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17 Resolving the International Debt Crisis

Stanley Fischer

17.1 Introduction

Since it was first recognized in August 1982, the international debt crisis has dominated economic policymaking in the developing countries, economic relations between the debtor and creditor countries, the attention of the multilateral institutions in their dealings with the debtor nations, and private-sector decisions on lending to the developing countries.

The economic difficulties of the debtors since 1982 are summarized by two facts: Per capita incomes in the Baker fifteen of heavily indebted countries fell on average 10 percent over the period 1981 to 1984 and have risen very little since; and domestic investment has fallen by an extraordinary 5 percent of GNP, significantly impairing growth prospects.

The most remarkable feature of the debt strategy followed since 1982 is that the heavily indebted developing countries have been transferring real resources of close to 5 percent of their income to the developed creditor countries. A solution of the debt crisis will either reverse the direction of this resource flow or at least significantly reduce it. Despite the virtual cessation of capital inflows, debt burden indicators, such as the debt-to-export ratio, have not improved. The picture for the debtors is not entirely bleak. Real interest rates fell between 1982 and 1987, though they appear late in 1987 to be rising again. Net exports showed extraordinary growth. Budget deficits have been reduced despite falling incomes. In 1987 commodity prices have begun to recover. The period has seen a shift toward rather than away from democracy.

Stanley Fischer is Chief Economist at the World Bank, a professor of economics at the Massachusetts Institute of Technology and a research associate of the NBER.

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There has also been very real progress for the creditor banks and for the international financial system. Most important, neither the commercial nor central banks have had to deal with large-scale debt defaults. Balance sheets of creditor banks have been strengthened. There is an active secondary market in developing country debt, and debt-to-equity swaps are a reality.

But the fact remains that five years after it began, the debt crisis is very much alive. None of the major Latin American countries has restored normal access to the international capital markets. Even a country like Colombia, which has rigorously met its payments, finds it difficult to roll over its debts. At least one major debtor has been in trouble each year. In 1987 it is Brazil, whose moratorium could mark the beginning of a new phase of the crisis.

In its brief life the international debt crisis has generated an impressive variety of proposed initiatives and solutions.[1] Least radical are proposals for procedural reform and changes in the nature of the claims on the existing debt. There have been several suggestions for the creation of a facility, or new institution that would in specified ways deal with the overhang of existing debt. And finally, there are proposals for debt relief. I take up these possibilities in turn in sections 17.3 through 17.5.

17.2 Preliminaries

The debt crisis involves at least three parties: the debtor countries, the creditor countries, and the private banks and their stockholders. A more sophisticated view further distinguishes between the governments of debtor and creditor countries and their citizens, between workers in the debtor countries and portfolio holders who succeeded in moving their capital abroad, and between financial and manufacturing interests in the developed countries.

Although the point is rarely explicitly recognized, alternative solutions to the debt crisis imply different burdens for different groups involved in the crisis. Up to 1987, most of the burden has been borne by wage earners in the debtor countries. Part has been borne by bank stockholders, who have seen the value of their shares rise less rapidly than the stock market as a whole. Some will be borne by the taxpayers of the creditor countries, as the banks record portfolio losses, lower profits, and lower taxes.

Before describing and evaluating plans to solve the debt problem, I make several stipulations about the nature of the problem and its solution.

1. The debt crisis will have to be resolved in a way that differentiates among countries. Bolivia's problem is different from Brazil's, and both are different from Tanzania's.

2. From the viewpoint of the stability of the U.S. banking system, the debt problem is dominated by just a few countries. The concentration on the Baker fifteen with its heavily Latin American flavor is a result of those countries' debts being predominantly to the private sector.
3. Concentration on the Baker fifteen overlooks the debt and growth problems of sub-Saharan Africa, which will have to be taken into account in any discussion of aid.
4. Just as the debt problem arrived unexpectedly as a result of changes in the international economy, it could quietly go away. Higher prices for commodity exports, and further reductions in real interest rates, would make the entire problem look manageable. It could also intensify quickly if the international trading system seizes up as a result of growing protectionism or a worldwide recession.
5. The interested parties, the banks and the debtors, each have little interest in revealing the dimensions of whatever compromises they might ultimately be willing to make.
6. Finally, there are important political constraints on solutions to the debt problem. There is no well-defined economic sense in which a Brazil, Mexico, or Argentina is incapable of servicing and ultimately paying off its debt.[2] However the new democratic governments in several of the heavily indebted countries are certainly too weak to achieve massive reductions in consumption. The question for both their own governments and the creditor governments is how far it is possible and politically wise to push their citizens to meet debt payments.

