11</sup> Note that Brazil was the only country in Table 3 to receive "new money" in 1988. While a few of the smaller countries have once or twice been able to get a "new-money package" since 1982, only the large countries have been able to draw repeatedly on new bank lending. Even for the large countries, the lending has been far from routine. Typically, the loan packages have taken several months, and sometimes more than a year, to negotiate. The negotiations are

TABLE 3  
STATUS OF DEBT NEGOTIATIONS FOR SELECTED  
LATIN AMERICAN COUNTRIES

Country	New-Money Package <sup>a</sup>			Commercial-Bank Arrears <sup>b</sup>		
	1985	1986	1987	1986	1987	Aug. 1988
<b>Large countries:</b>						
Argentina	Y	Y	Y	Y	N	Y
Brazil	N	N	N	N	Y	N
Chile	Y	Y	N	N	N	N
Mexico	Y	N	Y	N	N	N
Venezuela	N	N	N	N	N	N
<b>Small countries:</b>						
Bolivia	N	N	N	Y	Y	Y
Costa Rica	N	N	N	Y	Y	Y
Dominican Republic	N	N	N	Y	Y	Y
Ecuador	Y	N	N	N	Y	Y
Honduras	N	N	N	Y	Y	Y
Panama	N	Y	Y	N	Y	Y
Peru	N	N	N	Y	Y	Y
Uruguay	N	N	N	N	N	N

<sup>a</sup> Y indicates there was a disbursement in the calendar year from a concerted loan agreement. N indicates there was no disbursement.

<sup>b</sup> Y indicates the country had arrears at the end of the period shown. N indicates it did not. These data do not indicate how long the debt service had been in arrears.

SOURCE: New-money data from IMF; arrears data from Institute of International Finance in Washington (except for Dominican Republic, which is from World Bank).

packages are hard to put together and require the active participation of the U.S. government to close each deal.<sup>12</sup> The Treasury saves its energy and political clout for the large debtors, so that the smaller countries end up with little or no bank financing.

almost always fractious, with constant breakdowns, threats, and posturings that unsettle the financial markets and undermine stabilization programs.

<sup>12</sup> As has long been recognized (see e.g. Sachs, 1984), the new-money packages pose a "collective action" problem for the banks. The bank lending might make sense for the banks as a group (e.g. as a way of avoiding outright default), but each individual bank would like to keep its own money out of the loan package in view of the debtor country's lack of creditworthiness. To overcome the collective-action problem, the loans typically have a "concerted" character such that every bank is called upon to put in new loans in proportion to its outstanding claims on the country. Even with this kind of equal sharing, the packages are hard to cobble together, since the obligation to extend new loans in proportion to outstanding exposure is not legally binding on the banks, but rather part of a negotiated deal that each bank may or may not accept. The U.S. Treasury has often had to put tacit or explicit pressure on individual banks to get them to adhere to these overall agreements.

An interesting case in point is the experience of Ecuador, where a new-money package collapsed in 1988 in part because the banks could not raise among themselves the full amount of new loans they had promised Ecuador. When the banks could not come up with the money they had promised, Ecuador naturally rejected the deal.

Table 4 reveals another important aspect of "new money." In no case is "new money" really net new money for the debtor. *The concerted lending by the commercial banks, net of amortizations on existing debt, is always smaller in amount than the interest payments that must be made by the debtor countries back to the banks.* Simply put, even with a new-money package, the check is always written from the country to the banks. Table 4 shows this fact by measuring the net resource transfer from the commercial banks to the countries. The net resource transfer measures the net new money loaned by the banks (new loans minus amortizations), *minus* the interest paid by the debtor country to the banks. In all cases, the net resource transfer from the banks is negative: net new money is less than the interest servicing on old debt.<sup>13</sup>

Table 5 gives the market verdict on the current approach, as measured by the secondary-market prices for Latin American debt from November 1985 to August 1988. We see the steady deterioration in the market valuation of the debt, signaling the growing belief that the debt will not be serviced in full in the future. As we shall see later, the decline in the market price of the Latin American debt is matched by a decline in the stock-market value of the commercial banks that hold the debt. This has a *positive* implication for achieving a formal reduction of the debt, since it implies that the bank shareholders have already absorbed (through capital losses in the stock market) the losses that are implicit in the various debt-reduction proposals. A formal process of debt reduction therefore would not have to induce a further decline in the market value of the banks.

### *The Role of the Commercial Banks*

One goal of the Baker Plan was to convince the banks to maintain a steady increase in their exposure in Latin America. The strategy is not working. The overall exposure of the U.S. commercial banks in Latin America has been falling in recent years, not rising. The total claims of U.S. banks on Latin America declined from \$83.9 billion at the end of 1982 to \$74.7 billion at the end of 1987. This \$9.2 billion decline is even larger in real terms, a drop of

<sup>13</sup> There is of course nothing wrong, in principle, with a debtor country making net resource transfers abroad. Indeed, that is the essence of debt servicing in the long run. The problem is that the net transfer has been far too high to be consistent with macroeconomic and political equilibrium, and that the creditor governments have put the achievement of the net resource transfer ahead of the economic and political goals of the debtor countries.



TABLE 4  
NET RESOURCE TRANSFERS FROM INTERNATIONAL FINANCIAL MARKETS TO  
SELECTED PUBLIC-SECTOR BORROWERS, 1985-87  
(in billions of dollars) <sup>a</sup>

Country	1985			1986			1987 <sup>b</sup>		
	NF	I	NRT	NF	I	NRT	NF	I	NRT
Argentina	2.8	3.3	- 0.5	0.5	2.7	- 2.2	0.8	3.3	- 2.6
Brazil	0.4	4.6	- 4.2	-0.2	4.8	- 5.0	0.1	2.1	- 1.9
Chile	0.7	0.9	- 0.2	0.3	1.1	- 0.8	0.2	1.0	- 0.8
Mexico	-0.5	6.9	- 7.4	0.0	5.4	- 5.4	3.2	5.4	- 2.1
Venezuela	-0.6	1.4	- 2.0	-1.1	1.7	- 2.8	-0.5	2.1	- 2.7
17 highly indebted countries	2.8	21.0	- 18.2	0.2	18.4	- 18.2	3.6	16.4	- 12.8

NOTES:

NF = net flow of capital (disbursements - amortization).

I = interest payments.

NRT = net resource transfer (NF - I).

<sup>a</sup> Numbers may not add up owing to rounding error.

<sup>b</sup> Estimates by the staff of the World Bank.

SOURCE: Data for 1985 and 1986 are from the World Bank Debt Reporting Service. Data for 1987 are estimates of the World Bank staff.

TABLE 5  
SECONDARY-MARKET BID PRICES FOR LATIN-AMERICAN DEBT,  
VARIOUS PERIODS, NOVEMBER 1985-AUGUST 1988 <sup>a</sup>

Country	11/85	8/86	7/87	8/88
Argentina	n.a.	66	47	26
Brazil	75-83	76	55	50
Mexico	78-82	56	53	50
Peru	32-36	n.a.	11	6
Ecuador	n.a.	65	45	26

<sup>a</sup> Bid price in dollars for a \$100 claim on the secondary market.

SOURCE: 11/85 from *The Economist* (Nov. 16, 1985); 8/86 from *Euromoney* (August 1986); 1987 and 1988 from Salomon Brothers (July 20, 1987, and Aug. 4, 1988).

\$23.4 billion in constant 1987 dollars.<sup>14</sup> The commercial banks are getting out. Since the banks are also rebuilding their capital, the decline in exposure *relative to bank capital* has been dramatic, as is shown in Table 6.

Note that the money-center banks in the United States now have an exposure in Latin America that is less than 100 percent of capital, compared with

<sup>14</sup> This point was suggested by an anonymous referee, who correctly stressed that under inflationary conditions the debtors are effectively amortizing principal as long as the debt does not grow in nominal terms at least at the rate of inflation.

TABLE 6  
EXPOSURE OF U.S. BANKS IN THE DEBTOR COUNTRIES AS A PERCENTAGE  
OF BANK CAPITAL, VARIOUS PERIODS, 1982-87

	End-1982	Mid-1984	End-1986	End-1987
All U.S. banks:				
All LDCs	186.5	156.6	94.8	78.1
Latin America	118.8	102.5	68.0	57.9
Nine major banks:				
All LDCs	287.7	246.3	153.9	130.9
Latin America	176.5	157.8	110.2	97.0
All other banks:				
All LDCs	116.0	96.1	55.0	43.1
Latin America	78.6	65.2	39.7	31.9
Addendum: Total bank capital (in billions of dollars)				
All U.S. banks	70.6	84.7	116.1	129.2
Nine major banks	29.0	34.1	46.7	51.5
All other banks	41.6	50.6	69.4	77.7

NOTES:

Exposure = total amount owed to U.S. banks after adjustments for guarantees and external borrowing.

All LDCs = OPEC, nonoil Latin America, nonoil Asia, nonoil Africa.

Latin America = nonoil Latin America plus Ecuador and Venezuela.

SOURCE: Country Exposure Lending Survey (Apr. 25, 1983; Oct. 15, 1984; Apr. 24, 1987; and Apr. 22, 1988).

an exposure-to-capital ratio of nearly 200 percent in 1982. This is an important point, to which we will return, because it highlights the fact that *the banks as a group are already out of crisis range* with regard to their Latin American exposure. Six years of little lending, combined with a buildup of capital, have given the banks the breathing space necessary to adjust to their *de facto* losses on Latin American debt.

Note that the smaller U.S. banks have even less proportionate exposure in Latin America. The exposure-to-capital ratio for the non-money-center banks at the end of 1987 was only 31.9 percent. Indeed, *there is not a single known case of a regional bank in the United States that faces any serious risk from its Latin American exposure.*

The decline in overall exposure is true for the money-center banks as well as for the regionals, a point shown in Table 7. This is important, because the money-center banks sometimes suggest that only the smaller banks want to exit from Latin America.<sup>15</sup> The hope held out by the creditors that the debtor

<sup>15</sup> The money-center banks want to encourage the view that they will stay while the regionals should exit. In the "market-oriented" approach to debt reduction backed by the U.S. govern-

TABLE 7  
TOTAL LDC LOAN PORTFOLIO AND PERCENTAGE CHANGE IN LDC DEBT EXPOSURE  
OF LEADING BANKS, 1987-88

Bank	Total LDC Loan Portfolio		Percent Change
	6/30/87	6/30/88	
New York:			
Bankers Trust	3,000	3,000	0.0
Chase	6,675	6,400	- 4.1
Chemical	4,500	4,500	0.0
Citicorp	11,325	9,450	- 16.6
Manufacturers			
Hanover	7,200	7,102	- 1.4
J. P. Morgan	4,050	3,630	- 10.4
Chicago and California:			
First Chicago	2,184	1,446	- 33.4
Bank of America	7,800	7,100	- 9.0
Continental			
Illinois	1,900	1,700	- 10.5
First Interstate	1,173	778	- 33.4
Security Pacific	1,340	768	- 42.7
Wells Fargo	1,140	885	- 22.4

SOURCE: "Banks Step Up Third World Debt Disposal," *Wall Street Journal* (July 26, 1988), p. 6.

countries will regain normal market access is belied by the overwhelming evidence that most commercial banks, both large and small, want to get out of the business of lending to Latin America, especially to Latin American governments.

The debt crisis is no longer a systemic banking crisis. To the extent that the debt problem remains a banking crisis at all, it is a crisis of a handful of banks around the world.<sup>16</sup> And even for these banks, there is little risk of insolvency as a result of the LDC exposure. In fact, as stressed later on, the

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ment, each creditor has an incentive to wait for the *other* creditors to offer debt relief first. The more the other creditors reduce their claims, the greater will be the value of claims of the creditors who hold out.

