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14 Conditionality, Debt Relief, and the Developing Country Debt Crisis

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14.1 Introduction

This chapter examines the role of high-conditionality lending by the International Monetary Fund and the World Bank as a part of the overall management of the debt crisis. High-conditionality lending refers to the process in which the international institutions make loans based on the promise of the borrowing countries to pursue a specified set of policies. High-conditionality lending by both institutions has played a key role in the management of the crisis since 1982, though the results of such lending have rarely lived up to the advertised hopes. One major theme of this paper is that the role for high-conditionality lending is more restricted than generally believed, since the efficacy of conditionality is inherently limited.

A related theme is that many programs involving high-conditionality lending could be made more effective by including commercial bank debt relief as a component of such programs. I shall argue that such debt relief can be to the benefit of the creditor banks as well as the debtors, by enhancing the likelihood that the debtor governments will adhere to the conditionality terms of the IMF and World Bank loans, and thereby raise their long-term capacity to service their debts.

Almost by definition, countries in debt crisis that appeal to the Fund or the Bank for new loans have already been judged to be uncreditworthy by normal market criteria. In such treacherous circumstances, it is appropriate to ask why the IMF or the World Bank should be extending new loans. As an alternative, for example, the international institutions could allow the creditors and debtors to renegotiate new

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terms on the old loans without any official involvement. Such two-party negotiations between creditors and debtors characterized earlier debt crises, before the IMF and World Bank existed (see Lindert and Morton, chap. 10 in this volume, for a discussion of the earlier history).

In principle, continued lending by the international institutions could be justified by several nonmarket criteria: as a form of aid, as an investment by the creditor governments that finance the IMF and World Bank in political and economic stability of the debtor country (see Von Furstenberg 1985a, 1985b, for such a view); as an extension of the foreign policy interests of the major creditor governments; as a defense of the international financial system, etc. Loans are not usually defended on these grounds, though in fact such considerations are frequently important. Of course, these criteria are valid to an extent, but also extremely difficult to specify with precision as a basis for IMF–World Bank lending.

Another defense of lending, also with considerable merit in some circumstances, is that the IMF (and World Bank to a far lesser extent), can act as a "lender of last resort," analogous to a central bank fighting a banking panic in a domestic economy. The argument holds that the private commercial bank lenders to a country might panic, and all decide to withdraw their funds from the country even though the country is a fundamentally sound credit risk in the longer term (see Sachs 1984, for such a model). In this case, lending by the IMF can eliminate the liquidity squeeze on the country, and thereby help both the creditors and the debtors. As in the case of a domestic banking panic, the IMF helps to overcome a well-defined market failure.

This argument was part of the basis of the original IMF intervention into the debt crisis in the early 1980s. The argument following the Mexican crisis in mid-1982 was that countries were suffering from a liquidity crisis, made acute by the simultaneous rise in world interest rates and the sudden cessation of commercial bank lending. It seemed at the time that the crisis could be quickly resolved (as argued, for example, by Cline 1984), since it represented merely a liquidity squeeze.

The liquidity arguments are no doubt true in some cases, but most observers now doubt that the developing country debt crisis represents merely a problem of liquidity. Six years after the onset of the crisis, almost no countries have returned to normal borrowing from the international capital markets, and the secondary-market value of bank loans to the debtor countries reflect very deep discounts in valuation. For many countries at least, the crisis represents more fundamental problems of solvency and longer-term willingness to pay on the part of the debtor nations.

In these circumstances, other justifications (that can be in addition to the liquidity argument) have been advanced for the large role of the

IMF and World Bank lending. By far the most important argument is that *strict conditionality* attached to IMF–World Bank loans can make such loans sensible on normal market terms. The assumption is that the international institutions are better than the banks at enforcing the good behavior of the debtor country governments, and therefore have more scope for lending.

The importance of conditionality in justifying IMF–World Bank lending is certainly well placed. Nonetheless, the role for high-conditionality lending is overstated, especially in the case of countries in a deep debt crisis. In practice, the compliance of debtor countries with conditionality is rather weak, and this compliance problem has gotten worse in recent years, since a large stock of debt can itself be an important disincentive to "good behavior." In other words, the debt overhang itself makes it less likely that conditionality will prove successful.

The reason is straightforward. Why should a country adjust if that adjustment produces income for foreign banks rather than for its own citizenry? since deeply indebted countries recognize that much of each extra dollar of export earnings gets gobbled up in debt servicing, a very large stock of debt acts like a high marginal tax on successful adjustment. Therefore, two counterintuitive propositions could be true when a country is deeply indebted: "Good behavior" (such as a higher investment rate) can actually reduce national welfare, by increasing the transfer of income from the debtor country to creditors; and explicit debt relief by the creditors can increase the amounts of actual debt repayment, by improving the incentive of the debtor country to take the necessary adjustments.

