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11 LDC Debt Policy

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1. Paul Krugman

U.S. Policy on Developing-Country Debt

U.S. policy on Third World debt was a major anomaly in the first Reagan administration. On taking office, that administration was strongly committed to the ideal of laissez-faire economic policies, suspicious of international economic coordination, and opposed to new forms of government intervention. Those administration officials who had strong views on the role of multilateral financial institutions such as the International Monetary Fund (IMF) and the World Bank—for example, Treasury Undersecretary Beryl Sprinkel—were sharply critical, arguing that, by providing an implicit safety net for both borrowing nations and lenders, these institutions encouraged irresponsible behavior. Initial administration policy called for limiting the resources and the role of both institutions and for a greater reliance on self-policing in international capital markets.

Yet, less than two years after taking office, the Reagan administration found itself at the center of an unprecedented piece of international financial coordination. This effort involved discreet but unmistakable coercion of private creditors, a key role for the previously scorned multilateral agencies, growing commitment of public resources, and eventually a de facto alliance between the U.S. government and some debtors to pressure banks into relinquishing their contractual rights. It is instructive to imagine how an administration economic official in 1981 would have viewed the Mexican debt reduction package of 1989, which in effect expropriated a large fraction of commercial bank claims, with partial compensation provided from official sources, that is, ultimately by creditor nation taxpayers. (Most estimates suggest that the banks did not lose and may have gained as a result, but that is not the issue.)

The question is how this policy emerged. How did a U.S. government that was ideologically committed to a hands-off financial policy, uninterested in international coordination, and convinced of the sanctity of property rights find itself leading a highly interventionist international effort that eventually came to center on debt forgiveness?

This paper examines the evolution of U.S. debt policy from the initial crisis through the 1989 Mexican plan, in an attempt to shed light on how and why policy decisions were made. It is important to emphasize that this paper is *not* primarily intended as an evaluation of the appropriateness or success of the policies followed: it will be evident that I have my own views about developing-country debt, but the main question here is why we did what we did, not what we should have done instead.

The paper is in three main sections. The first provides a brief history of debt policy, highlighting several crucial turning points. The second discusses conceptual issues in debt policy, reviewing the options that faced the U.S. government. The third is concerned with the actual process of policy-making. A brief final section asks whether the evident defects in the process of policy formation actually did much harm.

11.1 A Brief History of Debt Policy

Table 11.1 presents a selective chronology of the debt problem. Some of the events singled out are familiar turning points; others are singled out because, in retrospect, they can be seen as indicators of future trends. The chronology also mixes real-world events with statements and reports. Obviously, such events as the publication of Cline's (1983) study on debt prospects were not as

Table 11.1 **A Debt Chronology**

1982	August	Mexican weekend: onset of crisis
	November	Mexico reaches IMF agreement
1983	February	Rohatyn plan for debt reduction
	March	Cline study of debt prospects
	December	Alfonsin takes office in Argentina
1985	October	"Baker Plan" unveiled at Seoul
1986	June	Bradley Plan for debt reduction
1987	February	Brazilian debt moratorium
	May	Citibank reserves against LDC debt
	December	Mexico attempts to reduce debt via bond swap
1988	June	U.S. agrees to allow African debt reduction
1989	February	Riots in Venezuela
	March	Brady Plan
	September	Mexican debt reduction package

important as, say, the Brazilian debt moratorium (practical men are the slaves of defunct economists, not live and kicking ones), but the statements are useful indicators of the drift in ideas.

What the chronology alone cannot convey is a sense of the dynamics of the problem. Any partition of events is arbitrary, but I will identify five stages in policy:

1. A "firefighting" stage from August 1982 through most of that fall, as desperate efforts were made to mobilize enough financial resources to prevent a feared financial crisis:
2. A relatively calm period in 1983 and 1984 during which problem debtors were widely viewed as being on the road to recovery, under programs that had as their centerpiece "concerted lending" by private creditors;
3. As the concerted lending strategy came under widespread attack in 1985, a rethinking of that strategy that culminated in the Baker Plan—in essence, a reaffirmation of the concerted lending strategy's basic thrust, but with an increased role for official lending;
4. The "menu approach" period, a period from 1986 through 1988 in which there was widespread optimism that new financial techniques could substantially reduce debt burdens; and
5. The official U.S. acceptance of the idea of coordinated debt reduction in the so-called Brady Plan and a first effort at implementing that plan in Mexico.

Let us review these different stages.

11.1.1 Firefighting

Although it arguably should not have, the Mexican payments crisis of August 1982 took the U.S. government completely by surprise. Federal Reserve staffers had prepared a report in April warning of potential debt-service difficulties, but this report did not receive high-level attention. The U.S. government should not be especially faulted for this, however, since few outside the government saw the crisis coming either. The rapid spread of the crisis to other debtor countries, most importantly Brazil, also came as a surprise.

Ex ante, one might have expected some agonizing over appropriate government policy. Mexico and the other debtors who soon found themselves in difficulty primarily owed their money to private creditors. Thus, one might have supposed that a free market–oriented administration would treat the matter as a private affair, especially given statements by such officials as Undersecretary Sprinkel in opposition to the international rescue role of the IMF. Indeed, such was the inertia of policy positions that, at the Toronto IMF–World Bank meetings in September 1982, *after* the Mexican crisis broke, the United States was at odds with all other major nations in its opposition to any large increase in the IMF's resources.

In fact, however, with very little hesitation, the United States plunged into the provision of cash to Mexico. Substantial administrative creativity was displayed in releasing cash; most notably, an advance purchase by the Strategic Petroleum Reserve was used to funnel funds to Mexico via its state-owned oil company. The Mexican example then served as a model for Brazil, Venezuela, and other countries as they developed similar debt-servicing problems. Any and all financial resources to hand—swap lines, General Agreement to Borrow, Bank for International Settlements (BIS) loans—were pressed into service to avert an immediate default.

In retrospect, this emergency financing played the role of a bridge to the more organized process of rescheduling plus concerted lending. We should not, however, abuse hindsight in interpreting the policy at the time. As of the early fall of 1982, emergency lending was *not* viewed as a temporary measure leading to a prolonged process of workout. Instead, the situation was viewed as both more dangerous and less fundamental—more of a bank run than a basic problem of excessive debt. The U.S. economy was in a deepening recession at the time of the crisis, and there were widespread fears that Third World debt could trigger a 1931-style financial collapse. At the same time, it was generally expected that, if such a collapse were avoided, the crisis would blow over quickly: Treasury and Federal Reserve officials expected to see normal market access restored within months if not weeks.

By late fall 1982, this perspective had changed in both respects. An immediate financial crisis had been averted, and the growing signs of a rapid U.S. recovery were making officials breathe easier. On the other hand, the magnitude of the debt-servicing problem became increasingly apparent, and the short-term emergency mentality shifted to a medium-term perspective.

11.1.2 Concerted Lending

The Mexican debt agreement of November 1982, and the similar agreement reached by Brazil in February 1983, set the basic pattern of debt policy for the next several years.

The basic premise of this policy was that the problem of debtors was one of liquidity, not solvency. That is, while the debtors could not maintain normal debt service given their inability to attract new funds from international capital markets, they would eventually be able to grow out of their problems given a combination of recovery in the world economy and appropriate policies at home. The main idea of the policy was therefore to buy time. If enough debt service could be postponed, countries might be able to meet their remaining obligations by adopting austerity programs under IMF surveillance. As their export revenues grew, the countries would begin to look more creditworthy, and eventually they would resume normal access to credit markets.[1]

1. Official statements during this period generally stressed the need for policy reform, not just austerity. That is, one would not simply wait for growth; one would do something actually to encourage it. In practice, however, this was little more than lip service. Optimistic estimates of growth prospects were based on historical relations between OECD growth and LDC exports, not on hopes for success of innovative growth-oriented policy, while the IMF-imposed economic plans

Table 11.2 **Long-Term Bank Credit Commitments to Developing Countries ($billion)**

	Developing Countries		Western Hemisphere	
	Spontaneous	Concerted	Spontaneous	Concerted
1983	17.6	13.9	1.9	13.3
1984	12.7	16.5	.6	15.5
1985	13.8	2.2	.2	2.2
1986	14.7	8.1	.8	7.7
1987	14.1	2.3	.4	2.3
1988	11.8	5.7	1.2	5.2
1989	12.9	2.3	1.6	1.6

Source: IMF, *International Capital Markets: Developments and Prospects* (April 1990), table A22.