<sup>16</sup> In the United States, there are probably only five banks that are seriously affected by the external debt (Bank of America, Chase, Chemical, Citicorp, and Manufacturers Hanover); in the United Kingdom, there are at most two banks, Lloyds and Midland; in Canada, there are at most two banks, Bank of Montreal and Bank of Nova Scotia; in Japan, there is at most one bank, Bank of Tokyo; in France, there are at most two banks; and in Germany, there are probably no banks at serious risk, since the German banks are almost fully reserved against future Latin American losses. But even for these banks, the serious risks from LDC debt have almost completely vanished. An orderly reduction of the outstanding debt down to its current secondary-market values would do little damage to these banks.

share prices of commercial banks already reflect deep discounts on valuation of LDC debt in their portfolios, so that debt reduction could be undertaken by the banks with little if any further decline in their share values.

### *The Role of the Taxpayer*

One of the arguments for the Baker Plan is that it saves taxpayer dollars relative to a solution involving debt reduction. However, almost all debt-reduction proposals call for the *commercial banks*, not the taxpayers, to absorb the losses on the developing-country debt. Indeed, it is more accurate to say that the current approach, not the debt-reduction approach, imposes the greatest burden on taxpayers.

The analytical point is clear. The debtor countries owe money to both commercial banks and official creditors. The money owed to the official creditors (e.g. the IMF, the World Bank, and the export-credit agencies of the creditor nations) is of course money owed indirectly to the "taxpayers" of the creditor nations. If the *overall* amount of debt is too large for the country to pay, then the commercial banks and the official creditors (i.e. the taxpayers) have to share in the loss. The more the loss is absorbed by the banks, the less will have to be absorbed by the taxpayers, and vice versa. If the claims on the banks are fully protected, the taxpayers will have to absorb the full losses on the debt.

Under the conventional strategy, the commercial banks are not expected to absorb any losses. All debts are rescheduled at market interest rates *plus* a risk premium; no principal is forgiven. This means, in practice, that either the process breaks down (as in many of the smaller debtor countries), or that the official creditors must absorb a disproportionate share of the shortfall in the debt-servicing capacity of the debtor countries (as in the case of many large debtor countries).

So far, the official creditors (i.e. the taxpayers) have not suffered *explicit* losses, but rather losses that are implicit in new loans to uncreditworthy borrowers, reschedulings, and so forth. The U.S. government (together with other creditor governments) has generally supported mechanisms that keep the official creditors from receiving much in net servicing on their claims, so that the debtor countries can devote the bulk of their debt servicing to the commercial banks.

The taxpayers are picking up a part of the bill for the commercial banks in various ways:

- Through official lending by the IMF and the World Bank, much of which is effectively recycled into commercial-bank interest payments. Note that the \$75 billion General Capital Increase of the World Bank is an explicit taxpayer contribution to this process.
- Through the Paris Club mechanism, whereby official creditors capitalize

*interest* as well as principal in their reschedulings, in contrast to the banks, which never reschedule interest.

- Through explicit debt forgiveness, as suggested at the Toronto Summit. It is important and interesting that the creditor governments apparently did not even suggest that the commercial-bank creditors should share pro rata in the reduction of the debt.
- Through direct new lending by the export-credit agencies and other governmental agencies of the creditor governments. The United States has recently arranged for, and contributed to, a \$500 million loan for Argentina (bridged to future World Bank disbursements) for the *stated purpose* of helping Argentina to clear past arrears on its commercial-bank interest payments.

One way to measure this subsidy of the banks is to examine the size of net resource transfers between the debtor countries and the various kinds of creditors. The banks, for example, receive the largest net resource transfers from the countries, while the official creditors receive the smallest and in fact often make net resource transfers into the debtor countries.

By measuring the net resource transfers of each kind of creditor in proportion to the outstanding claims of that creditor, we can calculate the effective cash return earned by each creditor. This measure, shown in Table 8, is a more accurate gauge of the return on loans to the debtor countries than the accounting measures that are normally reported. It counts as interest earned only that part of the interest payments received by the creditor *that is not covered by new loans from the same creditor*.<sup>17</sup>

TABLE 8  
EFFECTIVE CASH RETURN OF OFFICIAL AND PRIVATE CREDITORS  
ON LENDING TO SELECTED DEBTOR COUNTRIES

Country	1985		1986		1987	
	Official	Private	Official	Private	Official	Private
Argentina	- 1.8	2.2	-1.3	7.2	-12.8	7.8
Brazil	4.4	7.6	3.5	8.7	7.4	3.0
Chile	-20.0	1.7	-9.0	7.8	- 0.4	6.9
Mexico	- 3.2	11.9	-3.4	8.5	- 2.2	3.4

DEFINITION: Effective cash return is defined as the net resource transfer to the creditor in period  $t$  divided by the stock of debt at the beginning of period  $t$ , expressed as a percent. A positive return means that the creditor is receiving more in interest than it is giving in net new loans (see text for discussion).

<sup>17</sup> In other words, if Mexico pays 9 percent interest on \$100 billion of debt but borrows \$6 billion of "new money" from the same creditors to cover part of the interest payments, the rate of return on the loan to Mexico is measured as 3 percent.

On this basis, we can see the implicit taxpayer subsidy of the commercial banks in recent years. For Argentina, Brazil, and Mexico, the commercial banks earned a rate of return of about two-thirds of the market rate (i.e. they had to refinance about one third of the interest that they were "paid"), while the official creditors earned a *negative* return in Argentina, Chile, and Mexico, and a modest positive return in Brazil. The negative return indicates that the official creditors were making net resource transfers into Argentina, Chile, and Mexico, while the banks were taking resources out.

The Argentine bailout in the summer of 1988 is a perfect illustration of the official bank subsidy implicit in the Baker Plan. By July 1988, the Argentine Treasury and central bank were virtually out of cash. Inflation in the previous twelve months had risen to almost 400 percent. There were almost no foreign-exchange reserves in the central bank. Argentina fell behind in its debt servicing to the commercial banks by the "magic" ninety-day limit beyond which the commercial banks would be required to put Argentine loans on a nonaccrual status.

At this point, the U.S. Treasury lobbied hard and successfully for the World Bank to make several new and rapidly disbursing loans to Argentina, which would bring World Bank lending to Argentina to more than \$1 billion in 1988-89. And it put together with other creditor governments a \$500 million bridge loan to the World Bank financing, for the *stated* purpose of allowing Argentina to clear arrears on its commercial-bank debt. The United States is also pushing hard for a new IMF program to Argentina, which would put in another \$1 billion or so, despite the fact that Argentina has violated the conditions on just about every IMF loan agreement of recent years. Finally, the Japanese have indicated their willingness to help support Argentina with several hundred million dollars of new Japan Export-Import Bank financing.

In the end, the commercial banks will likely receive net resource transfers from Argentina in the amount of \$2 billion per year, while the official creditors will likely make net resource transfers toward Argentina of a similar amount.

This kind of hidden taxpayer bailout was made even more explicit in the case of Mexico at the end of 1988. In October, the U.S. Treasury undertook a \$3.5 billion "bridge loan" to Mexico that was ostensibly bridged to a World Bank lending program that had not yet been put in place.

It is interesting that the secondary-market price of debt is lower than would be justified by the cash-flow earnings of the banks in the past three years. Since the banks have had to lend only a small fraction of the interest they have received from the large debtors, they have received an effective return that is close to the market interest rate. Were this return expected to continue in the future, the secondary-market price would be close to par.

The low and falling secondary-market price of the debt suggests that the market expects the net cash return to fall in the future, either as the countries reduce their net outward transfer or as the official creditors stop providing a net flow of resources to the debtor countries in support of the banks.

### *The Debt Crisis and International Trade*

Because Latin America has received little new international lending since 1982, the Latin American countries must pay their interest bills on the foreign debt by running large trade surpluses. The debt crisis is therefore a major factor in the deterioration of the U.S. trade balance in recent years, as Latin America has cut imports and raised exports to U.S. markets. The \$1.3 billion U.S. trade surplus with the region in 1980 became a \$14.1 billion U.S. trade deficit with the region by 1987. A detailed analysis using a simulation model of world trade has confirmed that as much as 25 percent of the deterioration in the *overall* U.S. trade deficit in the 1980s can be attributed to the collapse of international financing for Latin America.<sup>18</sup>

### **3 Debt and Politics in Latin America**

As the economic situation in Latin America has continued to deteriorate in recent years, the politics of the debt have not stood still. Throughout Latin America, politicians who follow the official creditor position are losing ground to politicians who advocate unilateral actions to suspend debt payments. The policies of the creditor governments are particularly unfortunate in the face of this political reality, since they offer conscientious Latin American politicians no realistic way to overcome their predicament.

If the politicians are "responsible" and follow the dictates of the creditor community, the resulting economic pain undermines their domestic political support. Moreover, the reform efforts these politicians carry out appear to the voters to be imposed from the outside (e.g. by the IMF) for the sake of the foreign creditors. The perception is accurate because, under the current rules of the game, belt tightening at home serves mainly to produce a larger trade surplus to pay the foreign creditors. That tradeoff is becoming increasingly difficult for politicians to justify to constituents whose living standards have declined sharply for almost a decade.

Thus, the current debt strategy is causing a radicalization and polarization of Latin American politics. For similar reasons (despite very different political histories and political institutions), the three largest debtor countries, Brazil, Argentina, and Mexico, are now extremely difficult to govern. Brazil has a runaway inflation and a lame-duck government apparently unable to

<sup>18</sup> See the study by Roubini and Sachs (1988).

forge the political consensus necessary to tackle the budget deficit. Argentina faces elections in May 1989, and the Alfonsín government is similarly frustrated in its efforts to regain budgetary control. And Mexico faces the prospect of intense political strife following a contested election in which the opposition rallied public support strongly against the current debt strategy.

*Politics of the Conventional Approach: Some Examples*

A few concrete examples (in Argentina, Ecuador, Peru, and Mexico) demonstrate the profound dilemmas facing Latin America's democratic leaders as they confront the problem of the debt.

*Argentina.* President Raul Alfonsín has tried for several years to implement important economic reforms to restore macroeconomic stability and renewed growth to the Argentine economy. The heavy debt burden (interest payments to foreign banks alone account for more than one-third of all government revenues!) has continually undermined the reform process. Debt servicing is the single most important component of the massive budget deficits in Argentina. Those budget deficits, in turn, contributed importantly to the collapse of the imaginative Austral Plan, which had held out the hope of economic stability in Argentina.<sup>19</sup>

As the Austral Plan collapsed, so too did the public's confidence in the government's economic management. The economy deteriorated in 1986 and 1987, mainly because inflation accelerated when the government did not have the reserves to stabilize the exchange rate. In the fall of 1987, the government decisively lost crucial parliamentary and gubernatorial elections to a revived Peronist party. As a result, the government faces powerful opposition to its economic policies and the country faces the possibility of renewed hyperinflation.

In July 1988, the Peronist party selected its candidate for the 1989 election. Both Peronist contenders had attacked Alfonsín's policy of following the IMF line with regard to debt servicing, but the more vigorous opponent of debt servicing (Carlos Saúl Menem) won the primary election. Menem is now heavily favored in the polls to capture the presidency in 1989. The banks and the official creditor community should certainly rue their decision to give

<sup>19</sup> In 1986, the critical year for the Austral program, the government made total debt-service payments (on medium- and long-term debt) of \$3.9 billion, or 5.2 percent of GNP. The net resource transfer to the private creditors was 3.2 percent of GNP. This net resource transfer was a tremendous drain on the budget (representing around half of the deficit in 1986). It was also a tremendous political drain, since it was nearly impossible to get political assent within Argentina for austerity measures that appeared to the public to be mainly for the sake of paying foreign creditors (World Bank, 1988b). The Argentine government was successful in reducing the budget deficit by about 6 percent of GNP during the first six months of the Austral Plan. But, given the high level of interest payments on foreign and domestic debt, a significant deficit remained that in the end helped to capsize the plan.



inadequate support to the Alfonsín government in 1986-87. Argentina's debt declined in value from 47 cents on the dollar before the legislative election of September 1987 to 17 cents on the dollar in December 1988.

*Ecuador.* The case of Ecuador has been alluded to earlier. The government of President Leon Febres Cordero was a favorite of the creditor community. It carried through free-market reforms, and it paid its debts on time until early 1987, when it was forced to restrict payments because of the collapse in oil prices and a subsequent devastating earthquake.