14.2 High-Conditionality Lending by the IMF and World Bank

The argument for high-conditionality lending is that the IMF and the World Bank can compel countries to undertake stabilizing actions in return for loans, thereby making the loans prudent even when the private capital markets have declared the country to be in uncreditworthy. A full theory of conditionality would have to explain three things. First, if the actions being recommended to the country are really "desirable" for the country, why is it that the country must be compelled to undertake the policy? Second, if the country must indeed be compelled to undertake the actions, what types of force or sanctions can be used to guarantee compliance? And third, why is it that international institutions are better able to impose conditionality than are the private capital markets?

One solution to the conundrum of why countries must be compelled to accept conditionality is the problem of "time consistency": A debtor

government accepts ex ante the need for a policy adjustment as the quid pro quo for a loan, but the government has a strong incentive to avoid the policy change once the loan is arranged. In this case, the role of conditionality is to bind the country to a course of future actions, actions which make sense today but which will look unattractive in the future. In other words, the goal of conditionality is to make the ex ante and ex post incentives for adjustment the same (where ex ante and ex post are with respect to the receipt of the loan).

The question of enforcement of conditionality agreements is in many ways tougher than the question of why conditionality is needed. The justification for IMF–World Bank lending rests on two propositions regarding enforcement: (1) that the enforcement of IMF–World Bank conditionality is sufficiently powerful to result in an "acceptable" rate of compliance with IMF–World Bank programs; and (2) that the official institutions have an advantage over the commercial banks in enforcing conditionality. Both assumptions are problematic.

For both the international institutions and the commercial banks, the legal bases of conditionality are weak. In the domestic capital markets, bond covenants are legally binding restrictions on the behavior of debtors, and can generally be enforced with only modest transactions costs. In the international arena, particularly for loans to sovereign governments, the transaction costs for enforcing loan agreements are extremely high. As most writers have recognized recently, the main method of enforcement for lenders (whether official or private) involve the threat of cutoffs of *new* loans to misbehaving borrowers. Such a cutoff in lending can of course be extremely disruptive and costly to a borrower.

Theoretical work and empirical evidence both establish that the threat of a lending cutoff is a credible, but inherently limited sanction. Thus, conditionality, whether by the IMF and World Bank, or by the commercial banks themselves, cannot, on an a priori basis, be expected to have the same force as a binding bond convenant in a domestic loan. From the beginning, we should appreciate the inherent limitations of the enforcement mechanisms in conditionality on international lending.

Conditionality is limited in effectiveness not only because of enforcement difficulties, but also because of the complexity of negotiating with a sovereign borrower. In the case of a bond convenant, there is a clear legal responsibility on the borrower to carry out the conditions of the covenant. When a government is the debtor, however, there is likely to be a considerable diffusion of power within the government, to the extent that the individual parts of the government negotiating the conditionality agreement may well lack the *authority* to implement the agreement.

14.2.1 The Debt Overhang and the Weakness of Conditionality

What must also be appreciated is the fact that the current *overhang of external debt to private creditors* can greatly hinder the effectiveness of IMF conditionality, at least under the prevailing design of IMF programs. Virtually all IMF programs to date have been designed under the assumption that the debtor country *can and will* service its external debts in the long run on a normal market basis. The programs are constructed under the maintained assumption of such normal debt servicing. (For example, in the technical calculations in Fund programs, interest rates on the existing debt are assumed to be at market rates; the country is assumed to clear all arrears on a reasonable timetable, etc.)

Contrary to this assumption, however, it might easily be the case that a country is better off defaulting on a portion of its debts than it would be with timely debt servicing, if such is possible (a dozen or more countries have indeed taken such unilateral action by 1987). There may simply exist no IMF high-conditionality program based on full debt servicing, that if followed, actually makes the country better off than it would be without the program but with a partial suspension of debt payments. In other words, the IMF program might simply be too tight relative to the available options of the debtor governments.

In such circumstances, four things could happen. The best outcome, I will suggest below, would be for the IMF to design a program that is actually based on partial and explicit debt relief. So far, the IMF has avoided this rather obvious approach, partly because it has underestimated the possible efficiency gains for all parties (creditor, debtors, and the Fund) that might result. The second possibility is that the IMF and the debtor government would fail to sign a program, and the country would simply suspend payments on part of its private sector debts. This has been the case with Peru during 1985–87, and Brazil in 1987. The third possibility, and indeed the typical case in recent years, is that the Fund and the country would sign a program based on full debt servicing, even though both parties *fully expect* that the agreement will breakdown in due course. Either the conditionality would be allowed to fall by the wayside and the country would continue to borrow from the Fund but without living up to earlier commitments, or the IMF program would eventually be suspended.