17.3 Procedural Reform and New Debt Instruments

Some debt plans would leave the present value of claims on the debtors unchanged while changing their form. Others would reduce the present value of claims on the debtors. In this section I take up both procedural and regulatory reforms, and suggestions for new debt instruments. In neither case are the changes designed to reduce the value of claims on the debtors.

17.3.1 Procedural Reform

Several procedural reforms are listed in table 17.1. There has already been progress in the implementation of a number of these reforms, including the first, for instance in multiyear reschedulings for Argentina, Mexico, and the Philippines. Because macroeconomic management skills are in short supply, reduction of the frequency of negotiations would help improve the overall quality of macroeconomic management in the debtor countries. The creditor banks can retain some of the

Table 17.1 Procedural Reforms

Change	Initiating Agency
1. Multiyear rescheduling	Banks and debtors
2. Reduced size of banking syndicates and exit option for small banks	Banks and debtors
3. Change accounting rules to allow partial writedowns and their gradual amortization	Bank examiners and accounting standards
4. U.S. information provision on foreign accounts	Bank regulators and IRS
5. U.S. taxation of foreign accounts	Congress

control afforded by frequent renegotiation by using IMF Article IV consultations as a framework for monitoring and conditionality.

The size of the banking syndicates involved in the debt negotiations are obstacles both to efficient negotiation and to the rapid mobilization of capital after an agreement has been reached. The desire of many of the small banks to leave the international debt business is well known. The exit vehicle may be either the interbank secondary markets or, as intended in the 1987 Argentine restructuring, exit bond issues.

Two aspects of the accounting and tax treatment of sales of debt at less than face value have to be distinguished. First, it is sometimes stated that a bank selling part of its claims on a given country for less than book value has to write down its remaining claims. However, some bankers believe that is not necessary, provided a good case can be made that the bank is likely to collect on the remaining debt.[3] Certainly the creation of loss reserves against developing country debt has *not* forced the banks to carry the corresponding debt on their balance sheets at its market value.

Second, any bank taking a loss in a given period has to record that as a loss in current revenue and cannot amortize it over time. If banks are convinced that amortization is preferable to a larger one-time loss, even though there is no good economic reason they should be, they could be allowed to write off the losses over a period of several years rather than immediately.

Although some capital flight can be regarded as a natural attempt by portfolio-holders in developing countries to diversify internationally, much of it is a form of tax evasion. Procedural reforms 4 and 5 would help the debtors deal with the tax-evasion aspects of capital flight. U.S. and foreign developed country banks that hold the accounts of citizens of other countries could be required to inform the tax authorities of those countries of the existence of the accounts.

Developed countries could instead impose a uniform tax on all interest on bank accounts, and indeed on other income generated from securities holdings, that are not those of their own taxpayers. This would reduce the attraction of capital flight. An alternative would be for the taxes to be imposed by the country from which the capital fled, for which purpose the provision of better information about foreign-held bank accounts would assist the tax authorities in the debtor countries. To be effective, all these changes would require international agreement.

17.3.2 Changing the Nature of Claims

A driving force behind proposals to change the nature of claims on the debtors is the conclusion that the structure of the debt in 1982 was partly responsible for the debt crisis. With a high proportion of all payment flows linked to short-term interest rates abroad, the debtors were vulnerable to a rise in real interest rates in the developed countries, and had no protection against changes in the terms of trade. The suggestions are probably motivated also by the view that eventually the structure of debtor country liabilities should correspond more closely to the structure of underlying assets, with more long-term fixed interest debt, more equity, more direct investment, and less floating rate debt.[4]

Table 17.2 describes the proposals for changes in the form of claims on the debtors. In this summary, I focus on the more important proposals listed in the table.

Secondary and Insurance Markets

Secondary markets have already developed to some extent. They do little to solve the debt crisis other than to enable the banks—if they were to sell their claims—to reduce their vulnerability to default in particular countries. The secondary markets could eventually become the locus in which an international facility deals with the debt. And, if the market became deeper, prices in them could serve as the basis for debt renegotiation.

Private insurance of the debt is not in principle different from the provision of a secondary market, except that it would enable banks tied into the debt to reduce their vulnerability to default. Insurance rates could be deduced from the discounts on debt in the secondary market, and would be extremely high for many countries. It is therefore difficult to see private insurance markets becoming large or significant.