In negotiations in 1987, the commercial banks and the U.S. Treasury refused to contemplate any program of significant debt reduction for Ecuador. The banks insisted on a conventional approach to the debt based on continuing interest payments and a modest amount of "new money." Remarkably, the amount of new money offered by the banks was set at \$350 million *before the earthquake* and was not adjusted upward thereafter. Even more remarkably, after an agreement in principle was reached based on this amount of financing, the banks could not deliver on their commitment, and in early 1988 they asked Ecuador to accept a smaller amount of financing.

The banks' strategy had a high price. The government's candidate to succeed Febres Cordero came in third in the first round of the presidential elections in January 1988. The platforms of the two leading candidates took a much tougher stance toward the debt. Soon after coming to office in the summer of 1988, the new government of President Rodrigo Borja rejected the conventional debt strategy and announced that it would negotiate only on the basis of a deep reduction in its debt burden. Just before the first round of the presidential election in January, Ecuador's debt sold for about 45 cents on the dollar. In December 1988, the debt sold for 14 cents on the dollar.

*Peru.* From 1980 to 1985, the administration of President Fernando Belaunde Terry attempted to carry out several measures of economic reform. As in the other cases, the heavy burden of the debt contributed to a collapse of economic stability and political support. President Alan Garcia and the APRA party came to power in 1985 on a program of partial and unilateral suspension of debt servicing. The new government's unilateral actions on the debt, a response to the grave economic and social situation in Peru, were met by enormous hostility in the world financial community.<sup>20</sup> Peru has paid heavily for the debt moratorium, but so too have the creditors. As the political and economic environment in Peru has continued to deteriorate, the price of Peru's debt has fallen to 5 cents on the dollar. In the latest polls for

<sup>20</sup> The desperation of Peru's economic circumstances defy easy description. Real wages have collapsed back to the levels of the early 1960s. The political situation has become increasingly polarized: the civil society is threatened by armed revolutionaries, narcotics traffickers, and political parties of the extreme left.

the presidential elections in 1990, the candidate of the Marxist coalition, Alfonso Barrantes, is ahead.

*Mexico.* The government of Miguel de la Madrid carried through important and brave economic reforms, particularly starting in 1985. During this period, Mexico continued to service its debts despite enormous austerity, falling living standards, and a sharply accelerating rate of inflation until the stabilization program of 1988. As a result of the austerity measures and debt-service payments, real wages have declined by an estimated 40 percent in recent years. The debt issue was raised during the campaign for the summer 1988 presidential election, in which opposition candidate Cuauhtemoc Cardenas, who put a debt moratorium at the center of his political program, received more votes than predicted. The political fallout of the Mexican election cannot yet be foretold, but the implications are sure to be significant. If the new government responds to overwhelming public sentiment, the debt strategy in Mexico will change dramatically.

### *Examples of Successful Debt Relief*

The cases just reviewed establish clearly the political dead end for many debtor countries that play by the debt rules as now constituted. But in two cases, Bolivia and Costa Rica, the U.S. Treasury and the rest of the creditor community have followed a much more moderate line, and the successes have been remarkable. Indeed, in both cases we have a living laboratory experiment that demonstrates the validity of the most important political arguments for debt reduction.

*Bolivia.*<sup>21</sup> President Hernan Siles Suazo assumed office in 1982 after eighteen years of military rule. Caught between strong social demands and enormous debt-service payments in 1983 and 1984, his government presided over a hyperinflation that reached 40,000 percent per year by the first half of 1985. The succeeding government of President Victor Paz Estenssoro has been brilliant and decisive in carrying through many economic reforms that have succeeded in restoring growth and eliminating the hyperinflation. In 1987, Bolivia's inflation rate of 10 percent was about the lowest in South America.

For all of the praise that the official creditor community has lavished on Bolivia, few have recognized that substantial *debt relief* has been a central component of Bolivia's economic success. When President Paz took office in 1985, foreign creditors (including the IMF and the U.S. government) pressed for a resumption of interest servicing on commercial-bank debts, which had been suspended by Siles during the previous year. The govern-

<sup>21</sup> For a more detailed discussion of Bolivian debt management and its relationship to Bolivia's overall economic performance, see Sachs (1988).

ment rejected this pressure. It argued that the economic chaos in Bolivia was so severe that the necessary economic and political reform required a period of complete moratorium on interest payments. Any ultimate solution to Bolivia's debt crisis, it contended, would require a major writedown in the value of the debt.

The IMF and U.S. government fought hard against this position, pressing Bolivia throughout the spring of 1986 to resume some interest payments to the banks. But ultimately the official creditor community relented and gave tacit assent to Bolivia's continued moratorium. Bolivia was granted an IMF program *despite the fact of growing arrears on its commercial-bank debts, and despite the fact that there was no settlement in sight between the banks and Bolivia.*

The moratorium, and the tacit assent to the moratorium from the official community, have played a decisive role in Bolivia's economic recovery. On the economic side, the allowance for commercial-bank arrears in the IMF program permitted the adjustment program to be realistic: it called for a level of government spending cuts and tax increases that could actually be met. Therefore, Bolivia did not face the repeated crisis of failed IMF programs that Argentina and Brazil, for example, have had to face.

On the political side, the government was able to take remarkably harsh adjustment actions (e.g. sharply higher taxes, major reductions in public-sector employment, and major increases in public-enterprise prices) without facing the charge domestically of subservience to the interests of the foreign creditors.<sup>22</sup> The Bolivian government repeatedly stressed that all the austerity measures were "for the sake of the Bolivians, not for the sake of the foreigners," a point that leaders elsewhere in Latin America have not been able to make. This political point goes far to explain why the Bolivian government has succeeded in its reforms, while Argentina, Brazil, Ecuador, Peru, and others have been frustrated in their reform efforts. The foreign creditors gave Bolivia the breathing space that has not been available elsewhere.

The Bolivian debt strategy has paid off as well in a longer-term manner. The creditors have gained, because the secondary-market price of Bolivia's debt has risen since late 1985, the *only case in Latin America where this has been true*. Moreover, Bolivia's creditors recognized that Bolivia's debt is

<sup>22</sup> For example, the Bolivian government discharged 23,000 of 30,000 tin miners in the state mining company after the collapse of world tin prices in October 1985. This discharge is the equivalent in magnitude to a layoff of about a million public-sector workers in the U.S. economy! (The real impact in Bolivia is actually much worse, in view of these factors: the subsistence level of the mining communities; the geographical concentration of the miners, with harsh effects on key regions in the country; the generally depressed economy, limiting alternative work opportunities for the miners; and the absence of social-welfare protections for the laid-off workers.)

simply too high to be paid in full. Therefore, in 1987 Bolivia and the commercial banks negotiated a program of debt buybacks in which Bolivia could use money donated by third governments to repurchase its debt in the secondary market. In this way, Bolivia canceled approximately half of its debt in mid-1988 (at a price of 11 cents on the dollar) and is currently negotiating with the banks over the disposition of the other half.

*Costa Rica.* The government of President Oscar Arias has, like Bolivia's government, maintained a unilateral partial suspension of debt-service payments on commercial-bank debt at the same time that it carried out a program of impressive economic reforms. As in the Bolivian case, the creditor governments and the IMF have accepted *sotto voce* the reasonableness of Costa Rica's debt-servicing suspension (Costa Rica's debt is about 100 percent of GNP, with interest costs on the order of 10 percent of GNP). The results of Costa Rica's economic program have been very positive: rapid growth, low inflation, and overall economic stability.

Unlike the Bolivian case, however, there has still been no *long-term* resolution of the debt problem (e.g. through a debt buyback), though Costa Rica and the commercial banks are actively considering various debt-reduction proposals. The U.S. Treasury recently blocked an initiative that would have used World Bank guarantees to support part of a debt-reduction operation. The Treasury did not object to taxpayer dollars going to Costa Rica: enough dollars go to Costa Rica each year (through aid, loans, etc.) to more than pay for a debt-relief operation. Rather, the Treasury's opposition was to the concept of officially mandated debt relief. So far, the official community has left Bolivia as a case by itself.

#### **4 The Situation of the Commercial Banks**

For many years, a tough U.S. position on the debt seemed to be the only prudent course for the creditor world in view of the apparently fragile position of the U.S. money-center banks. At the end of 1982, for example, these banks had more than 180 percent of their capital tied up in loans to Latin America. But it is important to understand that, after six years of debt crisis, the U.S. commercial banks are no longer in a dire situation as a result of the LDC exposure. The original motivation for the hardline approach has vanished, and the range of options available for managing the crisis has expanded dramatically. It is now feasible to press the banks to accept a reduction in the Latin American debt without serious risk to the banking institutions.

Three points can be stressed in this regard. First, from 1982 to 1988 the U.S. commercial banks rebuilt their capital base at the same time that they stopped increasing their Latin American exposure. Meanwhile, the major

debtor countries continued to pay most of the interest due on their debts. The effect, already noted in Table 7, was a major reduction in the exposure ratios of the money-center banks, so that by now less than 100 percent of money-center bank capital is tied up in Latin America. A careful analysis by Huizinga (1989) for the World Bank has recently shown that by now *no* U.S. banks will be threatened by insolvency as long as they can recover a mere 30 percent of the face value of their LDC claims.

Second, the stock-market values of the U.S. banks already reflect a significant anticipated loss on their LDC exposure, in fact a loss of about the same size as the secondary-market discounts on the LDC debt. In other words, banks like Citicorp and Chase Manhattan are already being valued in the stock market *as if* their claims on Argentina are worth 30 cents on the dollar and their claims on Mexico are worth 50 cents on the dollar. The implications of this market discounting are profound: the money-center banks could now sell off their LDC exposures at a significant discount without *further* reducing the value of bank shares. Similarly, they could accept a safe bond (e.g. with interest guaranteed by the World Bank) with an interest rate set below market rates in return for their current risky claims that carry a full-market interest rate.<sup>23</sup>

Third, the debt relief can probably be structured in a way that does not damage the book value of the capital base of the banks. Suppose, for example, that the bank gives up its current claim on Mexico in return for a restructured claim that has *the same face value of principal but one-half the market interest rate*. Assume that the reduced interest payments are guaranteed by the official creditor community (e.g. through World Bank guarantees). The new instrument would have the same market value as the current debt (both the current debt and the new guaranteed debt would have a market value worth one-half the face value of the current debt), so that the debt conversion would have no effect on the market value of the bank.

More important, under generally accepted accounting practices and the guidelines of the Federal Accounting Standards Board (FASB), the debt conversion would not have to affect the book value of the capital base of the bank. According to FASB 15, the restructured debt, under certain conditions, could be carried on the books at the original face value even though it now

<sup>23</sup> This discounting of anticipated future losses on the debt helps to account for an otherwise puzzling phenomenon. When Citicorp made the surprise decision in May 1987 to reserve against potential losses on LDC debt, the bank unexpectedly announced a \$3 billion loss (almost 25 percent of bank capital at the time). The market's reaction was a 14 percent *increase* in share prices! Clearly, the announcement was unanticipated, but the losses themselves had been widely anticipated. The market was delighted that Citicorp was moving toward a solution of its own "debt overhang," even though it meant acknowledging on paper the losses that the market had long anticipated.

has a submarket interest rate.<sup>24</sup> Thus the bank would not face a loss of capital by accepting the reduced interest payments.<sup>25</sup>

In the end, such a debt conversion would have the following implications: (a) a reduction of Mexico's contractual interest payments by one-half; (b) no loss, relative to the status quo, in the bank's stock-market valuation; and (c) no need for the bank to write down the capital value of its claim on Mexico according to FASB 15.

It might seem like magic that a bank could accept a reduction by half of the contractual interest rate and yet not suffer any loss in market value. The reason is clear. In the example, the bank gives up an asset with a *risky* interest stream that pays the market rate in return for a *guaranteed* interest stream at half the market rate. In the case of Mexico, the risky interest stream is already valued by the market at half its face value.

