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DEVELOPING-COUNTRY DEBT: A MIDDLE WAY

BENJAMIN J. COHEN

INTERNATIONAL FINANCE SECTION
DEPARTMENT OF ECONOMICS
PRINCETON UNIVERSITY
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The author of this Essay, Benjamin Cohen, is William L. Clayton Professor of International Economic Affairs at the Fletcher School of Law and Diplomacy, Tufts University. Among his books are *Banks and the Balance of Payments* (1981) and *In Whose Interest? International Banking and American Foreign Policy* (1986). This is his third contribution to this series.

PETER B. KENEN, *Director*
International Finance Section

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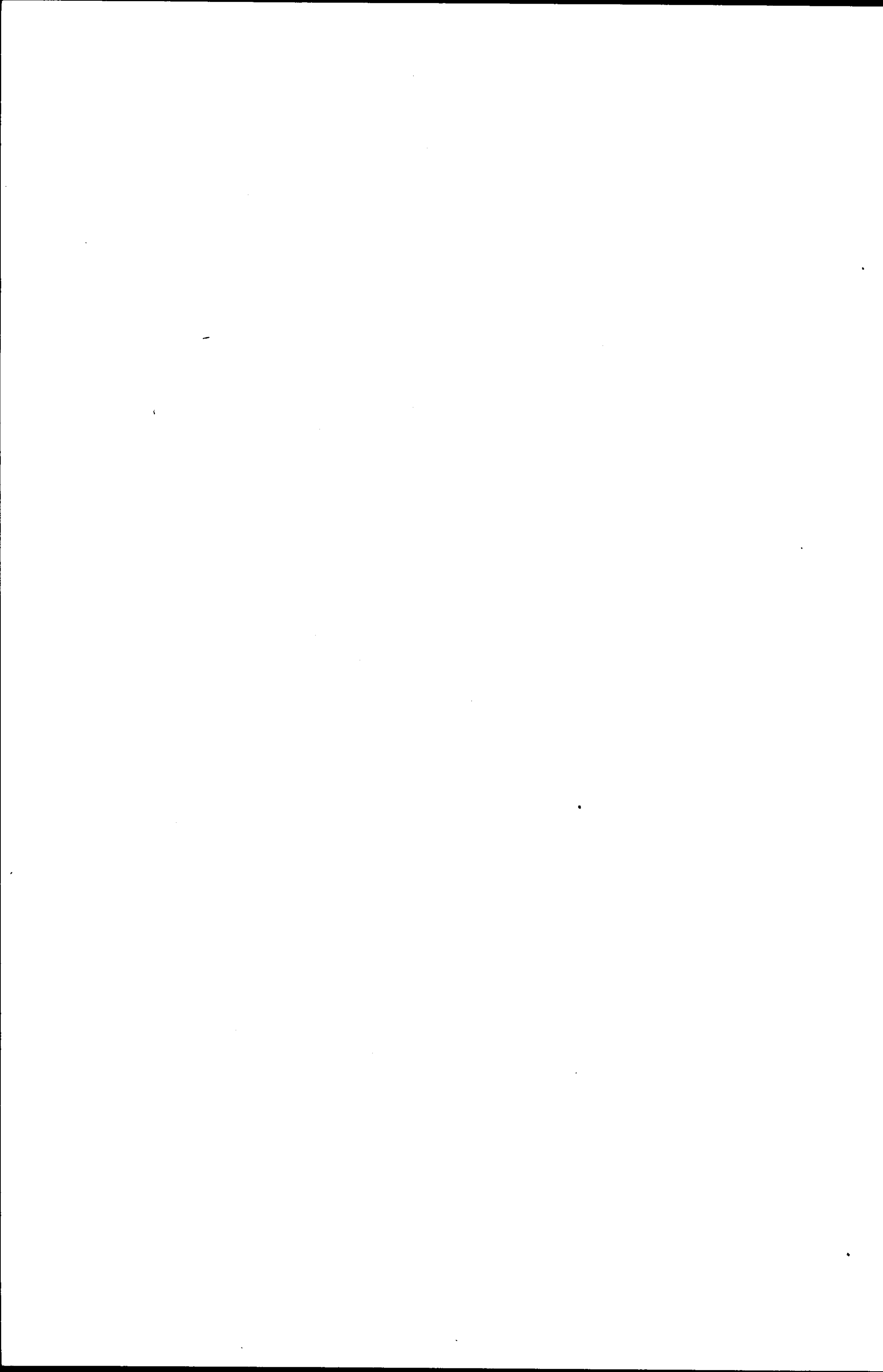

DEVELOPING-COUNTRY DEBT: A MIDDLE WAY

1 Introduction

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

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

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

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

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

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

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

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

2 An Unexploited Opportunity for Joint Gain

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

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

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

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

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

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

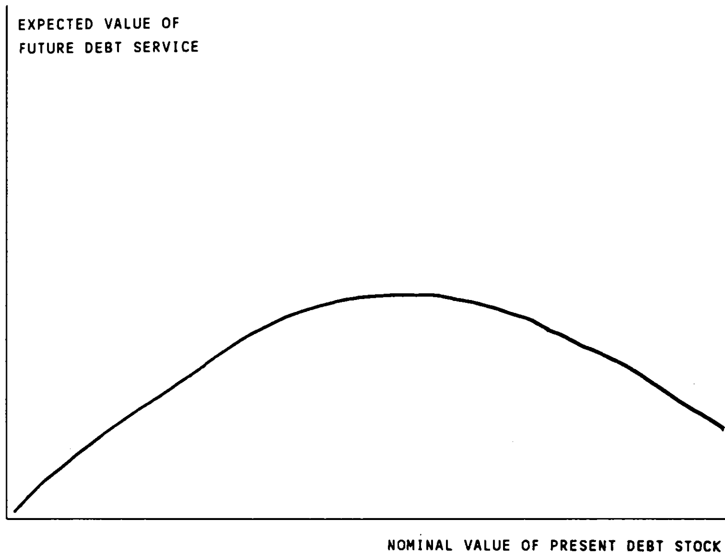
In such circumstances, a strong case can be made that at least in some situations creditors as well as debtors would be significantly better off with a cooperative strategy of debt relief. The logic of the case has been most elegantly summarized by Krugman (1988), using what he calls the "debt relief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

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

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

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

THE DEBT RELIEF LAFFER CURVE



3 Explaining the Current Outcome

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4 The Need for Collective Action

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

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