A fourth possibility that deserves important consideration, would be for the IMF and World Bank to approve programs with debtor countries that allow for a buildup of arrears (i.e., nonpayments) to the commercial bank creditors, in well-defined circumstances. These circumstances would include (1) a large overhang of debt that is deemed to be highly

inimical to the stabilization efforts of the country; and (2) the unwillingness of the commercial creditors either to grant relief or significant new financing. By allowing for the buildup of arrears to private creditors, the IMF could design more realistic programs without the need to press the private creditors for specific amounts of debt relief. The debt relief would instead emerge in the bilateral bargaining of the debtor and the creditors.

14.3 The Recent Experience with Conditionality

Multicountry analyses of IMF conditionality generally arrive at a fairly pessimistic assessment of IMF loan practices. In particular, the evidence suggests that IMF programs are very frequently, if not typically, unsuccessful in restoring stability and growth in countries beset with balance of payments and inflation problems. As an example, in a review of Fund programs supported by standby arrangements in upper-credit tranches during 1969–78, Beveridge and Kelley (1980) found that fiscal targets were achieved in about half the cases, but "[b]y 1977 and 1978, expenditures were contained as planned in less than 20 percent of the programs, compared with over 50 percent in 1969 and 1970" (p. 213). Also, Beveridge and Kelley found that governments were not generally successful in meeting targets with respect to the composition of expenditure between current and capital outlays.

Stephan Haggard's (1985) recent review of IMF programs under the Extended Fund Facility (EFF) is no more heartening. According to Haggard's count, "of the thirty adjustment programs launched under the auspices of the Extended Fund Facility, twenty-four were renegotiated, or had payments interrupted, or were quietly allowed to lapse. Of these twenty-four, sixteen were formally cancelled by the IMF, virtually all for noncompliance" (pp. 505–6).

Haggard's bleak conclusions are echoed in a recent study by Remmer (1986) of IMF programs during 1954–84. It is worth quoting Remmer at length on the question of IMF conditionality:

> Unsuccessful implementation of IMF recipes has been the norm in Latin America, not the exception. A high proportion of standby programs have failed to push key indicators of government finance and domestic credit even in the right direction. Moreover, examining IMF standby programs on a before and after basis shows that changes in key indicators are more readily attributable to chance than to the operation of IMF stabilization programs. The obvious conclusion is that the economic, social, and political impact of IMF programs has been overstated. To describe the IMF as a "poverty broker," as does the title of a recent book, or to charge the Fund with undermining democracy is to engage in hyperbole. The power of the IMF remains

a useful myth for governments seeking a scapegoat to explain difficult economic conditions associated with severe balance of payments disequilibria, but the ability of the IMF to impose programs from the outside is distinctly limited (p. 21).

14.4 External Debt and Conditionality

The theme of this section is that high external indebtedness can reduce the incentives for a country to undertake necessary macroeconomic adjustments, and thus further reduce the chance that the terms of a conditionality agreement will be fulfilled. Indeed, for very high levels of indebtedness, it may be useful for creditors to forgive some of the debt as an incentive for better performance, recognizing that such an incentive could actually *raise* the repayments to creditors in the long run.

There are really two linkages between a debt overhang and the effectiveness of conditionality, one obvious and the other a bit more subtle. The obvious linkage has already been made: In the absence of debt relief, a country may have no incentive to honor a conditionality agreement, and to carry through on an economic reform program. The foreign debt acts like a tax on adjustment. The debt relief removes the tax, and encourages the country to undertake efficient reforms.

The second linkage occurs when debt relief is a *necessary but not sufficient* condition for inducing the country to undertake needed reforms. It may be, for example, that a prerequisite of new investment spending requires *both* new external financing and debt relief, and the external financing itself requires conditionality, since the creditors understand that the country would prefer to borrow abroad and then not undertake the investment.

14.5 Some Implications for the Pace and Phasing of Adjustment Programs

The postwar history of stabilization, liberalization, and conditionality can make a pessimist of the most tenacious optimist. Few stabilization and liberalization plans meet their initial objectives, and many fail miserably. We have seen that conditionality is inherently limited in its capacity to effect adjustment in the debtor countries, and that the limitations are even more severe in the presence of a debt overhang. In many cases, debt relief might have to be combined with conditionality to improve the likelihood of success of IMF and World Bank programs.

Given these limitations, it is important to make the objectives of conditionality consistent with the limited efficacy of conditionality.

Programs of the IMF and World Bank should be tailored according to a realistic assessment of the possible accomplishments. One of the most important issues in this regard is the balancing of the demands of stabilization with those of longer-term structural reform. Since the major debtor countries suffer from acute macroeconomic disequilibria (with inflation rates in Argentina, Brazil, and Mexico well exceeding 100 percent per year in 1987), a crucial issue is the balancing of macroeconomic stabilization with other types of structural reform.