The normal method of postponing debt service is, of course, rescheduling of repayment of principal. It was generally believed, however, that this would not be sufficient—that the debtor countries could not in fact run trade surpluses large enough to cover all the interest on their debt. Thus, there had to be de facto relending of interest payments. This could have been accomplished via interest capitalization, but this option was opposed for a variety of reasons, described in the appendixes at the end of this paper. Instead, a more ad hoc approach was adopted in which existing creditors were rounded up to provide new loans the proceeds of which could be used to pay interest on existing debt. This procedure was widely referred to as "involuntary" lending but was more discreetly described as "concerted" lending in official documents.

Table 11.2 shows the role of concerted lending in the debt problem from 1983 to 1989. It shows long-term credit commitments by commercial banks to developing countries in general, and to Latin American countries in particular, and separates these commitments into "spontaneous" lending (i.e., normal voluntary lending) and concerted loans. Two points stand out. First, for the Latin American nations, essentially all bank credit since 1982 has taken the form of concerted lending. Second, the major period of such lending was 1983 and 1984. It dwindled to negligible sum in 1985, and despite occasional packages—for example, the sizable package negotiated by Mexico in 1986, after the combined effects of the 1985 earthquake and oil price collapse created a desperate need for cash—concerted lending ceased to play a major role.

It is also important for discussing the eventual abandonment of the concerted lending strategy to note that concerted lending was not identical either to net financing for developing countries or to the change in bank exposure. Bank exposure grew by less than the concerted lending numbers would suggest. To

emphasized stabilization rather than growth. Realistically, U.S. policy may be summarized as, "Get the debtors to run as big a trade surplus as they can, push the banks to relend the interest the countries can't pay, and wait for better conditions."

a limited extent, this was because of a variety of leakages—for example, repayment of principal on loans not covered by rescheduling agreements and contraction of short-term credit. After 1985, there was also a significant reduction in bank claims as a result of debt buy backs, swaps, etc. Meanwhile, bank credit was supplemented by official credit and some other capital flows, such as direct investment, while offset in part by capital flight.

Timing and coverage issues make an exact comparison difficult, but the rough comparisons shown in table 11.3 may be useful. From the end of 1982 to the end of 1985, concerted lending commitments totaled about $30 billion. However, the commercial bank debt of fifteen heavily indebted countries rose by only $22 billion, and this rise was nearly offset by a fall in other private debt. From the end of 1985 to the end of 1988, concerted lending commitments totaled approximately $15 billion; the change in bank claims was *minus* $1.5 billion, largely because about $14 billion in claims was canceled through buy backs and swaps.

Official financing nonetheless covered some debt service: the fifteen heavily indebted nations were able to finance a cumulative current account deficit of $17 billion in 1983–85 and of $35 billion in 1986–88. ("Financing" through arrears played a significant role in the latter period.)

In retrospect, it is apparent that the concerted lending strategy did not really function as advertised. It was initially envisioned that the brunt of the financing burden would in fact be borne by the commercial banks, with official finance playing a secondary role. In reality, this was true only at the very beginning—perhaps only in the first year. Thereafter, bank claims on problem debtors grew very slowly in nominal terms and thus declined both in real terms and a fortiori as a share of bank assets, while official creditors bore a steadily increasing share of the risk.

This risk shifting, which accelerated over time, would eventually be a key argument for the rethinking of debt strategy that culminated in the Brady Plan. In 1983–84, however, this was far in the future.

11.1.3 The Baker Plan

There was a kind of pause in the debt problem during 1984. Essentially, this pause was due to a temporary glut of cash in debtors' hands. Debtor trade

Table 11.3 **Financing of Fifteen Debtors ($billion)**

	1983–85	1986–88
Current account	−17.0	−35.3
Change in commercial bank debt	22.2	−1.5
Change in other debt to private creditors	−18.4	−1.8
Change in debt to official creditors	37.8	50.4
Long-term borrowing from official creditors	34.7	32.1

Source: IMF, *World Economic Outlook* (May 1990), tables A39, A42, A47.

adjustment proceeded much more rapidly than had been expected: the fifteen heavily indebted nations moved from a trade surplus of $4 billion in 1982 to $43 billion in 1984 and reduced their current account deficit from $51 billion to near zero. At the same time, the commitments from early rounds of concerted lending were disbursed. The result was that major debtors found themselves with swelling foreign exchange reserves and no immediate need for new financing.

During 1985, however, pressures began to build again. The debtor countries had achieved their rapid trade improvement overwhelmingly through import compression rather than export growth, and a counterpart to the import compression was a severe slump in output. As debtor countries attempted to reflate, they found that the foreign exchange constraint was once again binding, and complaints rose about the increasingly niggardly supply of bank finance.

At the same time, the prospects for a restoration of normal capital flows to problem debtors—an event that had initially been expected to occur within a few years—appeared to recede. In spite of a rapid economic recovery in the United States and a more modest one in the rest of the world, exports of developing countries did not show strong growth. Indeed, thanks to falling commodity prices, they actually fell in 1985. Thus, the ratio of debt to exports, widely watched as an indicator of creditworthiness, worsened instead of improving.

As a result, during the first half of 1985, there was a growing sense that a departure was needed in the debt strategy. A number of plans for debt reduction as opposed to further financing were circulated outside the U.S. government, and Preston Martin, the vice-chairman of the Federal Reserve, publicly called for debt reduction in June 1985. He was, however, reprimanded by Paul Volcker.

Instead, the U.S. government chose to emphasize a revitalization of the basic debt strategy of the previous two and a half years rather than a fundamental departure. In October 1985, at the Seoul IMF–World Bank meeting, Treasury Secretary Baker announced a program intended to expand financing for a group of heavily indebted countries—the "Baker 15," now a standard subcategory in IMF analyses.

Although hailed at the time as a major new initiative, the Baker Plan was quite conservative in that it did not change the basic premises of the previous strategy. Debt problems continued to be viewed as issues of liquidity rather than solvency, even though by 1985 it was no longer possible to attribute them to recession in the OECD nations. The United States remained firmly opposed to any debt package that involved debt reduction as opposed to a postponement of obligations. Indeed, until 1988, the United States refused even to allow other official creditors to offer unilateral debt forgiveness (which several European nations wanted to offer to desperate African nations), for fear that a damaging precedent would be set.

The main innovation of the Baker Plan was its call for a shift in the sources of official lending, with the World Bank now expected to play a much larger role, shifting away from its traditional project lending. Under the initial proposal, World Bank lending would still have played a secondary role to concerted lending by private creditors: the initial plan called for $9 billion of World Bank money and $20 billion from commercial banks over the next three years. In practice, as we have already seen, the Baker Plan had the effect of accelerating the shift of risk from the commercial banks to official creditors.

It is also important to see the Baker Plan in context. It came closely on the heels of the Plaza Accord to drive down the dollar. Both actions were seen as indicating a new U.S. willingness to engage in international policy coordination; in both cases it was widely expected that the initial actions would be only a forerunner to more extensive commitments. Thus, even though the sum of money proposed in the Baker Plan was modest even in prospect, the plan did temporarily dispel the sense that the debt strategy had run aground.

11.1.4 The Menu Approach

The renewed enthusiasm for a strategy of growing out of debt that followed the Baker Plan did not last very long. Among debtors, Peru and then Brazil tried a tactic of aggressive confrontation with their creditors. In the United States, however, policy discussion was dominated for much of 1986 and 1987 by hopes that market forces could be harnessed to alleviate the debt problem.

Mexico instituted the first debt-equity swap program in 1984, and Brazil and Chile followed in 1985; by 1986, Chile's program had assumed significant proportions relative to its debt, and it grew even larger in 1987. In essence, these programs allowed creditors to cash in their claims, provided that the proceeds were invested in the debtor country and that other restrictions were met. The main attraction of such swaps was the existence of a secondary market in debt at which claims on problem debtors traded at substantial discounts from par. A potential investor could therefore make the investment at lower cost by first acquiring debt on the secondary market, then convert that debt into local currency.

Initially, debt-equity swaps were viewed with enthusiasm both by U.S. financiers and by U.S. officials. They were seen as a double advantage: both canceling a part of the debt, and thus reducing the burden, and attracting direct investment as a new source of funds. Over time, it became clear that the advantages of such swaps had been overstated; the limitations of debt-equity conversions are reviewed in the appendixes at the end of this paper. For a time, however, debt-equity swaps were seen as demonstrating the possibility of alleviating and perhaps even solving the debt problem through market mechanisms. The idea was that, by offering creditors a "menu" of debt conversion alternatives, they could be induced both to cancel a significant fraction of debt and to supply a stream of additional financing.