Note the difference between the debt-reduction mechanism described here and the Morgan-Mexico bond swap that had such a poor market reception in 1988. In the current example, the banks are willing to cut the interest rate in half because the resulting interest stream is made *perfectly safe*, by way of guarantees (or, presumably, some other mechanism such as collateral or seniority). In the Morgan-Mexico deal, the interest payments on the new bonds were not in any way guaranteed or even made legally senior to the existing debt; the banks therefore did not find it attractive to convert their existing debts into new and risky bonds.<sup>26</sup>

Although this discussion may seem rather abstract, the chief point is easily

<sup>24</sup> Technically, for FASB 15 to apply, the new debt instrument would have to be understood as the result of a "restructuring" of the old debt rather than a market trade of one asset for another.

<sup>25</sup> All statements regarding the regulatory environment must be considered provisional, since the big eight accounting firms in the United States maintain slightly different standards. Each proposed debt-conversion mechanism requires separate and detailed scrutiny. It is also true that, to the extent that accounting provisions stand in the way of a final settlement of the debt issue, those provisions could be changed by a combination of executive-branch and Congressional action.

<sup>26</sup> In the Mexico-Morgan deal, the banks were offered a swap of their existing debt for new bonds with reduced *principal* and full market interest rates. Thus, in contrast to our example, the banks were asked to suffer a reduction of principal, not a reduction in the interest stream. This arrangement was flawed for two reasons. First, by swapping debt for bonds with a lower *principal* value, the banks were forced immediately to accept a loss in the book value of their capital, which many did not want to do. Second, the interest stream on the new bonds was not guaranteed, while the principal was guaranteed through the collateral of zero-coupon U.S. Treasury bonds purchased by Mexico for that purpose. In present-value terms, the principal, which was guaranteed, represented only about 16 percent of the contractual value of the new bond. The other 84 percent of the face value of the new bond, equal to the discounted value of the interest stream, was unguaranteed. The short answer to the Mexican bond swap is: guarantee the interest as well as the principal.

verified by looking at the stock-market values of the major U.S. banks. As seen in Table 9, banks with a heavy exposure in Latin America have low price/earnings ratios compared with banks with little or no Latin American exposure. The reason is simple: the heavily exposed banks have good interest earnings on their books from their Latin American assets, but the market does not expect the earnings to continue in the future. Moreover, the banks' real earnings are overstated to the extent that the banks must lend the debtor countries much of the money they need to pay the interest.

Thus, if a bank gives up its risky Latin American debt for a safe asset with a lower interest stream, its earnings will go down but its share price will tend to remain unchanged because of the rise in the price/earnings ratio.

TABLE 9  
THE PRICE/EARNINGS RATIOS OF BANKS WITH LARGE EXPOSURE  
AND NO EXPOSURE IN LATIN AMERICA

Bank	Exposure/ Book Value <sup>a</sup>	Price/Earnings Ratio <sup>b</sup>
Large exposure:		
Citicorp	1.2	6.6
Bank of America	1.7	5.4
Chase	1.4	5.1
Manufacturers Hanover	1.8	4.7
Chemical	1.4	5.4
Marine Midland	1.1	6.8
Irving Bank	1.4	6.1
Average	1.4	5.7
No exposure:		
Midatlantic Bank	0	9.5
Michigan National	0	8.5
Meridian Bancorp	0	10.0
BayBanks	0	9.0
First Security-Utah	0	13.0
State Street Boston	0	15.1
Commerce Bankshares	0	9.2
Dominion Bankshares	0	9.3
Amsouth Bankcorp	0	9.2
Average	0	10.3

<sup>a</sup> Ratio of exposure in Argentina, Brazil, Mexico, and Venezuela to book value, for 1986.

<sup>b</sup> Market price divided by expected earnings for 1987, prior to additions to loan-loss reserves in 1987 (i.e. earnings are measured net of losses incurred by addition to loan-loss reserves) (from Keefe, Bruyette, and Woods, Inc.).

SOURCE: From Sachs and Huizinga (1987), Table 13, p. 578.

## 5 Proposals for Debt Relief

Proposals for new approaches to the debt crisis are by now legion. A recent issue of *International Economy* (July/August 1988), for example, offered a "debt-plan scorecard," which detailed twenty-four leading proposals. Dozens more have been advanced and described elsewhere.<sup>27</sup> There are certainly far too many proposals to treat comprehensively in this essay. Instead, I will examine the relative strengths and weaknesses of a few of the major proposals.

Almost all plans start from the premise that there should be a reduction in the net resource burden on the debtor countries (the net interest payments minus the net new loans). The advocates of these plans generally agree that the current process is draining excessive resources from the debtor countries, thereby creating economic and political instability to the *mutual* detriment of both the debtors and the creditors. But from this point the plans diverge in major ways as to how they would reduce the net resource transfer and who would bear the burden of the change.

The biggest practical difference among the proposals is whether they would reduce the country's net resource transfer by increasing current lending to the country (the "financing" approach) or by reducing the debt payments (the "debt reduction" approach). The financing approach would push the burden of adjustment to the future by limiting the resource outflow today while increasing the resource outflow due in the future. The debt-reduction approach would cut the debt payments today (by canceling part of the interest or principal due) without increasing the debt payments due in the future. Clearly, the current strategy is supposedly a financing approach, even though almost all observers doubt that the Baker Plan has generated adequate resources for the debtor countries.

Another major way the proposals differ is in the role that the official creditors are to play. (Most of the proposals involve the role of the official creditors.) The official role has two facets: the use of public funds and the design of the regulatory environment. The proposals differ most sharply over the amount of official lending (the banks, not quite the advocates of *laissez faire*, propose ever-greater use of official loans) and the uses to which public money can be put.<sup>28</sup>

Most observers, even the staunchest opponents of debt-reduction proposals, would agree that the net resource transfers from the debtor countries have been too large to serve the interests of either the debtors or the credi-

<sup>27</sup> Recent surveys of debt proposals include Fischer (1989), Feldstein et al. (1987), and Lomax (1986).

<sup>28</sup> For example, advocates of debt reduction want public money to be available for debt buy-backs and guarantees of below-market interest-rate exit bonds. Supporters of the current approach, by contrast, are happy to make loans with taxpayer money but have so far fought the use of such loans for debt reduction. A case in point is Costa Rica, cited earlier.



tors.<sup>29</sup> Most would also agree that the Baker Plan has not really helped to mobilize new capital flows to the debtor countries on a sustained and dependable basis. Beyond this point, the advocates of financing or reducing the debt tend to part company.

The advocates of financing argue basically as follows. First, most or all of the countries are solvent in the long run. That is, they have the resources and the economic base to service their debts in the long term. The debt crisis rather reflects a short-term problem: the obligations (i.e. interest payments) are due today, while the economic capacity to service the interest will be available only in the future, after significant structural reforms.

Second, to forgive debt would undermine the world financial system, make it more difficult for the debtors to borrow in the future, and reduce their incentive to carry out necessary structural reforms.

Third, debt forgiveness instead of financing would ultimately reward the debtor countries that misused their borrowed funds and punish the debtor countries that managed their economies efficiently.

Advocates of reducing the debt retort that the financing approach has been tried for six years and has failed. This failure, by far the most damning indictment of the financing strategy, is judged to be inevitable for several reasons. First, because of the huge number of creditors involved (including hundreds of banks, official creditors, and suppliers), it is impossible to mobilize the creditors on a wide enough and sustained enough basis to allow for economic recovery in the debtor countries. New-money packages don't work: they are offered to only a few debtors, they are too small, and they take too long to negotiate. In the end, the debtors suffer from insufficient financial flows and the creditors suffer from the failure of the debtor countries to achieve economic recovery (which shows up in the low secondary-market prices of the debt).

Second, even if the debt could eventually be serviced on normal terms out of a country's own resources, in most countries it is too large to be serviced on that basis for many years to come. Thus, under the financing approach new-money packages are continually needed. There is also the ongoing uncertainty as to whether adequate financing will be available in the future. Since the debt overhang will undoubtedly remain large for many years, there is the continuing prospect that future financing will be too small and that a balance-of-payments crisis will arise at some point.

Third, the likely practical effect of these difficulties is that *public funds* (i.e. taxpayer money) will be used to make up for the inadequate financing provided by the commercial banks. Thus, the financing approach tends to

<sup>29</sup> See, for example, Balassa et al. (1986). The authors endorse the basic strategy of the Baker Plan, but they argue that net new lending to Latin America should be about three times higher than that targeted by Secretary Baker.

encourage a hidden taxpayer bailout of the banks. The banks make inadequate loans, and the official creditors make up the difference. Eventually, the share of the debt owed to the banks is reduced and the share owed to the official creditors rises.

Fourth, the debt overhang itself creates adverse political and economic incentives in the debtor countries. Under the financing approach, the better a country performs, the less it needs emergency loans, and the more resource transfers it must make to the rest of the world. Good behavior thereby causes larger net debt servicing. The result is that the debtor countries come to view economic reform as something that is done for the sake of foreign creditors rather than for the debtor country. In effect, the debt overhang acts as a tax on economic reform. This adverse incentive effect can be overcome only by reducing the debt that is due, so that more of the benefits of economic reform accrue to the country trying to act responsibly. In this sense, the possibility of getting a debt reduction will act as a spur to economic reform, not as a disincentive. Moreover, in most proposals debt reduction is tied to an internationally supervised program of economic reform in the debtor country. Countries that don't adjust don't get the debt reduction.

Fifth, debt reduction would not jeopardize the financial system, or even the ability of countries to receive new credits in the future. The best way to make a country creditworthy again is to reduce its debts to a manageable level, so that loans can safely be made to that country again. This is the true lesson of nearly two centuries of debt negotiation.<sup>30</sup> Moreover, it seems clear that few countries in Latin America, even those that continue to service their debts on time, have much prospect of new borrowing for several years to come.

Finally, advocates of debt reduction downplay the "moral hazard" problem of rewarding countries that misused their borrowed funds. It is clear that no debtor country has been "rewarded" by falling into a debt crisis: the declines experienced in GNP and living standards will be enough to dissuade most governments in the future from deliberately misusing borrowed funds, even if some debt forgiveness is now granted. In other words, those who have behaved poorly have already been punished for their transgressions. Moreover, as I have stressed, most debt-reduction proposals require strong debtor-country adjustment efforts under international supervision.

In fact, the moral-hazard question cuts in two directions. By using foreign-policy pressure and official funds to help keep the commercial-bank debt

<sup>30</sup> Many recent studies have confirmed that debt reduction has played a vital and successful role in the resolution of earlier crises. And the deeper the debt reduction, the *more* creditworthy the debtor country has often been in the next round of borrowing. Without debt, there is less risk in new lending. See e.g. the historical study of the Depression-era defaults, by Jorgenson and Sachs, and the other essays in Eichengreen and Lindert, eds. (1989).

a float, the creditor community is sending a signal to the banks: "Don't worry about the creditworthiness of your borrowers, since the taxpayer will come to your aid in the end." Debt-reduction plans may reward bad debtors, but the current strategy certainly underwrites bad loans.

In the real world, misbehaving debtors are not the ones that suffer most from a hard-line position on the debt. Throughout Latin America, it was the military dictatorships in the 1970s that borrowed, and often misused, the foreign loans. Now, fragile democracies are being asked to pick up the pieces. There is great irony, and little evident fairness or wisdom, in holding the Alfonsín government, or the people of Argentina more generally, responsible for the misdeeds of the generals.

## **6 Achieving Debt Reduction**

In practice, financing strategies based on large new outlays of official funds are almost sure to be rejected unless accompanied by a debt-reduction plan for the commercial banks. The reason is obvious: taxpayers in the creditor countries (and their legislators) are growing increasingly reluctant to support official lending to the debtor countries, especially when this lending is looking more and more like a rescue plan for the commercial banks. There was considerable pressure in Congress in 1988 to link the U.S. contribution to the General Capital Increase (GCI) of the World Bank to proposals for reducing the commercial-bank debt. In the end, the funding for the first two years of a planned five-year appropriation for the GCI was passed without the link, but the issue is sure to be revisited by the U.S. Congress in future years, not only for the scheduled future appropriations for the World Bank but also for funding for the IMF and the Inter-American Development Bank. The only official creditor that seems willing and able to offer substantially increased lending to Latin America is Japan, and here, too, it appears that the increased lending will be linked to debt reductions by the commercial banks, according to the outlines of new debt proposals broached by the Japanese government at the Toronto Summit and at the IMF-World Bank Meetings in Bonn in September 1988.