The main theme of this section is that structural reform (especially a shift towards greater outward orientation and trade liberalization) is a very difficult process that takes many years to bring to fruition. The process is so difficult economically and politically that it is likely to fail under the best of macroeconomic circumstances, and is in general greatly jeopardized by a concurrent macroeconomic stabilization crisis. The historical record suggests that stabilization should be given temporal priority in the design of adjustment programs, with structural reforms proceeding gradually and mostly *after* macroeconomic balance has been restored.

The historical record (e.g., as contained in the important studies of Krueger 1978 and Bhagwati 1978) suggests that most attempts at liberalization fail. Moreover, a high inflation rate seems to be a serious hindrance in successful liberalization, since in most cases in which liberalization was attempted with an inflation rate above 30 percent, the experiment failed. There are several reasons for this adverse linkage, including the fact that fear of accelerating inflation may induce governments to undertake inadequate devaluations at the start of a liberalization exercise, and then to fail to keep the exchange rate adjusting downward in correction for a domestic inflation rate in excess of the world rate.

Other research, by Killick et al. (1984) and Ching-yuan Lin (1985), agree with the proposition that the simultaneous application of stabilization and widespread liberalization is unlikely to be sustainable and successful. Killick notes that a degree of liberalization was sought alongside stabilization in at least 8 of 23 standby arrangements in 1978–79, with meagre results. He concludes, "It does not seem that the means available to, or employed by, the Fund are strong enough to achieve its liberalisation objective in more than rare cases" (p. 238). Lin has made a persuasive case, this time based on a comparative economic history of East Asia and Latin America, that a reduction in inflation should take precedence over all other targets, including liberalization, when inflation rates are high and prone to rise. In a detailed comparison of the stabilization experiences of Latin American and East Asian countries, Lin argues that the success of the Asian cases was built on a reduction of inflation that preceeded the liberalization attempts by 5 years or more:

> In both Chile and Argentina, the control of hyperinflation and the liberalization of the economy occurred at the same time [in the mid-1970s]. This greatly compounded the difficulties of the domestic industries by forcing them to cope with both the depressive effects of the stabilization policies and the increased competition of foreign producers at the same time. This contrasts sharply with the situation in Taiwan and South Korea, where the control of hyperinflation preceded intensive trade policy reforms by several years (chap. 4, p. 8).

Lin also points out at some length that inflation control was supported by a worsening rather than an improvement of the trade balance, since foreign funds were used to support the governments of Taiwan and Korea after the resort to money creation was brought under control:

> In all of the cases mentioned, the eventual contraction of the inflationary process required the restoration of political stability and productive capacity, with the injection of massive foreign aid and the restriction of deficit financing by the central bank playing important roles (ibid.).

14.6 Conclusions: Toward an Improved Use of Conditionality

We have noted that the efficacy of conditionality is inherently limited, and that the current overhang of debt greatly complicates the situation. In cases of extreme indebtedness, the debt itself might set up incentives that are adverse to significant adjustment or liberalization. In such a case, partial debt forgiveness can actually raise the expected repayments to the creditors, while at the same time giving greater incentive to the country for favorable adjustment. To be most successful, debt relief should almost surely be combined with IMF–World Bank conditionality, to enhance the likelihood that the debt relief actually turns into economic reform.

The historical experiences with liberalization alone, and with stabilization alone, are not very encouraging. The difficulties of combining the two policy initiatives are formidable. The historical record suggests that it is virtually impossible to bring inflation under control, while simultaneously trying to liberalize the economy. One is hard pressed to fund an example of an economy which stabilized, liberalized, and improved the external position all at the same time. Only South Korea, Brazil, and Indonesia seem to provide examples of implementing the first two measures, and in those cases the programs were supported by a strong military government that substantially reduced real wages (at least in Brazil and South Korea) at the outset of the programs, and by favorable world conditions, including growing world trade, and after a few years, access to foreign borrowing in significant amounts.

These findings suggest the following list of guidelines for improving the use of conditionality in future lending by the IMF and the World Bank. Most important, the IMF and World Bank should recognize the limited efficacy of conditionality, and act accordingly:

1. Approve fewer programs.
2. Require more prior actions in cases where the efficacy of the conditionality is doubtful.
3. Encourage governments to enlist the necessary range of political support behind the terms of a high-conditionality program before the program is made final.
4. Approve programs which allow a buildup of arrears to private creditors in cases where the private creditors (a) fail to grant debt relief and (b) fail to provide sufficient amounts of new financing.
5. Encourage the use of debt relief schemes as a way to enhance the likely adherence to conditionality terms.
6. Narrow the goals of conditionality: Make macroeconomic stabilization the preeminent aim, with structural reform to be implemented only as macroeconomic stability is restored.

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