Chile proved unique in its willingness to pursue debt-equity conversions on a large scale relative to debt. In spite of pressure both from the financial community and occasionally from the U.S. Treasury (which at times appeared to

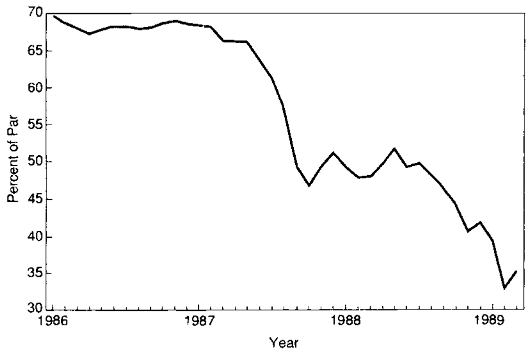

Fig. 11.1 Secondary market prices of LDC debt

view a willingness to facilitate debt-equity swaps as a key test of debtor-country virtue),[2] Mexico and other nations scaled back their programs because of budgetary issues. There remained a hope, however, that sophisticated financial engineering could still play a major helpful role. The attraction of such schemes grew in particular because of a market event: the collapse of secondary market prices.

As late as the beginning of 1987, the secondary market discounts on developing-country debt were moderate: the average discount for the heavily indebted nations (fig. 11.1) was only about 35 percent, and that for Mexico and Brazil was less. In February 1987, however, an increasingly frustrated Brazil declared a moratorium on debt service, leading to a general decline in secondary prices. In May 1987, Citibank announced that it was reserving against its developing-country claims, a move that was quickly matched by other creditors. In principle, reserving is an accounting measure that should have had little real effect, but in this case it apparently served as a signal that the debt problem was not improving, and secondary market prices crashed further, to an average of 40 percent or less of par.

Given the huge discounts on developing-country debt, it was natural to search for ways to capture that discount and pass at least part of it on to the debtor. A major effort along these lines was the Morgan-Mexico swap announced in December 1987. New bonds were issued and offered in exchange for existing debt. The new bonds were expected to sell at much lower discounts than commercial bank debt, partly because their principal was guaranteed by money placed in escrow at the U.S. Treasury, but also because Mexico attempted to convince its creditors that the new bonds would be treated as senior to the old debt. Thus, it was hoped that the debt swap would reduce overall debt.

2. The persistent faith of the U.S. Treasury in debt-equity swaps was demonstrated by press interviews given by Treasury Undersecretary David Mulford in the spring of 1989—by which time the severe difficulties of such swaps were generally understood—in which he argued that swaps could make a major contribution to the Brady Plan.

In practice, the discount on the new bonds was much higher than hoped; to a first approximation, Mexico did no better than it would have had it used the money placed in escrow to finance a straight buy back of debt for cash (see Lamdany 1988). While hopes were expressed that a second try would yield better results, in effect the disappointment with the Morgan-Mexico deal marked the end of optimism that a menu of clever financial packages could do much to resolve the debt problem (except, perhaps, at the U.S. Treasury, where the initial version of the Brady Plan seemed to presume that small official resources could be leveraged up into major debt relief).

11.1.5 The Brady Plan

By 1988, it was already clear that the Baker Plan, like the previous concerted lending strategy, was not working as advertised. With debt claims selling at 35 percent of par and debt-export ratios higher than they had been in 1982, it was no longer realistic to suppose that a return to normal market access was a reasonable target for the medium term. Any reconsideration of the strategy was, however, unwelcome for most of the year, for two reasons: the administration in general did not want publicly to abandon a widely touted policy before the election, and the secretary of the Treasury did not want to repudiate its own policy publicly. The United States was more willing than before to accept the idea of debt reduction in some circumstances. Notably, no objection was raised to the use of external resources to buy back and cancel much of Bolivia's debt, and, in September, the United States agreed that other official creditors could forgive African debt if they so desired (although the United States would not participate). However, any major change in U.S. policy was ruled out.

Following the election, however, an interagency group began serious discussion of debt strategy. According to accounts of participants, what this group found most alarming was not so much the generally disappointing results of the Baker Plan as the evident shifting of risk from private creditors to government and multilateral agencies. A chart that looked something like figure 11.2

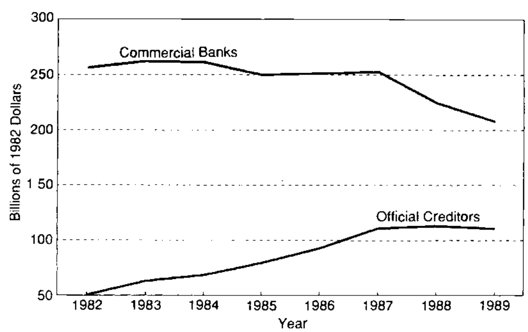

Fig. 11.2 Composition of "Baker 15" debt

was the subject of alarmed discussion. This figure shows claims on the "Baker 15" by private and public creditors, deflated by the U.S. CPI. Recall that both the initial concerted lending strategy and the Baker Plan were advertised as "bail-ins" rather than bailouts for banks; by late 1988, they were looking rather like bailouts after all.

Adding pressure for a change were serious riots in Venezuela following imposition of an austerity plan in February 1989. Although it was quickly noted that Venezuela was perhaps the least deserving of the debtor nations—more than 100 percent of its debt accumulation had been used to finance capital flight rather than investment—the riots reinforced a sense that something new had to be done.

Finally, in March 1989, the new Treasury secretary, Nicholas Brady, announced that the United States now favored a policy of debt reduction. The circumstances surrounding the Brady speech need further discussion and are revealing about the U.S. policy process; I return to these in the third section of the paper. For now, however, let us focus on the substance.

As initially presented, Brady's initiative had two somewhat contradictory features. On one side, for the first time Brady threw the support of the U.S. government behind the idea of seeking debt reduction rather than growing out of the debt problem. On the other hand, his speech emphasized the use of voluntary, market-based mechanisms to reduce debt. (Bankers were later to make a point of the fact that the word *voluntary* was used seven times in the speech).

The reason these features were somewhat contradictory was that it was difficult to envision any large-scale debt reduction within a voluntary framework. As initially presented, the Brady Plan seemed to envision the use of resources from creditor nations and multilateral institutions as sweeteners for financial engineering along the lines of the Morgan-Mexico plan. The results of that plan suggested, however, that such schemes would do little better than straight buy backs at reducing debt. A large debt reduction through buy backs, however, would be extremely expensive, even at the secondary market prices prevailing at the time of the announcement—and a buy back scheme would drive these prices up further. (Secondary prices of developing-country debt actually did rise by about a third in the two weeks following the Brady speech.)

Following Brady's speech, Treasury officials floated suggestions that a debt reduction on the order of 20 percent would be sought. Even though this seemed modest, the available resources at the World Bank plus other likely sources seemed inadequate to support voluntary debt reduction on that scale while at the same time continuing to meet debtors' financing gaps. And, if resources had been made available on the requisite scale, the benefits would have gone in large part to the creditors.

This raises some interesting questions about U.S. policy-making. Why did Brady make a proposal that was immediately seen by knowledgeable observers as infeasible? Was it simply an error, or was it a way of establishing a position for a subsequent, achievable policy? I will return to these questions below. The important point now, however, is to note the position that the Brady speech created. Essentially, the U.S. government had committed its prestige to achievement of significant debt reduction, but such debt reduction could not be achieved without either committing much larger resources or abandoning the principle that debt reduction would be voluntary.

Three alternatives thus presented themselves. The U.S. could forgo the goal of large-scale debt reduction, abandon the principle of voluntarism, or commit much larger amounts of money than Brady seemed to have envisioned. It is still too early to tell the full story, but in general the United States gave ground on all three fronts.

The reduction in the ambitions of the Brady Plan may best be seen by considering the case of Mexico, which was the first major beneficiary of the plan and arguably the country for whose benefit the plan was devised. In the end, after very intense negotiations, Mexico achieved a reduction in the present value of its debt of approximately $14 billion, or 14 percent. This was clearly insufficient to make much real difference in the Mexican situation, although it was enough to count as a political victory for the Salinas government that indirectly raised confidence. Mexico was unique in its situation, both as a model of reformist policy and as a vital interest of the United States that would receive special treatment in any case; thus, the modest size of the Mexican package implies that the Brady Plan as a whole will be even more modest.

Whether the principle of voluntarism has been abandoned is more controversial. As of the time of this writing, four debt reduction packages had been concluded subsequent to the Brady Plan—in Mexico, the Philippines, Costa Rica, and Venezuela. The Philippine plan was of minor size both relative to its debt burden and in dollar terms, while Costa Rica is of course a small nation. Thus, the two major debt reductions have been the Mexican and the Venezuelan, which essentially followed the Mexican model.