This basic fact forces us to direct our attention to the various proposals for debt reduction by the commercial banks. There are essentially two kinds of debt-reduction proposals now under active discussion in the financial community. The first kind relies on so-called "market-based" schemes, such as the Morgan-Mexico bond swap and the Bolivian debt buyback. These proposals call for debt reduction in the context of bilateral negotiations between the debtor country and its creditor banks. The second kind calls for a global solution based on the establishment of a new international debt facility that would take over the commercial-bank debt at a discount and then pass along some or all of that discount to the debtor countries.

### *The Bilateral Approach to Debt Reduction*

The bilateral approach is very attractive, for several reasons: it can be experimental; the hypothetical arguments for debt reduction can be tested on a country-by-country basis; the debt reductions can be tailored to the specific needs of the particular debtor country and its creditors; and it does not require an initial large outlay of public funds. Unfortunately, early experimentation with the bilateral approach, especially in Mexico, has not been encouraging. Mexico was not able to achieve significant relief from its bond swap. It seems clear that important debt reductions will not occur in the bilateral context unless there is *much more active support by the creditor governments and the official institutions.*

Under the current rules of the game, the debtor countries do not have enough bargaining power to achieve significant debt reduction in bilateral negotiations. Debtor governments will be able to bargain effectively with the commercial banks for debt reduction only when the commercial banks are convinced (a) that the creditor governments will not apply foreign-policy and financial pressure on the debtor country to continue to service the debt in its entirety and (b) that the official community will not indirectly bail out the banks by providing new official loans to the debtor country. To date, the banks have not been willing to contemplate significant debt reduction with most countries because these two conditions have not been met (Bolivia is an exception). In almost all cases, it has seemed to the banks to be in their best interest to oppose debt-reduction proposals, since they have assumed that the U.S. Treasury and the international institutions (the IMF and the World Bank) would back them up in negotiations.

Probably the most effective *single step* that could be taken to encourage debt reduction would be for the creditor governments to recognize the legitimacy of arrears on commercial-bank interest payments in situations where a country's debt burden should be reduced through bilateral negotiations. The IMF, for example, would be willing to grant programs to a debtor country even though it had growing arrears to its commercial-bank creditors. Thus, the country would be "legal" vis-à-vis the official creditor community, even though it had interest arrears to the banks.<sup>31</sup> As soon as the commercial banks recognize that the official community is accepting the buildup of arrears by the debtor country, they will be much more disposed to search for long-term solutions to the debt.<sup>32</sup>

<sup>31</sup> Once the country has an IMF program, it is better placed to negotiate relief in the Paris Club and to get new lending from other sources, such as the World Bank, the multilateral development banks (e.g. the Inter-American Development Bank), and its bilateral official creditors.

<sup>32</sup> The Bolivian experience is a case in point. The banks pushed Bolivia to resume interest payments on the commercial-bank debt until the IMF agreed to a loan with Bolivia in the

Active official support of debt-reduction schemes will also be necessary to overcome the so-called "holdout" problem that afflicts most negotiated debt-relief schemes. The basic problem with "voluntary" debt-relief schemes is that each creditor has an incentive to hold out against debt reduction, hoping that the other creditors will be the ones to forgive their claims. For example, even if each individual bank recognizes that a certain country's debt should be reduced by half, it may be in the interest of each bank to continue to demand *full* repayment of its own claims on the country, hoping that all the other creditors will cut their claims on the country by half.

The incentive each individual creditor has to resist debt reduction is of course the reason that most debt-relief operations in the domestic economy (e.g. in bankruptcy proceedings) are *imposed* on the various creditors (for their collective benefit!) by an outside arbiter, rather than being the result of a voluntary operation. As a practical matter, successful voluntary debt-reduction operations are probably as unlikely as the idea of voluntary bankruptcy proceedings without the weight of the bankruptcy code. In the international community, however, there is no bankruptcy court to distribute the losses from the debt crisis. Significant reduction will therefore probably require political leadership (presumably from the U.S. government, together with the other creditor governments, and the IMF and World Bank) to broker the kind of deal that would emerge from a formal bankruptcy proceeding.<sup>33</sup>

To use the popular jargon, we will need "concerted debt reduction" packages just as we now have "concerted" new-money packages. And, as with the new-money packages, the U.S. Treasury Secretary will probably have to jaw-bone recalcitrant banks into participating in the packages.

For mistaken reasons, the most controversial part of bilateral debt-reduction proposals is the role to be played by official money in the provision of debt relief. Official money might be used for several purposes, including (a) to lend to a country so that it can buy back its debt on the secondary market, (b) to guarantee interest payments on a submarket interest-rate

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summer of 1986, despite Bolivia's growing arrears to the commercial banks. Once the banks saw that the IMF would not condition its own lending on Bolivian interest payments to the banks, they became more willing to negotiate with Bolivia on a long-term and realistic solution to the debt. The Bolivian buyback was the first result of those negotiations.

<sup>33</sup> Some bankers have suggested that voluntary bankruptcy does in fact take place. In the domestic economy, banks sometimes reduce interest rates and principal on a debtor in financial distress even without a formal bankruptcy proceeding. But such "voluntary" reductions usually occur in one of two circumstances. First, there may be only a very small number of creditors, so that it is relatively easy to negotiate a joint package among them. Second, the *credible threat* of a formal bankruptcy proceeding, with all the attendant negotiating and legal expenses, may be enough to persuade the parties to settle out of court. In the case of sovereign debt, the number of creditors is enormous, and the threat of legal bankruptcy proceedings is absent.

bond, or (c) to purchase debt directly, as in the proposals for an international debt facility. There is enormous political squeamishness in the United States about such proposals, which is surprising since taxpayers' money is already being put at risk through direct lending to the heavily indebted countries by the various official creditors. We have already seen that official money will be *safer* to the extent that the commercial banks reduce the size of their claims on the heavily indebted countries, and that, in order to get the banks to do this, they must believe that debt reduction is in their short-run and long-run interest.

### *The International Debt Facility*

The most popular and realistic proposal for a comprehensive settlement of the debt crisis calls for the establishment of a new international debt facility (IDF) to give official creditor support to a worldwide reduction of the debt burden. Indeed, the concept is now endorsed in U.S. law in the trade legislation signed in 1988.<sup>34</sup> The many specific proposals for such a facility differ slightly in the details, but they all share the same basic approach.<sup>35</sup> The commercial banks would accept a major reduction in the contractual debt-servicing burden of the developing countries, in return for which the remaining debt would be guaranteed by the international debt facility.

There would, of course, be several ways to implement this approach. In the most common version, exemplified by the American Express Bank Plan, the IDF would buy up the existing debt from the commercial banks for cash at around the secondary-market prices. The IDF cash for this purpose would be raised by issuing bonds guaranteed by the creditor governments. The debtor countries would henceforth owe the money to the IDF. The IDF would in turn reduce the debt burden to the debtor countries through some combination of reductions in interest and principal. The cash flow of interest payments received by the IDF from the debtor countries would then be used to service the IDF bonds.

It should be clear that the IDF breaks even in this process if the present value of debt repayments received from each debtor country equals the

<sup>34</sup> As noted earlier, the law provides that the Secretary of Treasury shall commence negotiations toward the establishment of an International Debt Management Authority, which is the name given to the IDF. But the legislation provides for an escape hatch for the Treasury Secretary if he certifies in a study submitted to Congress that such negotiations would have a deleterious effect on the overall debt situation.

<sup>35</sup> Proposals for an IDF to reduce the principal or interest on existing bank debt have come from many sources, including the following nonexhaustive list: Professor Peter Kenen of Princeton University, the American Express Bank, the Bank of Nova Scotia, the Deutsche Bank, President Mitterrand of France, Former Finance Minister Kiichi Miyazawa of Japan, Congressman Donald Pease of Ohio, and Dr. Arjun Sengupta, the Executive Director for India at the IMF.

amount paid by the IDF for the country's debt. Suppose, for instance, that the IDF spends \$40 billion to purchase Mexico's \$80 billion face value of bank debt at a discount of 50 percent. If the IDF then turns around to Mexico and cancels half the debt that is due (either by cutting the principal or by maintaining the principal but lowering the interest to *one-half* the market rate), the IDF will break even, assuming that Mexico fully services the reduced debt burden.

The banks would stand to lose little if anything, relative to the status quo, by selling their debts at the secondary-market price. The bank share prices are already discounted in anticipation of future losses on the debt, so that the market value of the leading banks would not have to fall after such a sale.

Note that it is possible for the IDF to make *positive profits* in the process if the relief given to the debtor countries is slightly less than discount at which the debt is purchased. Suppose, for example, that Argentina's debt is purchased by the IDF at its current price of 25 cents on the dollar and that Argentina's interest payments are rescheduled at 35 percent of the market rate. Assuming that Argentina can meet the reduced interest payments, the transaction would amount to buying an asset at 25 percent of face value and earning 35 percent of face value.

This kind of gain is likely, because today's price of Argentina's debt has been reduced by the *inefficiencies* of the current debt strategy. With the debt crisis as it is currently managed, Argentina can be expected to pay only one-fourth of the debt (hence the price of 25 cents on the dollar). But with a program of real debt relief, which would allow for the stabilization of Argentina's political and economic situation, Argentina would be able to pay more than 25 percent of the debt.<sup>36</sup>

There are many other ways that the IDF could operate. The country and the commercial banks could negotiate a reduction of the interest rate on the debt on a bilateral basis, with the understanding that the IDF would then guarantee a part of the flow of interest to the banks. The debt would remain with the banks, but if the interest bill was not paid the IDF would partially or fully make up the difference to the banks. A third mechanism could be for the IDF to make loans directly to the debtor country so that the country could repurchase its debt on the secondary market (as in the case of Bolivia during 1988).

<sup>36</sup> There is an easy way to illustrate this argument. The hard-line creditor position vis-à-vis Argentina has made it more likely that Argentina will elect as its next president a candidate who endorses a complete moratorium on debt payments. The current low price of Argentina's debt reflects not only Argentina's low ability to pay but also the very real possibility of a complete debt moratorium. If a package of debt relief were negotiated, the extreme position of maintaining a debt moratorium would lose political support and the market price of Argentina's debt would rise accordingly (perhaps to 35 cents on the dollar).

The U.S. Treasury has strenuously opposed the debt facility on the grounds that it would cost the taxpayer too much money. This judgment is almost surely in error. Under an IDF, it is the banks, not the taxpayers, that absorb the losses on the LDC debt. There is, on the contrary, a good chance that the taxpayers (as shareholders of the IDF) would make money. Indeed, since the Treasury has insisted that the debtor countries can pay back *all that they owe*, the Treasury should favor the IDF as a way to arbitrage the debt market on behalf of the taxpayers. If Argentina can really pay back its debt 100 cents on the dollar, then a repurchase of Argentina's debt at 25 cents on the dollar, with the requirement that Argentina pay 35 cents on the dollar, is a wonderful deal for the taxpayer!

Of course, there is the risk for the taxpayer that the IDF may be called upon to honor its interest guarantee if a debtor country defaults on the *reduced* debt-servicing burden. For example, if the IDF buys Argentine debt at 25 percent of face value and Argentina can manage to pay only 15 percent of the current face value, the IDF would indeed lose (in capital value) 10 percent of the face value of Argentine debt. (This loss would, of course, represent 40 percent of the original purchase price of the debt.) This is the risk that so greatly concerns the U.S. Treasury. The Treasury seems to believe that it is too risky to buy Argentina's debt at 25 because Argentina may be able to pay only 15; therefore, let's keep Argentina's debt at 100!