There have also been proposals for public sector provision of insurance or guarantees, perhaps through an agency associated with the World Bank.[5] Such an agency could help mobilize new private capital, perhaps at lower cost than through private insurance because the World Bank and other multilateral agencies have developed expertise

Table 17.2 Changing the Nature of Claims

Change	Initiating Agency
1. Development of secondary and insurance markets	Creditor financial institutions and official institutions
2. Indexed loans	Debtors and banks
3. Contingent lending obligations	Debtors, banks, and offical lenders
4. Longer debt maturities	Debtors and banks
5. Debt-equity swaps	Debtors and banks
6. Servicing of debt in local currency	Debtors and banks
7. Return of flight capital	Creditor and debtor governments, and banks
8. Country funds	Debtors and creditor financial intermediaries
9. Debt subordination	Debtors, existing and new lenders
10. Interest capitalization	Debtors and banks, plus creditor governments

in evaluating loans to developing countries. The agency need not necessarily subsidize insurance rates. To prevent the moral hazard problem of inadequate monitoring of loans by lenders that contributed to the creation of the current debt crisis, the agency would probably insist on significant co-insurance by the lenders.

Indexed Loans

Any loan that ties payments from debtors to creditors to some objective criterion is an indexed loan. Payments may be fixed in real rather than nominal terms, or may be specified as some percentage of GNP. Exchange participation notes suggested by Bailey (1983) tie payments to export earnings.[6] In well-operating markets such claims could be priced and traded, and there is no difficulty in principle in envisaging their introduction.

Direct swaps of debt for claims on commodities which the recipient exports are another form of indexed instrument. By tying the payoff of loans to a specific amount of the country's production, such agreements reduce the transfer problem.

Debt-Equity Swaps

Debt-equity swaps are the central element of most market-oriented debt restructurings, and they have also been implemented, for example in Mexico, Chile, and Argentina. The essential transaction is simply that a debt claim on a country is swapped by that country's central bank for local currency claims that should be invested in local firms.

The greatest attraction for the creditors is that debt-equity swaps often carry an implicit subsidy of the equity investment. Swaps may involve the purchase of debt in the secondary market at a discount, and redemption at face value. However there is no reason, if the debtors decide to subsidize, that they need to do so on the basis of the New York price. Another approach has been used by Chile, which auctions off the right to exchange dollar debt for peso assets.

Obviously, debt-equity swaps replace interest payments by dividend payments, and are not a source of new money for the debtor country. In addition, they may merely be subsidies for investment flows that would have taken place anyway, and they may lead to round-tripping.

None of these problems rules out debt-equity swaps as a useful supplement to handling the debt crisis. The present value of the dividend outflow is probably similar to the expected present value of interest outflows on the debt, but it does reduce the probability of debt default and does provide a payment stream that better matches the country's economic performance.

Local Currency Servicing

Closely related to the notion of debt-equity swaps is the proposal from debtors that they be permitted to service their debt in local currency, with automatic reinvestment of the proceeds in the domestic economy. Part of the servicing might be made available to the government; the remainder would be relent to the private sector, in forms chosen by the creditors.

This proposal has the benefit for the debtors of reducing the need to generate foreign currency to service the debt, though it does not reduce the need to mobilize resources to service the debt. It has the advantage for creditors that their debt is serviced in full, but the disadvantage that they would be constrained from reducing their total exposure in any given country. In addition, it establishes a simple formula by which all existing creditors provide continuing finance for a country.

Flight Capital

It would be difficult to place flight capital as the centerpiece of any debt strategy. If it would come back for reasonable interest rates and small subsidization of debt-equity deals, it would not need any special attention. It is quite likely though that especially high rates of return would be needed, because the owners of flight capital would fear the imposition of ex post sanctions of some type.

Interest Capitalization

The last item in table 17.2, interest capitalization, could change resource transfers to the debtors quite radically and rapidly. Capitalization

simply limits the amount of interest that has to be paid in any one year, perhaps to a given nominal interest rate on the debt, or to a given percentage of GNP, a given percentage of export earnings, or by some formula related to commodity prices. The remainder is capitalized and automatically added to the debt, to be paid off over a specified horizon.

The obvious fear from the viewpoint of the creditors is that the amounts capitalized will grow too fast for the country ever to be able to pay all the interest without further capitalization. Whether that is a realistic fear depends entirely on the prospects of the country and the exact formula used for capitalization. But if every reasonable capitalization formula results in debt instability, then there is no chance that current claims on the country can be collected in full.

Interest capitalization has received more support in Europe than in the United States. U.S. regulators would have to change rules if capitalization were to become a practical option.

Most of the proposals discussed in this section are for changes in the form of the debt that—except to some extent in the discussion of debt-equity swaps—do not reduce the present value of debtor country obligations. Alternative proposals typically include elements of debt relief.

17.4 New Institutions

The overhang of the existing debt is the main obstacle to a renewal of resource inflows to the heavily indebted developing countries. Very early in the debt crisis both Kenen (1983) and Rohatyn (1983) proposed the formation of an international institution to buy debt at a price below the face value and provide relief to the debtor countries. The proposal has been developed by Weinert (1986–87) among others.