In the Mexican debt reduction, the idea of voluntary action was essentially abandoned. Mexican debt was converted into new instruments, and the agreement contained a paragraph stating that the conversion would explicitly constitute a new contract (a "novation"). This was taken to imply that the new contracts would not be subject to the sharing clauses originally contained in loan agreements and thus in effect that banks that refused to participate in the debt reduction would not be able to demand payment. So the only "voluntary" aspect of the debt reduction was the choice among several options offered to creditors: whether to receive bonds with reduced interest payments or lower face value or, alternatively, to offer new money.

As compensation for the forced debt reduction, banks were given guarantees of principal and partial guarantees on interest. Evaluating these guarantees is tricky, but most estimates suggest that the compensation per dollar of reduction in the present value of claims was well below the secondary market price of debt—perhaps 25 rather than 40 percent. At the same time, however, the debt reduction enhanced the value of remaining claims so that the market value of the debt after the reduction was little changed.

In the appendixes at the end of this paper, I argue that a Mexican-style debt reduction package, in which banks are given the choice of exiting at the initial secondary price or of providing new money, is in effect a way of ensuring that the bulk of the benefits of the commitment money from international financial institutions go to the country rather than to its creditors.

The Venezuela debt reduction was similar in form to the Mexican plan, in that a menu of options was offered; however, the terms were more generous.

The size of resources available for debt reduction is to some extent an arbitrary number. Initial estimates in the weeks following the Brady speech suggested that as little as $10 billion might be available. The current usual number suggested is $34 billion: $12 billion each from the World Bank and the IMF and another $10 billion from Japan.

So the outcome of the Brady Plan to date is two fairly modest debt reductions for large debtors—altogether the debt reduction attributable to "Brady Plan" initiatives has been perhaps 5 percent of the outstanding debt burden rather than 20 percent. The form of the major debt reductions, however, marked a fundamental change in procedure: essentially, bank claims were seized by a kind of international eminent domain rather than through a voluntary market transaction.

11.1.6 Observations

This brief history conveys two impressions. First, after the dramatic rescue operations of 1982 and 1983, the pace of events in debt policy seems remarkably slow. The failure of the concerted lending strategy to deliver significant increases in commercial bank exposure was apparent by mid-1984, yet there was no revision of the policy until October 1985, and the Baker Plan amounted to a reaffirmation rather than a change in course. Even more strikingly, the failure of the Baker Plan to yield either significant new private capital flows or any prospect of a return to creditworthiness was evident by mid-1987, with the Citibank provisioning and the collapse of secondary market prices. Yet the Brady Plan did not come until March 1989—and has moved forward at a very sluggish pace.

Second, after the 1982–83 response, U.S. policy has consistently been very cautious about departures from previous strategy—to an extent that seems to have surprised debtors and creditors alike. Thus, in 1985, there was widespread expectation of a major rethinking of debt policy; the Baker Plan was instead more of a continuation of existing policy, with only modest new resources proposed and much less actually delivered. In 1989, the Brady Plan was initially treated as a major departure in strategy, but it soon became clear that the United States was prepared neither to devote major new resources nor to back any radical demands for debt reduction on the part of the developing countries themselves.

The overall picture, then, is one of a U.S. policy on developing-country debt that has responded as little as possible, as late as possible—essentially a reactive policy. (This is not necessarily a bad thing.) Later in this paper I will try to account for this absence of initiative. First, however, it is necessary to review the options on debt policy: what the United States *might* have done.

11.2 Debt Policy Options

The theory of debt policy has been the subject of an excessive literature. This paper will not review that literature in any depth; many of the key concepts appear in the volumes edited by Sachs (1989) and by Frenkel, Dooley, and Wickham (1990). Instead, I want to focus on three key dimensions of choice in debt policy.

The first dimension of choice is that of how much to have a debt policy at all—of intervention versus laissez-faire. It was by no means necessary that the U.S. government intervene in the debt problem. Most of the debt of problem debtors was owed to private creditors, primarily commercial banks. These private creditors lent money voluntarily before 1983, charging premia over low-risk rates that reflected their own judgment of the risk entailed in such lending. Why should the U.S. government take any responsibility if these risky loans happened to go bad?

This is not as naive a question as it sounds. Before World War II, as Eichengreen and Portes (1989) have noted, the U.S. government paid little attention to defending the interests of its bondholders with claims on Third World debtors. Even in 1982–83, conservative critics of the emerging debt policy argued that, by intervening, the United States was reinforcing a moral hazard problem, in which banks would lend and/or countries borrow irresponsibly in the expectation of a bailout. Later, a different critique would arise from the left, claiming that the U.S. government's intervention had been detrimental to the interests of the debtors, deterring them from making a straightforward default.

On the other side, there are several rationales for intervention. The most widely discussed have been the following:

1. *Stability of the international financial system.* Relative to the size of the world economy, the debt problem is not especially large. The combined gross national products of the "Baker 15" amount to only about 4 percent of that of the OECD, the face value of their debt to only about 1 percent of OECD wealth, the interest on that debt to only about one-quarter of 1 percent of OECD GNP. The Third World debt problem nonetheless provoked considerable anxiety in 1982 because the debt was concentrated in the hands of large commercial banks, which are highly leveraged, so, even though the debt was small relative to the size of the OECD economy, it considerably exceeded the capital of money center banks. As a result, it was feared that the debt crisis could spiral into a collapse of the banking system. This created a perception

of urgency about government intervention that overrode what might otherwise have been caution in 1982–83.

2. *Free-rider problems.* A few months after the onset of the crisis, one began to hear from a number of quarters the argument that government action was necessary to induce creditors to act in their own interest; Cline's influential 1983 study was representative on this point. The argument ran as follows. Once a country was in trouble, it was in the interest of any individual creditor to halt lending and, indeed, to pull out as much money as possible. When all creditors tried to do this, however, they provoked a liquidity crisis that would without action have forced immediate default. Yet there was a perceived possibility that the debtor countries could return to solvency given a breathing space and that creditors as a group would be better off if they gave the country time. So there was a conflict between the interests of individual creditors and their collective interest. As a result, official arm-twisting to force creditors not just to reschedule but to increase their exposure was actually doing them a favor.

This argument also surfaced in a different form in later discussions of debt reduction, where it was argued that pure debt forgiveness might be in the collective but not the individual interest of the creditors. We return to this point below.

In either case, it is tricky to turn the free-rider argument into a case for commitment of official funds to the process, which as we have seen was the bulk of the financing after the first year or so. However, a few shaky grounds for official finance can be offered. To the extent that the United States and other governments might find themselves short of sticks with which to coerce banks into acting in their own interests, a carrot might have been necessary. Also, if coordination of creditors turns out to be difficult, official lending may be a second-best answer for protecting the value of claims that ultimately represent domestic wealth. Early analyses of the debt strategy emphasized concerted lending as the main solution to the free-rider problem, with official lending as a secondary lubricant. As we have seen, of course, this is not what happened.

3. *Other economic interests.* Aside from the financial stake in recapturing as much as possible of the value of bank claims, creditor country governments found themselves with some other economic interests, notably on the trade side. Since the trade adjustment forced by the debt crisis primarily took the form of import compression, the debt problem had a significant impact on industrial country exports. Arguably, then, this created a trade policy and/or macroeconomic interest in helping in a debt workout.

While the trade consequences of the debt problem were widely cited by reports prepared outside the government calling for more generous terms for the debtors, however, it is doubtful whether concern over these consequences played much role in actual policy. Notably, periods when debtor countries were running very large trade surpluses, as in 1984–85, and as a result did not immediately need much cash, were times of quiescence rather than urgency in U.S. debt policy.

4. *Political interests.* The last concern motivating the U.S. government in its departure from laissez-faire on debt was concern over the possible radicalizing effects of a confrontation between debtors and creditors. In particular, the United States could not ignore the possible effects of debt on Mexican politics. It was not unimportant that the crisis first broke in Mexico; it is doubtful that the U.S. response would have been as swift and decisive had, say, Brazil been the first major debtor to get into trouble. It is also no accident that the first major Brady Plan debt reduction also involved Mexico; as described below, Mexican President Salinas deliberately positioned himself so that a debt reduction package was essential to him politically and thus in such a way that the U.S. government had a compelling interest in making such a package happen.

I would argue that, in practice, U.S. policy has primarily been motivated by the first and last of these concerns: by the desire to protect financial stability and by worries over the political implications of debt. The economic case for coordination arguably *should* have been driving U.S. debt policy, and lip service was given to it as a principle; but, in practice, when either financial or political jitters were absent, U.S. debt policy tended to drift.

11.2.1 Financing versus Forgiving

Given a determination on the part of the U.S. government to do something about debt, what should it do? Should it seek to postpone debt service, giving the countries involved time to improve their situation, or should it seek to reduce the obligations of the countries permanently?