In fact, with a well-managed program IDF losses should be very small, probably well below the official creditor losses under the current approach. Consistent with all the existing proposals, three factors would tend to limit IDF losses. First, if the IDF made profits on the loans of some countries, these would offset the losses on others. (I assume here that the IDF would not pass along the entire discount to the debtor country, so that if the country fully serviced its remaining debt, the IDF would make a profit.) Second, the IDF would undertake debt-conversion operations only for countries participating in internationally supervised economic-adjustment efforts. The debt of countries not undergoing economic reform would be managed according to the status quo. Third, the costs of the IDF would be widely distributed in the creditor world, thereby spreading the risk among a large number of countries. In fact, there are many reasons to believe that Japan would be willing to bear a disproportionate share of the financial support of the IDF.<sup>37</sup>

<sup>37</sup> Japan has recently recognized in many international forums its special responsibilities as the world's largest creditor nation. Japan has been contributing a disproportionate share of funds in recent years to the IMF, the World Bank, and the Paris Club. Moreover, Finance Minister Miyazawa recently endorsed the basic mechanism of an IDF in several forums. Interestingly, the legislation on the International Debt Management Authority in the trade law seems to reflect this new financial reality when it states that "support for such an authority should come from the industrialized countries, and . . . greater support should be expected from countries with strong current account surpluses."



Contrary to popular view, the costs to the official community of operating an IDF would be modest *even if the IDF incurs unexpectedly large losses*. To be concrete, suppose that the major creditor countries participate in the IDF in the proportions shown in the accompanying box.<sup>38</sup> These countries

Country	Percent of IDF Capital
Japan	30
United States	25
Germany	12.5
United Kingdom	12.5
France	10
Italy	5
Canada	5

would contribute the callable capital to back up the bonds of the IDF. The maximum amount of bonds that the IDF would have to issue would be the total current secondary-market price of the total debt eligible for purchase by the IDF. Eligible debt should be restricted to medium- and long-term commercial-bank debt of the public sector of the problem debtor countries.<sup>39</sup> This is the category of debt that is addressed in almost all proposals for an IDF.

In Table 10 we see the face value of the total stock of eligible debt as of the end of 1986 (the last available data from the World Bank) for the twenty-five largest debtor countries. We also see the secondary-market price of the debt, as of July 1988, and the current total market value of the end-1986 debt (the price multiplied by the debt stock). Note that the \$194 billion face value has a market value of \$89 billion, showing that the weighted average price of debt is 46 percent of face value.

Unfortunately, because of delays in reporting by the World Bank, we do not yet know the end-1987, much less the current, stock of debt for the countries in Table 10. As a rough guess, suppose the face value of the debt rose

<sup>38</sup> The proportions could be based on many alternative criteria, such as GNP, share of each country's bank debt in the total, or share of contributions to the IMF or World Bank. The proportions used in the box are a very rough guess at an appropriate weighting that combines such considerations as the size of the creditor country, the share of each country's commercial-bank exposure, and the balance-of-payments position of the country in question.

<sup>39</sup> Note the limitations on coverage. The IDF would apply only to commercial-bank debt. It would cover only medium- and long-term debt, leaving short-term debt (mainly trade credits and interbank credit lines) untouched. It would apply only to the debt of the public sector, i.e. sovereign debt, and not to private-sector debt. Only "problem" debtor countries would be eligible, i.e. only those countries that have rescheduled their commercial-bank debt as of a given cutoff date (e.g. 12/31/87) would be eligible for participation.

TABLE 10  
FACE VALUE AND MARKET VALUE OF COMMERCIAL BANK DEBT,  
25 PROBLEM DEBTOR COUNTRIES  
(in millions of dollars)

Country	Book Value of Debt at End-1986	Bid Price of Debt at July 1988 <sup>a</sup>	Current Total of Market-Value Debt at End-1986
Argentina	\$20,395	\$26	\$ 5,302
Bolivia	126	10	13
Brazil	49,624	50	24,812
Chile	12,084	61	7,810
Colombia	4,144	66	2,735
Costa Rica	1,530	14	214
Dom. Rep.	328	19	62
Ecuador	4,972	26	1,292
Honduras	165	22	36
Ivory Coast	2,487	28	696
Jamaica	407	37	151
Mexico	58,757	50	29,379
Morocco	2,568	51	1,310
Nicaragua	1,145	2	23
Nigeria	6,512	27	1,758
Panama	1,878	26	488
Peru	3,225	6	194
Philippines	4,207	54	2,272
Romania	2,261	87	1,967
Senegal	234	48	112
Sudan	554	2	11
Uruguay	1,301	61	794
Venezuela	9,968	55	5,482
Yugoslavia	4,510	48	2,165
Zaire	403	19	77
Total	\$193,785	\$46 <sup>b</sup>	\$89,154

<sup>a</sup> For a \$100 claim on the secondary market.

<sup>b</sup> Weighted-average bid price.

SOURCE: World Bank, and Salomon Brothers (Aug. 4, 1988).

by 20 percent between the end of 1986 and the end of 1988, putting the face value at \$238 billion, implying a market value of roughly \$110 billion.<sup>40</sup>

In the extreme case in which *all* of the listed countries participate *fully* in the IDF, with the IDF guaranteeing *100 percent* of the restructured debt,

<sup>40</sup> The increase of 20 percent in debt would include the results of net new lending plus the effects of the dollar depreciation, which has raised the dollar value of nondollar-denominated debt. The 20 percent estimate is probably on the high end of a reasonable guess.

the creditor governments would be committing to guarantee the full \$110 billion or so of the debt. If the responsibility for the \$110 billion was allocated according to the shares just indicated, each country would guarantee the amount of IDF lending shown in the accompanying box.<sup>41</sup>

Country	Amount of Lending (in billions)	Share of GNP
Japan	\$ 33.0	1.4%
United States	27.5	0.6
Germany	13.8	1.2
United Kingdom	13.8	2.0
France	11.0	1.3
Italy	5.5	0.7
Canada	5.5	1.4
Total	\$110.0	

The amounts of money involved are very modest when viewed in the proper perspective. First, and most important, these amounts reflect *contingent liabilities*, not actual outlays. We have seen that it is perfectly possible that the IDF will cost the creditor governments no money whatsoever, and that indeed the IDF might turn a profit. The contingent liability arises only if the IDF loses money on the debt-conversion operations, that is, only if the debtor country fails to meet payments on the greatly reduced stock of debt.

Second, in the illustration the Group of 7 countries cover all the costs of the IDF. But it is perfectly conceivable that the burden could be carried more widely among the twenty-four countries of the entire Organization for Economic Cooperation and Development.

Third, the numbers shown are for the case in which every eligible debtor country participates at the maximum rate. Since participation will require adherence to the strict conditionality of the IMF and World Bank, including tough prior actions in the area of economic reform, 100 percent participation is highly unlikely.

Fourth, the actual budgetary appropriations required would be a mi-

<sup>41</sup> Note that the maximum liability (which would be spread out over several years in any case) stands at 2 percent of GNP. The low share for the United States reflects the weak balance-of-payments position of the United States, as well as the heavy burden that the United States bears in other areas for the Group of 7 countries. The somewhat larger share for the United Kingdom is based, provisionally, on the relatively large exposure of several U.K. banks in Latin America. As stressed earlier, the rough allocation of responsibilities shown here is for purposes of illustration only.

nusculare share of the amounts shown in the box. Consider the World Bank General Capital Increase (GCI) as a model. There, a sum of \$75 billion in callable capital is to be raised among the creditor governments, with paid-in capital of 3 percent of the total \$75 billion, that is, paid-in capital of \$2.25 billion. The U.S. share of the GCI is approximately 17 percent, or \$14 billion, with a paid-in total of \$420 million. The paid-in capital is to be distributed to the World Bank in six calendar years, in even proportion. Thus, U.S. appropriations for the \$14 billion share come to just \$70 million per year for six years!

The IDF would probably require a higher ratio of paid-in capital, given the greater riskiness of its portfolio. For purposes of illustration, let us suppose that the paid-in capital comes to 10 percent of the contingent liability, roughly in line with the proposal of the American Express Bank.<sup>42</sup> Furthermore, let us suppose that the pay-in period is five years. The contingent capital of each of the Group of 7 countries shown earlier would result in the budgetary appropriation shown in the accompanying box.

Country	Yearly Budgetary Expenditure (in millions)	Total of 5 Years (in billions)
Japan	\$660	\$3.30
United States	550	2.75
Germany	276	1.38
United Kingdom	276	1.38
France	220	1.10
Italy	110	0.55
Canada	110	0.55

Let us put these numbers in perspective. The annual foreign-aid budget of the U.S. government is approximately \$15 billion. The U.S. share of the IDF, which would clean up the commercial-bank debt crisis for twenty-five countries around the world, would amount to about 4 percent of the annual foreign-aid appropriation!

The IDF, then, can be a remarkable bargain. The cost is small in part because the stock of commercial-bank debt at its current secondary-market price is a very small share of OECD GNP (the \$110 billion is less than 1 percent of OECD GNP; the full \$238 billion of face value is less than

<sup>42</sup> In the American Express Plan, each \$1 of equity capital held by the sponsoring governments is used to back \$10 of bonds and \$2 of preferred shares. The ratio of common equity to debt is therefore 10 percent.

2 percent of OECD GNP). In addition, the cost is small because it is the commercial banks, rather than the taxpayers, that really pay for the program. The banks absorb the initial book loss (from \$238 billion to \$110 billion), and the creditor countries pay only that part of the *reduced* debt that cannot be serviced by the debtor country. Remember, too, that the bank shareholders have *already* absorbed the prospective book loss of the banks in the form of lower share prices, and that the book losses can be structured as a reduction of interest payments rather than principal, as a way to avoid a major reduction in the book value of the capital of the banks.

Of course, the costs to the taxpayers would be higher than shown if the IDF incurred large losses. Then the U.S. Congress and the parliaments of the other countries would have to make supplementary appropriations. Let us examine a "bad case" scenario. Suppose that after the debt is reduced by more than half, the debtor countries can manage, on average, to service only half of what is due on the greatly reduced debt. Instead of paying the market interest on \$110 billion of debt, they are able or willing to pay only half that amount. Suppose further that LIBOR is 10 percent per year, again a bad-case figure. Instead of paying \$11 billion per year in interest to the banks, the countries would pay only \$5.5 billion.

The backers of the IDF would then lose half of their "investment" in the IDF. Japan, for example, would stand to lose, in present value, half of its \$33 billion share, or \$16.5 billion (approximately 0.66 percent of current GNP). The United States would suffer a capital loss of \$13.5 billion, about 0.30 percent of current GNP. The annual losses would of course be one-tenth of that amount, since they would reflect the annual interest loss on the IDF loans. The U.S. loss, for example, would be about \$1.35 billion, or a little less than 10 percent of the annual foreign-aid budget. In sum, the bad-case scenario would produce the results shown in the accompanying box.

Country	Annual Loss (in billions)	Present-Value Loss (in billions)
Japan	\$1.65	\$16.5
United States	\$1.35	\$13.5
Germany	\$0.69	\$6.9
United Kingdom	\$0.69	\$6.9
France	\$0.55	\$5.5
Italy	\$0.28	\$2.8
Canada	\$0.28	\$2.8

It might be argued that these numbers understate the overall treasury costs, since the banks' losses will lead to declines in taxes and therefore to

greater budgetary expense. But since the banks are likely to lose the money on the LDC debt whether or not an IDF is created, the tax losses are likely to be incurred in either case. That is the message of the secondary-market prices and the dozen or so unilateral moratoria on debt payments now in place. The real question for policymakers is whether those losses occur in an orderly fashion or in the context of a breakdown of economic relations between the debtor and creditor nations.

Nevertheless, it is worth making a rough estimate of the tax losses. In the United States, the total banking-sector exposure to the public sectors of the problem debtor countries shown in Table 10, as of the end of 1987, came to \$48.3 billion.<sup>43</sup> Assuming that the banks take the average writedown on this debt that we found in Table 10, accepting a loss of 54 percent of face value, the book-value losses of the banks come to \$26 billion. The reduction in the banks' taxes on these losses would be about 20 percent of the losses, or \$5.2 billion. If, as is likely, the losses would be amortized over a period of five to ten years, the annual revenue shortfall would amount to approximately \$0.5 to \$1 billion.

Remember, once again, that these Treasury losses could materialize under *any* debt strategy: they are not really the incremental cost of an IDF.