Kenen's 1983 proposal was for the governments of the creditor nations to set up an International Debt Discount Corporation (IDDC) to which they would contribute capital. The IDDC would issue long-term bonds to the banks in exchange for their developing country debts, at a discount on face value. If the IDDC misjudged and was unable to collect, the creditor governments would bear the losses.

The plan is elegantly simple in replacing developing country debt in banks' balance sheets with the liabilities of the IDDC, in effect requiring the banks to lend to the IDDC. The key questions about each such plan are how large a write-down the banks take, whether they would be willing, or could be made willing, to do so, and how much relief is provided to the debtors.

Any IDDC-type scheme creates a free-rider problem. If the IDDC buys up much of the developing country debt and makes some form

of debt relief possible, then the credit standing of the debtors improves. Those creditors who stayed out of the IDDC agreement have a capital gain. For that reason an IDDC would have to find some means of ensuring almost complete participation by the creditors.

The IDDC notion is at the least interesting; if it could be carried off with relatively small injections of public money it would also be important. If there is to be an overall solution to the debt problem it will almost certainly involve an IDDC-type institution. But since the procedures it set up for pricing debt will determine the burdens borne by both banks and debtors, and the possible extent of creditor nation government support, its operating rules and management are bound to be the subject of protracted negotiations. It might be possible in such a negotiation to separate technical discussions on the terms and methods of buying debt from aid discussions that determine the concessions that are given to each country.

17.5 Debt Relief

The case for debt relief is that debtor countries will be unable to grow unless they can increase imports, that no solution currently in sight permits them to do that without reducing income levels to politically unacceptable levels, and that ultimately they will in any case not pay most of their debts.

The case against debt relief is that of precedent, and the view that contracts that were voluntarily entered into should not be abrogated. The question of the precedent that would be set by giving debt relief is not simple: Debt contracts involve both creditors and debtors, and the use of political authority to enforce the debts sets a precedent for creditors, whose incentives to exercise appropriate caution in lending are reduced.

Relief can come through direct negotiations between the creditor banks and each debtor country, or with the intervention of the international institutions and/or creditor governments. Or it may be imposed unilaterally by some of the debtor governments, either in the form of a moratorium which does not repudiate the debt, or in the form of unilateral action that leaves them to deal with the legal consequences of their actions. Or it could come in some combination of the above.

It might be possible for the major debtors to settle their own debt problems in direct negotiations. So long as the creditor countries permitted these negotiations to proceed without interference, and at critical stages were willing to help—for instance by changing banking regulations—agreement is quite possible. The agreement would likely be conditional on the country's economic policies, and could involve the international institutions in monitoring roles.

17.6 Scenarios

Three basic scenarios present themselves. The first is an evolution of the muddling through strategy that has been followed to date. Its benefits and costs were described in the introduction.

The second scenario would see a series of direct agreements between each debtor and its creditors, involving relief and substantial lengthening of the debt. The negotiations for such agreements would be protracted and possibly crisis-laden, and would likely involve the international institutions in monitoring roles.

The third possibility is the setting up of a large international organization, the IDDC, to attempt to dispose of the debt problem. This too has the benefits of settling the crisis and enabling economic management teams to concentrate on policies for growth. It would also provide a longer-term solution for the banks.

Of course, the scenarios are not mutually exclusive. The second and third possibilities could be combined, with the debt crisis eventually being resolved through a mixture of direct agreements between creditors and debtors with extra relief being provided for the most impoverished countries though an IDDC or the existing international institutions. Elements of the first scenario would be seen in the evolution of international lending in the direction of more equity-like claims.

In all cases the solutions would involve agreed-upon policy reforms in the debtor countries to attempt to ensure that the debt problem does not soon recur.

Notes

1. Dornbusch (1987), Feldstein et al. (1987), and Krugman (1986) present useful surveys of alternative solutions; the classification of debt initiatives used here is taken from Krugman.
2. See Feldstein (1986) for a detailed scenario.
3. This was the position taken by a panel of the American Institute of CPA's in 1985 (see "The Outlook" column, *Wall Street Journal,* 26 October 1986).
4. Lessard and Williamson (1985) provide a very useful review of alternative proposals for changing the form of finance of the debtor countries. See also World Bank (1985) and IMF (1986).
5. National export credit agencies perform some of the same functions. The World Bank has provided some investment guarantees in the co-financing of projects with commercial lenders.
6. Lessard and Williamson (1985) analyze this and related proposals which they call "quasi-equity" investments.

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