The conventional view is that it is appropriate to "finance" the debt, simply postponing debt service, if the country's problem is merely one of liquidity but that one should seek debt forgiveness if the country is insolvent. This is a useful way to ask what features of the country's situation should be examined, but it is ultimately inadequate as a way of posing the problem. The reason is that a country that was demonstrably solvent would not be illiquid: it would be able to borrow from confident creditors. Thus, a debt problem is prima facie evidence of at least a significant risk that the country is indeed insolvent.

Instead of a hard and fast distinction between liquidity and solvency, then, we should instead ask whether creditors are best served by maintaining the face value of their claims and playing for time or by reaching a settlement that reduces a country's obligations. There is by now a standard way of thinking about this issue, the "debt value curve" (illustrated in fig. 11.3).[3]

3. This curve, which I apparently first introduced (Krugman 1990), is often referred to as the "debt Laffer curve." I named it that to emphasize the theoretical possibility that reducing debt could actually increase expected repayment. It is probably better, however, to drop Laffer's name in order to deemphasize the question of whether countries are literally on the wrong side of the curve—which no major debtor can be confidently asserted to be. As it turns out, for Brady Plan issues it is more important to emphasize instead the fact that the curve may be fairly flat in the relevant range—which *is* borne out by the evidence.

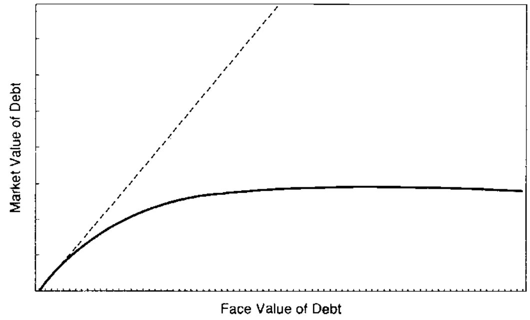

Fig. 11.3 The debt value curve

On the horizontal axis of figure 11.3, I show the face value of claims on a country, on the vertical axis the present value of expected payments (which will normally be close to the value of the debt on the secondary market). For low levels of debt, the face value will lie close to the forty-five-degree line since the country will almost always be able and willing to pay in full. For higher levels of debt, however, the expected payments will fall short of the face value to a steadily increasing extent. And it is at least possible that, at sufficiently high levels of debt, less is more: that a reduction in debt would actually increase the expected payments to creditors.

The reason for this potential downturn, if it happens, is that a debt burden so large that it is virtually unpayable acts like a heavy tax on an economy, both discouraging effective action on the part of the government and discouraging private investment.

When is it in the financial interest of creditors as a group to forgive debt? In principle, when the country is actually on the downward-sloping side of this curve. In this case, a lower debt burden will improve a country's prospects sufficiently to make the smaller face value of debt actually worth more.

Four points should be noted about this analysis. First, the simple fact that debt is worth considerably less on the secondary market than its face value is not a sufficient indicator that debt reduction is in the interests of creditors. There is a range of the debt value curve that lies well below the forty-five-degree line yet is still upward sloping. Underlying this observation is the point that a debt that *probably* will not be paid in full nonetheless *might* be paid; creditors who reduce their claims lose the possibility of benefiting from surprising good fortune.

Related to this point, it is by no means straightforward to evaluate just when debt reduction is in fact in creditors' interest. Estimates of the debt value curve, for example, by Claessens et al. (1990), suggest that some debtors may indeed be on the wrong side. But the largest debtors are not, and, in any case, these estimates are far from reliable and play no role thus far in practical discussion. The most that one can say with any confidence is that a country with a very low secondary market price is more likely to be on the wrong side than one whose debt sells at close to par. The sharp fall in secondary market prices in 1987 therefore made the case for debt reduction stronger but not conclusive.

Finally, note that any case for debt reduction is, like the case for lending to a troubled debtor, a collective rather than an individual one. Each creditor would benefit if all other creditors reduce their claims, but would prefer to maintain its own at full value. Thus, even when debt reduction is clearly in everyone's interest, no individual creditor may be willing to act.

On the whole, no convincing case has yet been made that debt forgiveness is in the financial interests of creditors—even though such an assertion was less implausible by early 1989 than a few years previously. This may, however, be a misleading way to pose the question because U.S. policy interests are not purely financial.

Suppose for a moment that, while private creditors are not convinced that debt reduction will actually raise the value of their claims, they do believe that the probability that the last dollar will be paid is low and that reducing the debt will at least somewhat increase the probability that what is left will be serviced. This amounts to a belief that the curve, if not downward sloping, is at any rate quite flat in the relevant range. In this case, creditors should be willing to agree to substantial debt reduction in return for modest compensation from official sources. And suppose that the U.S. government perceives other interests, say political, in promoting debt relief. Then a debt reduction deal will be attractive: a small expenditure of public money can buy large debt reduction, with non-economic benefits that outweigh the cost.

Note that this is a different case for officially sponsored debt reduction from the usual one. Most calls for debt relief are based on the assertion that the creditor nations have a compelling, urgent national interest in debt relief. Here, their interest need not be so overwhelming because the costs of debt reduction need not be large.

It is probably excessively charitable to think of the Brady Plan as being based on a clear appreciation of the likelihood that debt reduction could now be carried out cheaply, but in a vague way the sense that banks could be induced to forgive debt with modest incentives did underlie the U.S. change of policy. Unfortunately, the plan immediately ran into a difficulty: the difference between collective and individual costs of going along.

11.2.2 Voluntarism versus Collective Action

Suppose that it is decided to pursue debt reduction, using official resources to compensate creditors. How should this debt reduction be carried out?

One model would be to impose a concerted solution: each creditor must reduce its claims by some fraction (or exchange its claims for new claims with reduced debt service). Creditors might be offered some kind of compensation under such a model, but they would not be offered a choice.

An alternative, however, would be to induce creditors to reduce claims voluntarily, by offering them the option of cashing in their existing claims for new claims that promise reduced contractual debt service but are "enhanced" in some way, for example, by guarantee of principal and some interest.

The natural preference of a market-oriented administration is for the voluntary approach—and, indeed, in Brady's initial speech the word *voluntary* was used repeatedly. Within a few days, it was apparent, however, that such a voluntary approach would be prohibitively expensive, and the major debt reductions so far, in Mexico and Venezuela, have been essentially involuntary.

The problem with the voluntary approach is straightforward. To a first approximation, offering creditors "enhanced" securities is simply a sophisticated way of buying back debt. And the price at which debt can be bought back is likely to be much higher than the cost to creditors as a group of reducing debt by a single dollar. The reason is that the secondary price of debt represents the *average* value of debt, that is, the fraction of debt that is likely to be repaid, not the *marginal* value, the likelihood that the last dollar will be repaid—surely a much lower number.

Matters are even worse when a large buy back is announced because then the secondary price of debt will rise; the cost of the buy back will reflect the average value of debt *after* a debt reduction has increased the probability of repayment.

Figure 11.4 illustrates the point. It shows a debt value curve that does not turn down but that is fairly flat in the relevant range. D_2 is the face value of debt before debt reduction, D_1 the face value after. V_2 is the initial value of the debt on the secondary market and V_2/D_2 the initial secondary price, indicated by the broken line.

The value of the debt to creditors will fall as a result of debt reduction, but only modestly, from V_2 to V_1. Thus, one might hope that creditors could be induced to accept such a debt reduction in return for compensation of roughly $V_2 - V_1$. But, if creditors are asked but not required to sell their debt, the cost will be much higher. The reason is that no creditor will sell claims for a price less than the secondary price that will prevail after the debt reduction, V_1/D_1.

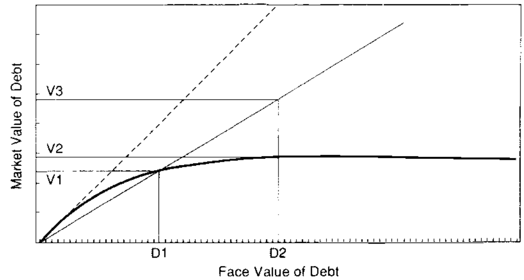

Fig. 11.4 Concerted vs. voluntary debt reduction

The value of the initial stock of debt at this higher secondary price is V_3. The required outlay to reduce debt by $D_2 - D_1$ will thus actually be $V_3 - V_1$—a much larger sum than would be needed simply to compensate creditors for their losses. The difference represents an extra cost to taxpayers, for the benefit of the private creditors.