A similar point should be made about losses on official credits. Taxpayers are likely to continue to bear some of the burden of the debt crisis through increased lending by the international institutions and the export-credit agencies, and through the relief granted in the Paris Club. But this burden will not be increased by virtue of an IDF. Indeed, as I have already suggested, taxpayers' expenses will probably decline in these other areas, for the simple reason that with less commercial-bank debt the countries will be able to pay more on their official credits.

A final concern about the IDF involves the participation of the commercial banks. Suppose that the IDF is established and begins to convert a substantial amount of debt. Each individual bank might have the incentive to resist participation in the debt conversion, recognizing that if all the other banks participate and accept lower interest rates, the remaining debt will become safe. This, of course, is the collective-action problem discussed earlier at some length. As noted then, there is a need for a collective authority to put together a *package deal*, so that the vast bulk of a country's debt is converted in one shot.<sup>44</sup>

<sup>43</sup> Data are from the Country Exposure Lending Survey (1988), Table II, under the heading "portion of total owed by public borrowers."

<sup>44</sup> An anonymous referee of this paper expressed the concern that if the IDF began to buy up the debt on the secondary market, it would drive up the price and frustrate the debt relief. This point is true and important. The IDF simply cannot work as a buyback operation unless a nearly

The notion of a package deal is familiar from the new-money packages that have been put together for the large creditors in recent years. In each of these cases, the U.S. Treasury has had to "twist some arms" of creditor banks to get the deals accomplished. Debt reduction via the IDF should involve a "concerted reduction" in analogy to a "concerted loan" in the present strategy. A concerted debt-reduction package should be even easier to put together than a concerted loan. As long as the new debt instrument has a market value at least as high as the current secondary-market value of the debt, almost all regional banks in the United States and almost all small and moderate-sized banks abroad would jump to participate.

The smaller banks have been much more willing than the big banks to recognize losses in return for a safer asset, for example, by selling off their portfolios in the secondary market or trading their debt holdings for exit bonds. This difference in behavior occurs for several reasons. First, the biggest banks, like Citicorp, are able to engineer especially favorable deals, such as debt-equity swaps, by virtue of their greater strategic presence in Latin America and their access to the debtor governments. Thus, they have opposed across-the-board deals (e.g. submarket interest rates) or standard debt instruments (e.g. exit bonds) that have proved to be attractive to the smaller banks. Second, the bigger banks have a greater exposure relative to capital, so that they are much more loath than the regional banks to recognize losses explicitly on their balance sheets. Third, the largest banks have acted strategically, by encouraging the smaller banks to grant relief, hoping that the debtor countries would then fully service the remaining debts.<sup>45</sup>

The bigger problem with participation would thus come from a few money-center banks in the United States and a handful of foreign banks. This situation is the opposite of the case of concerted lending, where the few large banks are in favor of the concerted loans but the hundreds of smaller banks must be cajoled into participation.

Several carrots and sticks are available to the creditor governments to induce full participation by the banks, and especially by the largest banks. The bank regulators in the creditor countries could enforce much more stringent accounting rules on the *existing* debt, so that there would be an incentive for each bank to participate in the debt conversion. For example, the U.S. banks could be required to mark to market the value of their LDC claims (i.e. to write them down to the level of the secondary market) unless

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universal package deal is established at the outset between the IDF and the creditor banks as a group.

<sup>45</sup> For a further theoretical discussion of why a heavily exposed bank might reject an efficient debt conversion (which raises the total market value of the debt), see Sachs (1988).

they agreed to participate in the debt facility, in which case they might be permitted to keep the debt on the books at or near the face value of principal.

Suppose that Brazilian debt sells at 40 cents on the dollar. Under the debt-facility proposal, the interest on the Brazilian debt would be cut to around four-tenths of the market rate (e.g. from 10 percent per year to 4 percent per year). The principal, however, would remain unchanged. The regulators could allow all converted debt to remain on the books at the face value of principal (under FASB 15) but require that unconverted debt be written down to 40 percent of the face value of principal. Alternatively, the regulators could allow a *gradual* writedown of principal in the case of converted debt. These accounting changes could be made to apply to capital-adequacy measures, so that the forced writedown of the existing debt would immediately reduce the bank capital, while participation in the debt-facility conversion would permit an avoidance or stretching out of the capital loss. The regulators would be justified in giving the converted debt more favorable treatment, because the unconverted debt would have more political and economic risk attached (since the debt payments would not be guaranteed). More generally, the regulators could negotiate with the few largest banks to trade off participation in the debt facility with less onerous regulatory treatment in other areas (e.g. in the United States, with the repeal of Glass-Steagall regulations).

But a much more general point about bank participation should be made. The banks know now that the main reason they continue to be paid is because of the foreign-policy pressure applied by the creditor governments to the debtor governments. If that government-to-government pressure is eliminated, the debtor governments will be in a much stronger bargaining position vis-à-vis the banks. This would be especially true if the creditor governments stopped lending money to the debtor governments (directly and via the international financial institutions) merely so that bank interest could be paid. Once the creditor governments make clear that they are not going to stand behind the banks in insisting on *full* debt servicing, the banks will be left with few alternatives but to join a take-it-or-leave-it offer by the IDF that is supported by the creditor governments.

To operationalize this new stance of the creditor governments, a simple yet powerful step would be for the creditor governments to grant IMF programs to debtor countries even when the debtor countries are in arrears to the commercial banks. If the IMF program and all of the rest of the official-creditor apparatus (World Bank lending, Paris Club reschedulings, etc.) remained in place despite arrears to the commercial banks, the banks would have little bargaining pressure with which to resist the compromise called for by the IDF.

Finally, if all this moral and regulatory suasion still falls short, there are a



number of legal mechanisms to compel the participation of the banks. They include, among other possibilities, direct legislation calling for commercial-bank participation; invocation of an IMF waiver on commercial-bank debt payments, under Article VIII of the IMF Articles of Agreement;<sup>46</sup> or U.S. government support of various legal defenses by the debtor governments in legal recovery actions by individual banks.<sup>47</sup>

In summary, an IDF makes eminent sense from the point of view of all the major parties to the crisis. For the debtor, the benefits are obvious: the IDF provides a substantial reduction in the contractual present value of future debt repayments. For the banks, the IDF offers the opportunity to exit from the crisis intact and to eliminate the continuing downside risks, without suffering further significant reductions in market value. The banks would accept book losses, but losses of a known and fully manageable amount that have already been anticipated by the market. For the official creditors (i.e. taxpayers), the IDF would be an extremely efficient use of tax dollars in a situation where tax dollars are *already being used in the management of the crisis*. Instead of supporting the interest payments to commercial banks on bad loans, the tax dollars would actually be harnessed to reduce the debt overhang.

Taxpayer money would stand at little risk. Most of the book losses would be taken by the banks, and those losses have already been incurred in lower prices of commercial-bank stocks. The taxpayer would share in the losses only if the debtor country could not meet the greatly reduced debt burden that remained after the debt-reduction exercise via the IDF. Careful estimates of the possible costs of this eventuality suggest that the IDF is a bargain, especially for the United States, with its vital foreign-policy interests in the region. It is likely that Japan can be induced to share disproportionately in the funding of the IDF, and the other countries of the Group of 7

<sup>46</sup> In the opinion of some international legal scholars, under Article VIII of the IMF Articles of Agreement the IMF can grant a waiver to a member government on its obligation to service its foreign debts. The waiver would provide a legal defense for the debtor government against subsequent legal actions undertaken by the creditor banks. The authority of the IMF to grant such a waiver, and its legal ramifications, are in dispute, but the possibility alone that such a waiver might be granted and be effective would make the major commercial banks reluctant to launch a frontal legal attack on the IDF.

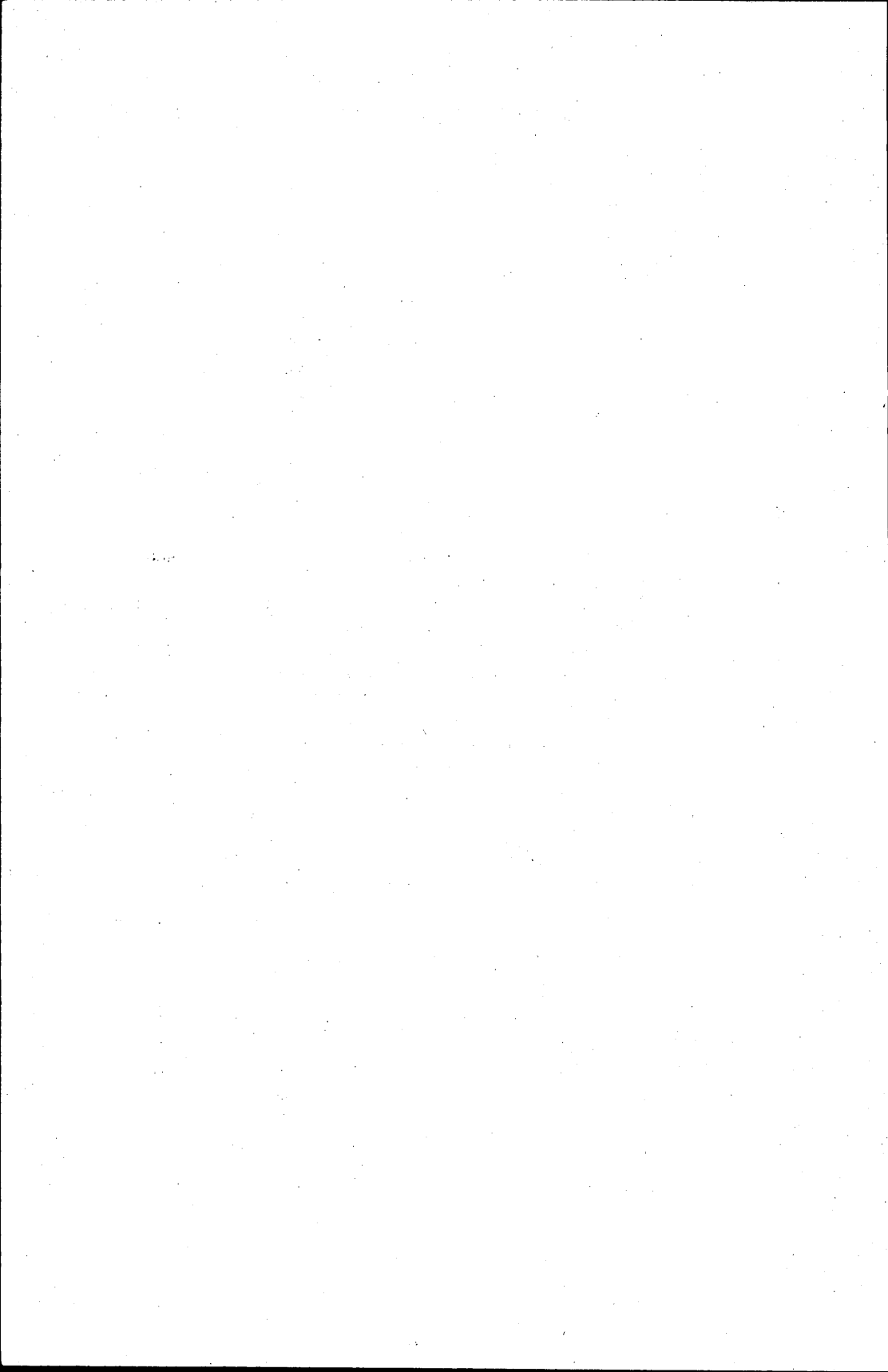
<sup>47</sup> In an important case, *Allied Bank vs. Costa Rica*, a U.S. Federal Court refused to enforce a debt contract of Costa Rica under a doctrine known as "state action," in which Costa Rica held that enforcement of the debt contract would run counter to government-to-government relations between Costa Rica and the United States. It was only when the U.S. government responded to the court that it was U.S. policy that in fact Costa Rica *should* pay the debt that the court ordered an enforcement of the contract. This ruling suggests that if the U.S. government were to judge that a specific contract between a debtor government and the creditor governments should not be enforced, the U.S. Federal Courts would give broad latitude to U.S. foreign-policy interests in supporting the U.S. government position.

can also share the burden. The expenditures of the United States in supporting the IDF are likely to remain a very small fraction of the foreign-aid budget, even in the event of some bad-case scenarios.

As taxpayers, the residents of the creditor nations would have little to lose. As citizens, they would have much to gain. They would contribute to a resurgence of economic and trade relations between the creditor and debtor nations. They would contribute to renewed economic development in Latin America and thereby help to prevent a radicalization of the region. And they would help to solidify democracy in Latin America, to the benefit of free men everywhere.

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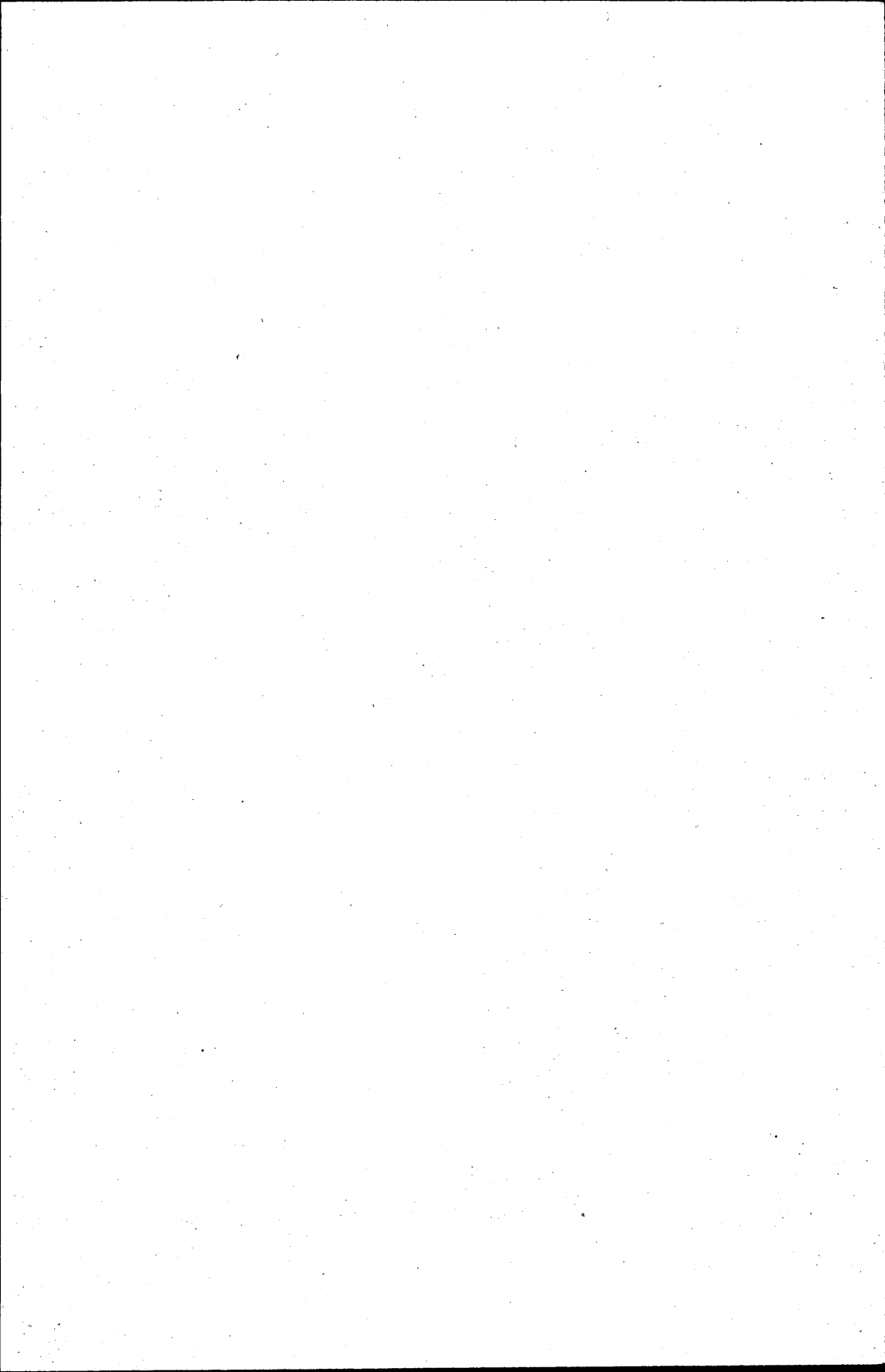
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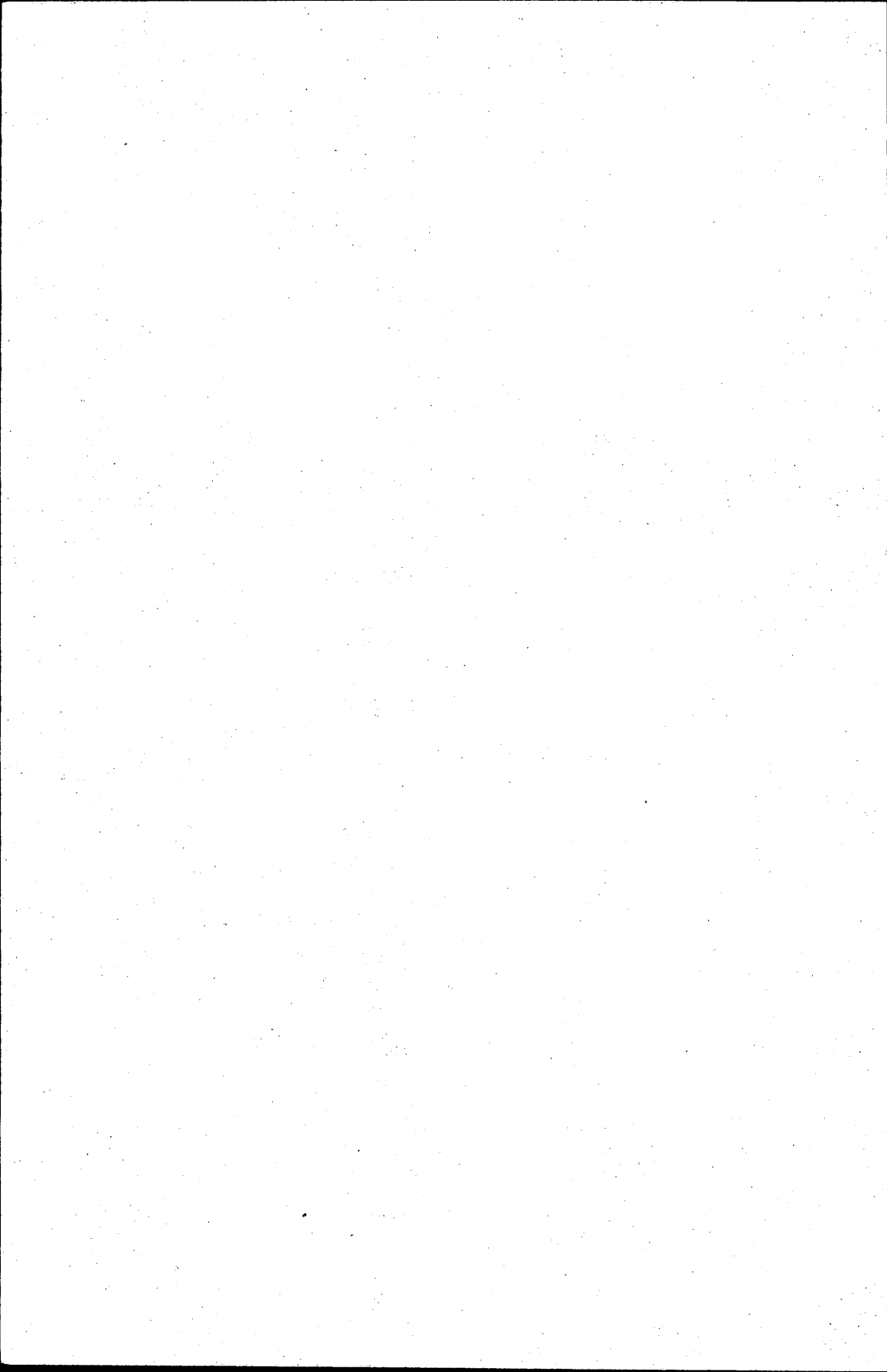
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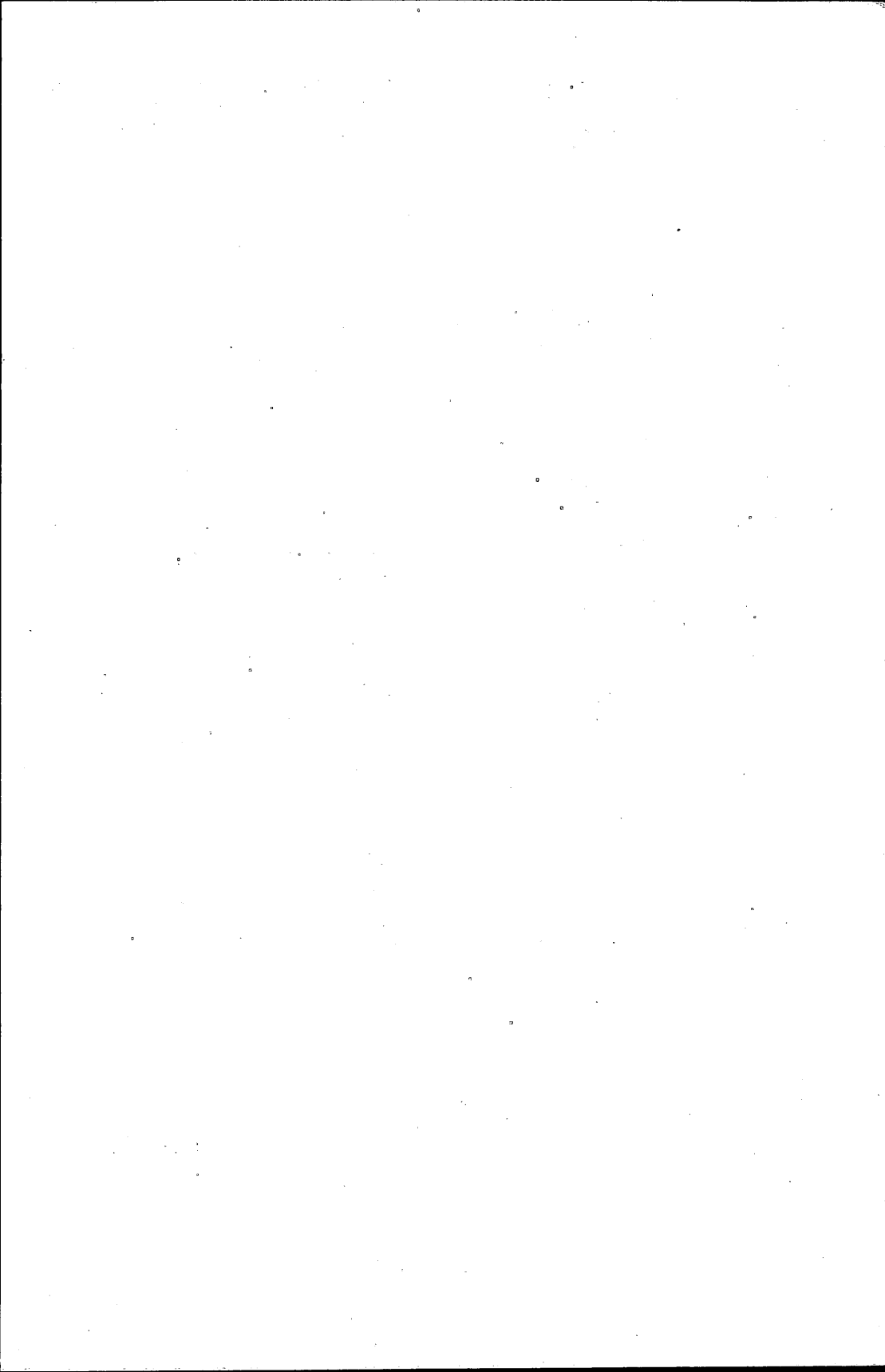
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