While calculations based on estimated debt value curves should not be taken too seriously, they give some idea of the problem. If the 20 percent debt reduction number floated soon after the Brady speech were meant seriously, it would have required canceling some \$90 billion in debt. Using the estimates of the debt value curve in Claessens et al. (1990), a buy back of this magnitude would have cost perhaps \$40 billion in cash equivalent—considerably more than the resources available even given the sizable warchest now accumulated.[4] Yet the sum needed to compensate creditors would have been much smaller, on the order of \$10 billion. The balance would represent a capital gain to creditors. For a larger debt reduction effort, the disparity would be even larger; Claessens et al. estimate that a \$200 billion debt reduction would cost creditors about \$25 billion but would cost \$110 billion if achieved through buy backs.

Given this arithmetic, why did the initial Brady proposal stress voluntary debt reduction? One possible answer is lack of clear thinking: as described in the third section of this paper, the circumstances of the Brady Plan's formulation were sufficiently harried that sheer confusion probably played a role. Another answer is that Treasury staff still hoped that clever financial packaging could have a multiplier effect on public resources—that the lesson of the disappointing results of the Morgan-Mexico plan had not sunk in or been seen the same way at the U.S. Treasury as it had elsewhere.

In any case, in the first major test of the Brady Plan, in Mexico, the idea of using a voluntary approach was quickly shelved. Instead, as already described, a combination of legal maneuvering and pressure on banks was used to leave banks no option other than to participate in a debt reduction program.

By all accounts, however, the negotiations leading to the Mexico package were extremely difficult, leading to doubts about whether the U.S. government could achieve similar deals for other nations or would even be willing to try for countries of less strategic importance. (The Venezuelan deal may belie this expectation, but the arithmetic of that deal is still unclear at the time of writing.)

4. As noted above, official resources now available for debt reduction are typically estimated at around \$34 billion. These resources are, however, available for loans and guarantees, not as cash. If the funds could be lent to finance cash buy backs without regard for the risk assumed by the World Bank and the IMF, they could still finance a considerable reduction in net debt: \$34 billion if the buy back price is 50 percent, \$51 billion if it is 40 percent. The international financial institutions have, however, been reluctant to engage in very large lending to finance buy backs, precisely because it would force them to assume too much risk—i.e., they prefer not to see the \$34 billion lending authority as the equivalent of \$17-\$20 billion of simple cash outlays.

11.3 The Process of Policy Formation

Up to this point, I have described the policies followed by the U.S. government and provided a framework that tells us how such policies should be conducted. But what actually determined U.S. policy?

To state the obvious, policy-making did not at all resemble the textbook ideal in which the government is modeled as a single actor, well informed, who acts in the public interest. Policy was made through an interaction of a number of institutional players, not all of them inside the U.S. government proper; institutional priorities and to some extent personal ambitions were key motivations; and much policy-making took place in a fog of misconception and misinformation. In other words, debt policy was made in the real world.

11.3.1 The Players and Their Motivations

A key organizing principle for thinking about U.S. policy-making is the "turf theory," sometimes summarized as, "Where you stand depends on where you sit." That is, the U.S. government may be seen as consisting of a number of institutions such as the Federal Reserve, the Treasury department, and so on, each of which has a built-in predilection for certain kinds of policy, based less on ideology than on what serves the institution's interests; policy then emerges from the interaction of these agencies.

This way of thinking about policy can be either excessively cynical or not cynical enough: an official at, say, the State Department might support policies that run counter to the interests of State per se either out of conviction or, in the "revolving-door" system, because his longer-term career objectives lie elsewhere. Still, a turf-theory approach does seem to yield a useful view of debt policy.

Let us therefore review the main institutional players on debt policy.

The Federal Reserve

From 1982 until the resignation of Paul Volcker in 1987, there is little question that the Federal Reserve was the lead player in U.S. debt policy—in spite of occasional efforts to dislodge it, as described below. This Federal Reserve dominance resulted from several factors.

First, unlike counterparts at other institutions, Volcker himself took a sustained personal interest in the debt problem, regarding it as a central issue. (Indeed, one may even argue that his interest was excessive: what would have happened had he given equal attention to the savings and loan issue?) For example, at several points, Volcker personally intervened to put pressure on banks to go along with concerted lending packages. Volcker's concern with debt, according to Federal Reserve staffers, reflected a sense of history and an urgent desire to avoid repeating the 1930s as much as a specific concern with the immediate financial obligations.

Second, the Federal Reserve had a high degree of continuity of policymaking. Volcker, of course, served far longer than any of his counterpart Treasury secretaries. A similar or even greater disparity was visible at lower levels. Most visibly, Edwin Truman was second-in-command on international economic issues for the whole decade; although he receives little press attention, Truman is a legendary figure among insiders for his acumen and knowledge.

Third, by all accounts the Federal Reserve boasts a much more experienced and talented staff than any other agency can offer. At the crudest level, the Federal Reserve pay scale exceeds that of the executive branch. Perhaps more significant, the Federal Reserve is a highly professionalized and depoliticized organization, in which a civil service career can lead to very high-level positions; this is in contrast to the U.S. government paper, where positions down to deputy assistant secretary or even lower are now usually filled by short-term political appointees. These appointees are less knowledgeable than their Fed counterparts, and it is difficult to attract ambitious staff at lower levels when they are aware of a fairly low ceiling on their ambitions.

Fourth, traditional players in the policy game within the executive branch were unusually weak for much of the period 1982–89—even the Treasury, and other players much more so. I return to this issue below.

So for most of the 1980s the Federal Reserve played the most important role in setting U.S. debt policy. But what were its objectives?

Clearly, the overriding objective of the Federal Reserve was financial stability. The emergency rescue operations of 1982 were led by the Fed, at times in the face of reluctance by the Treasury, to prevent a potential banking crisis. The concerted lending strategy served the same function. The chief concern of the Federal Reserve was to head off country defaults that would force major banks into bankruptcy. In the initial period, this meant a preoccupation with maintaining the paper value of claims.

Concern over financial stability galvanized the Federal Reserve into action in 1982–83. But, as we saw, the pure financial stability issue faded in importance as banks increased their capital. What motivated the Federal Reserve after that point?

The answer is unclear. Some Federal Reserve staffers now concede privately that the policies of 1982–83—the push for new finance, the opposition to any move that would write down debt and thus threaten the financial system—became reflexive and that the Federal Reserve developed a bias toward new money as opposed to forgiveness more on the basis of habit than of analysis. Indeed, arguably, the advantage of continuity in personnel had the disadvantage that officials from Volcker on down remembered what they thought in 1982 all too well and were reluctant to propose policy changes that would prove their old opinions wrong.

The Treasury

Traditionally, the U.S. Treasury has been roughly coequal with the Federal Reserve in setting international economic policy. In the 1980s, however, the Treasury suffered from several disadvantages as a policy-making center.

First, as already suggested, the Treasury was notably lacking in experienced players at high levels. During the first Reagan administration, the highest officials at Treasury with *any* background or experience in international finance were at the deputy assistant secretary level. Nor were the high officials at Treasury widely regarded as quick learners: Federal Reserve officials were privately scornful of their counterparts' qualifications, and sources have reported at least one occasion in which the Fed's Truman publicly reprimanded senior Treasury officials for their ignorance.

This situation changed in some respects after 1985, when a new team including James Baker, Richard Darman, and David Mulford moved into the top positions at Treasury. Although none of these men had experience with international financial policy per se, they were much more highly regarded than their predecessors. However, the change in top personnel apparently did little to change the Treasury's growing weakness at staff level.

Part of this weakness was due to the general problems of the U.S. executive branch: low pay, lack of opportunities for promotion, and a gradual reduction in staffing. Press reports and conversations with sources confirm, however, that this structural problem was exacerbated by an attitude of disdain for staff work on the part of a series of Treasury officials, from Regan to Mulford.[5]

As a result, the Treasury suffered (and continues to suffer) from a lack of effective staff work, which makes policy initiative difficult. One Federal Reserve staffer asserts that "there's nobody at Treasury who can build a spreadsheet."

Nonetheless, by virtue of its institutional position, Treasury has been a major player on debt. What are its objectives? We may distinguish three levels of objective: administration, department, and personal.

Since the Treasury is an arm of the executive branch, it is of course responsive to directives from above. On the domestic side of Treasury, there was a strong conservative ideological mission among many appointees in the first half of the 1980s. On the international side, however, ideological crusading was relatively scarce. Especially after 1982–83, the basic international financial concern of the administration was apparent and clearly coincided with the Fed's objectives: preserve the stability of the financial system.

5. A widely reported anecdote bears repeating here. When Mexican finance minister Pedro Aspe arrived at a meeting with some of his own staff, Mulford demanded that they leave, saying, "What are your [expletive] numbers guys doing here?" The U.S.-trained Mexican team subsequently took considerable pleasure in referring to themselves as "[expletive] numbers guys". A confirming anecdote: soon after the signing of the Mexican debt reduction accord, Mulford rather smugly told an off-the-record meeting that the key to getting anywhere was to ignore the numbers.

At the other end of the spectrum, individual officials at Treasury inevitably have their own agendas—agendas that sometimes lead to conflict with the Federal Reserve. Most important is the understandable desire of high officials to play an active role in formulating policy and to be seen doing so. This is normal but in the case of debt policy had some peculiar results. Treasury officials were generally inexpert themselves and poorly staffed; this made it difficult for them to play a leading role in policy formulation and generally put the Fed in the driver's seat. Yet the Treasury officials chafed under this restraint and carried on a continual low-grade struggle to wrest control of issues away from the Fed.

We may illustrate this conflict with two examples; the major example, the formulation of the Brady Plan, is dealt with below.

First, throughout the post-1982 period, administration debt policy was at least in principle formulated within some kind of structure of interagency groups: a subset of the cabinet at the top, an assistant secretary–level group below, and staff-level interagency task forces or working groups below that. At no point was the Federal Reserve represented in these groups. This makes some constitutional sense since the Federal Reserve is not exactly part of the executive branch or, indeed, of the government. But, given the crucial role of the Fed in the actual policies, especially at staff level, the absence of even an observer status effectively gutted the process. The reason for Fed exclusion is generally acknowledged to be Treasury concern that the Fed would dominate the interagency process if it were allowed into the room.

Another example of the pressures generated by the desire of Treasury officials to play a more active policy role was the brief flurry of excitement generated by Secretary Regan in December 1982, when at a G-5 finance ministers meeting he suggested the need to create a new international institution to handle the debt problem. This suggestion generated a flurry of speculation about the apparent shift in U.S. policy and its reasons, but in fact the statement was undertaken on the secretary's own initiative, without any prior staff work at Treasury, let alone interagency consultation. Staffers at Treasury speculated privately at the time that Regan's statement had been motivated by the desire to play a more active role in the meeting.

The efforts of the Treasury in effect to grab hold of the ball reached a pinnacle in the case of the Brady Plan, but I return to that below.

The Rest of the U.S. Government

One of the surprising aspects of U.S. debt policy has been the virtual silence of arms of the U.S. government outside the Fed and the Treasury. Within the executive branch, one might have expected some role for the State Department; outside, one might have expected some role for Congress. In fact, neither materialized in any important way.

Traditionally, the State Department plays the role of resident internationalist inside the U.S. government—the advocate of measures that serve U.S. diplomatic and political interests even at some financial and/or economic cost. It might have been expected to advocate a soft-money policy, that is, more lending in the early stages of the debt problem, an earlier turn to debt forgiveness. In fact, it did not.

State's silence was apparently due to the effects of politics on the choice of personnel. George Shultz, as secretary, had surprisingly little interest in economic affairs. His undersecretary for economics was Allen Wallis, an economist with strong conservative credentials but little taste for policy formulation. And the assistant secretary for economics for most of the 1980s was Richard McCormick, a former aide to Jesse Helms who, despite earlier experience as a foreign service officer, showed little interest in usual State Department preoccupations.

Congress traditionally has little role in international financial (as opposed to trade) policy. The debt problem attracted the interest of a number of members, Senator Bill Bradley in particular. During the period between the Baker and the Brady plans, Bradley was perhaps the most visible advocate of debt reduction. The so-called Bradley Plan, unveiled in 1986, remained a benchmark for such plans until the Brady speech, and Bradley received advice from leading academic advocates of debt relief, such as Harvard's Jeffrey Sachs and MIT's Rudiger Dornbusch. Treasury officials were routinely grilled on debt issues by congressional committees, and some sources suggest that the pressure from Congress on Secretary Brady and especially on Undersecretary Mulford may have played a role in provoking the Brady Plan.

At no time, however, did Congress manage to find any direct lever for affecting debt policy. At no time in the 1980s did U.S. debt policy require enabling legislation.[6] Only by directly passing legislation forcing a change in debt strategy could Congress have had any impact on the policy, and this was never a serious prospect.

So the story of U.S. debt policy is overwhelmingly one of the Federal Reserve and the Treasury.

Outside Forces

The U.S. government played a leading role in determining debt strategy throughout the period 1982–89. To some extent this is surprising since U.S. banks accounted for less than 30 percent of the bank loans to problem debtors. However, there was no other independent player able to formulate an alternative.

That said, the role of two other key players needs to be recognized. These were the following:

1. *The banks.* The process of concerted lending led to the creation of bank advisory committees, effectively leading banks to speak with far more of a

6. Increases in IMF and World Bank resources did require legislation, and in principle Congress could have held them up as a way to exert pressure on debt policy. But, whether from lack of interest or concern over the damage that such a strategy would do, no confrontation occurred.

single voice than usual. In some ways, these bank advisory committees were more of a match for the Federal Reserve than the Treasury, in that key members—especially Citibank's William Rhodes, who remained chairman of the Mexican advisory committee throughout the period—both came to their positions with considerable expertise and remained in place for extended periods.

2. *The IMF.* During most of the 1980s, the IMF, like the Fed, was a highly professionalized institution under a strong leader. Arguably, the concerted lending strategy can be attributed at least as much to the IMF's Jacques deLarosiere and his staff as to Paul Volcker and his. The staff work that helped lead to the 1989 change in policy direction also was largely carried out at the IMF rather than the Fed or the Treasury.

The point for understanding U.S. debt policy in the 1980s is that the effective policy-making apparatus was not contained within the boundaries of the U.S. government. Senior staffers at the IMF had more impact on U.S. debt policy than senior staff at any U.S. agency except, and perhaps including, the Treasury.

11.3.2 The Rhythm of Policy

Action Forcing Events

Given this set of players, how was policy actually made? The best answer seems to be that policy was made as little as possible. The Federal Reserve's interest in the debt problem was a narrow one: it wanted to preserve financial stability, which it came to interpret as meaning preserving the face value of bank claims. It would initiate policies when this goal was threatened, but not otherwise.

The Treasury might have wanted to initiate policies aimed at broader interests, but it lacked the knowledge and staff to formulate any departure in policy. Therefore, like the Federal Reserve, it acted reactively. The result was that policy was very much driven by "action-forcing events"; absent such events, nothing much happened.

The first action-forcing event was, of course, the Mexican crisis and its spread to other debtors. The Treasury and the Fed, together with the IMF and the bank advisory committee, moved cooperatively to head off the crisis and put together the concerted lending strategy: an altogether remarkable response, even though it did not in the end work out as planned.

The Baker Plan does not at first sight appear to have responded to a similar event. However, the climate of dissatisfaction over the results of debt policy was significant by the fall of 1985; the United States (in general) and James Baker (in particular) were trying to establish a new regime of international cooperation, and it was very necessary for political reasons that the United States present some kind of plan at the Seoul meetings. If this sounds like a weak justification for a policy initiative, we must note that the Baker Plan was a weak policy initiative: cut through the favorable publicity, and one finds a modestly funded continuation of the existing strategy.

The reactive character of policy also appears in smaller responses. Concerted lending, as we saw, evaporated after 1983–84. No real effort was made to restart it, even after the announcement of the Baker Plan. When Mexico found itself in crisis in 1986 as a result of oil price collapse and earthquake, the Federal Reserve and the Treasury once again set to work rounding up banks for another round of lending.

The major change in policy in 1989, however, does not fit this description too well. What can we say about the genesis of the Brady Plan?

The Brady Plan

The genesis of the Brady Plan may be viewed in three quite different ways. All contain some truth.

One way to approach the creation of the plan is to note the real reasons why such a policy change made sense. Playing for time, and waiting for countries to return to normal access, no longer made much sense. The stronger capital positions of banks made concern over the financial repercussions of debt reduction less urgent. The decline in secondary market prices made debt reduction appear more feasible with limited resources. The evident shifting of risk away from banks and to official creditors was raising fears that the process was turning into a bailout. Arguably something like the Brady Plan was long overdue, and the Treasury was simply doing what it should have done before. The Federal Reserve, one may argue, was simply too committed to its opposition to debt reduction to appreciate the obvious; the Treasury, once the author of the Baker Plan was gone and the election was over, was not.

A second explanation, stressed by several officials inside and outside the U.S. government, focuses on the special relationship between the United States and Mexico. The Salinas government in Mexico decided quite early on that it needed a debt reduction, as much or more for domestic political reasons as for strictly economic ones. And the Salinas administration, with its remarkably aggressive reform efforts, was the best Mexican government the United States could hope to have. Thus, there was a strong U.S. policy interest in giving Salinas some highly visible reward. In a meeting between President-elect George Bush and Salinas in the fall of 1988, Mexico was essentially promised that something would be delivered; the Brady Plan may thus be seen as a way in which the United States provided a context in which it could do Mexico a favor.

The final, cynical view is to think of the Brady Plan as in large part a turf struggle within the U.S. government rather than a serious response to real policy concerns.

The actual process by which the Brady Plan emerged was certainly a peculiar one. First, the review of debt policy that provided the basis for the policy change was carried out, as usual, by an interagency group in which the Federal Reserve was not included. Second, according to a number of sources, at a certain point a special team was formed within Treasury, its activities kept secret even from the interagency group, to prepare a debt reduction plan. The number of staff was very small—three or four people—none of them with extensive background.

Third, Secretary Brady announced his conversion to the idea of debt reduction in a speech that was not cleared with other agencies (including the Fed) and was in effect presented to the White House as a fait accompli only shortly before delivery. Finally, when questions were raised about the conceptual basis of the plan (its reliance on voluntary debt reduction) and the size of the resources required, the understaffed Treasury reportedly did not at first turn to the Federal Reserve for staff support: it turned to the World Bank and the IMF. This makes some sense since the international financial institutions would serve as the prime source of finance for debt reduction packages, but the neglect of internal staff resources is odd.

In other words, while a good case can be made that the Treasury policy shift was a reasonable and indeed overdue response to changed circumstances and that it was also a deliberate foreign policy move aimed at Mexico, the actual process of the policy shift looks suspiciously like an effort by the Treasury, particularly by-now Undersecretary Mulford, to grasp control of the debt issue away from the Federal Reserve. In this it succeeded.

11.4 Evaluating U.S. Debt Policy

This paper is intended primarily as a descriptive rather than prescriptive exercise. Nonetheless, it is unavoidable that some evaluation be offered.

U.S. debt policy may be evaluated in two ways: as a process or by its results. It may seem that the latter always supersedes the former, that the proof of the pudding is in the eating. But the uncertainties of economics are too large to judge policymakers solely by their success. Not only may a good policy hit bad luck; officials may be right for the wrong reasons or wrong for the right ones. Without question, one of the ways that Paul Volcker earned his right to be regarded as one of history's great central bankers was by his decisive actions on debt in 1982–83, yet a respectable case can be made that the world would have been better off had the Fed had a weaker leader and had the debtors simply been allowed to go into open default, as they did in the 1930s. So we need to evaluate the process on its own terms, before asking whether the policies that emerged from it were actually more or less right.

The policy-making story described in this paper is a mixed one. The initial phase of U.S. debt policy was marked by a rare combination of intellectual clarity and decisiveness. After that point, the story is much less inspiring. As described above, policy was reactive rather than creative for most of the period

1983–88, intellectual confusion was rampant, especially over such issues as debt-equity swaps, and there was a preoccupation with the public relations aspects of policy as opposed to substance. The pettiness and amateurishness of the policy process leading up the Brady Plan are fairly hair raising. On the other hand, policy formulation was untainted by special interest politics (a brief flurry over James Baker's holdings of Citibank stock was silly) and the international diplomacy by which agreement was reached quite skilful.

What about the results? Was the policy actually a good one?

There are two overwhelming facts about the results of the debt crisis in the 1980s. First is that financial stability was maintained: there was no 1930s-style collapse. Second is that the economies of the debtor nations performed very badly: real GNP per capita in almost all highly indebted countries was lower in 1989 than it was in 1981.

The policy response of 1982–83 can fairly take credit for the preservation of stability. It is hard to see that any very different strategy could have been undertaken given what was known at the time; the actual strategy was implemented forcefully and bought time while the overall world economic and financial picture improved sharply.

The question is whether another policy could have brought faster growth. The U.S. government could have been more aggressive in seeking to mobilize bank capital after 1983, and it could have sought a Brady-style debt reduction plan two years earlier. Alternatively, the United States could have declared a victory and gone home, implicitly encouraging debtor countries to go into arrears. In either case, the resource transfers from debtors to creditors might have been smaller.

But would this have brought better economic performance? Many observers have contrasted the 1930s—during which many debtors defaulted, then went on to do reasonably well economically—with the almost universally dismal record of debtors in the 1980s. Eichengreen and Portes (1989) have also shown that, during the 1930s, countries that were willing to default early and massively did better than those that were not. However, in the 1980s, there was no visible correlation between the burden of debt service and economic success. So by selective use of evidence, it is possible to make either case. One may maintain, as Cline (1990) implicitly does, that growth in debtor countries would have collapsed whatever the debt strategy and that the fact that the financial system has remained intact despite the growth collapse represents a signal success for policy. Or one may argue, as so many critics have, that the "overhang" of debt that could not be eliminated because the preoccupation with financial stability acted as a major drag on growth.

The political economy point, however, is that it is hard to see how the essentially reactive U.S. policy could have evolved much differently. It is interesting as an economic counterfactual to ask what would have happened had, say, Felix Rohatyn's 1983 global debt reduction plan been put into effect in 1984; but it was never a serious political possibility.

Appendix A
Debt-Equity Swaps

Six years after Mexico introduced its debt-equity swap program, the economics of such swaps are still the source of considerable mystification. Most economists working on developing-country debt regard swaps with considerable suspicion, while many private-sector participants take their desirability as axiomatic. So it is worth taking some space to describe the issues.

In essence, in a debt-equity swap, an investor is allowed to redeem external dollar debt for local currency, on the condition that this currency be invested in an approved local asset. From the point of view of the investor, this is a more attractive proposition than simply exchanging dollars for local currency at the central bank because the debt can be acquired at a discount on the secondary market.

What does the country gain? It does *not* reduce its overall foreign liabilities, except to the extent that it charges investors a fee for the right to carry out the swap. Instead, it converts one kind of obligation, debt, to another, equity. The country also does *not* attract additional net foreign investment: when an investor pays for his investment with the country's own debt, as opposed to dollars, this does not provide any immediate increase in its ability to import.

The potential gain comes instead from the change in the nature of the foreign claim. Equity investments will produce a stream of repayments to foreigners that is delayed relative to debt service, which may be an advantage in a country short of liquidity; they shift some risk from domestic residents to foreigners; and the foreign investors may bring intangible benefits in terms of knowledge, competition, etc.

Against this potential gain may be set two potential costs. First, debt-equity swaps pose a fiscal problem. Essentially, they "unreschedule" debt, forcing governments to redeem debt immediately. While the redemption takes place in local currency, simply issuing the currency would be inflationary, so responsible governments must issue new domestic debt to soak up the issue of local currency. The problem is that the real interest rate on this domestic debt is usually much higher than that on the rescheduled foreign debt that it replaces, thus aggravating fiscal problems.

Second, in many cases, debt-equity swaps are used to finance investments that would have taken place in any case. They thus divert foreign exchange that would otherwise have arrived at the central bank into the secondary market, aggravating rather than helping the liquidity situation.

Most developing countries now appreciate these problems and have scaled back their debt-equity programs.

Appendix B
The Limited Menu Approach in Concerted Debt Reduction

Both the Mexican and the Venezuelan debt reduction packages offered creditors a choice: either accept a conversion of debt into a smaller claim backed by some enhancements, or provide new money. These schemes were intricate and are still the source of considerable dispute. However, it may be argued that, in principle, such a "limited menu" approach offers a neat way to reduce debt without providing capital gains to creditors. This argument is laid out formally by Diwan and Kletzer (1990); here, I summarize it briefly.

It helps to imagine a scheme considerably simpler than either of the actual debt reduction packages. Suppose that creditors are offered only two choices: to be bought back at the market price prevailing before the scheme was announced or to provide new money in some ratio to original claims. Suppose also for a moment that creditors are identical in their concerns and expectations.

The new money option has an obvious undesirable feature: the new money is lent at an expected loss. However, the debt reduction that results from the buy backs should lead to a rise in the secondary market price of debt, and, by choosing the new money option, a bank preserves its ability to benefit from this rise. Now, notice that, if a large number of banks choose the new money option, debt will not fall by much, and hence the secondary price will not rise much; this will make the new money option unattractive. Conversely, if few banks choose new money, the secondary price will rise considerably, and new money will be more attractive. If the right number of banks choose new money, the new money option will yield the same value as exit; and the fraction of banks choosing the new money option will tend to be such as to produce this result.

In the Mexican case, those banks that chose to reduce their claims were given new assets that were, according to the estimates of Diwan and Kletzer, worth about 42 percent of original face value. Those banks that chose the new money option were obliged to increase exposure by 25 percent, but they benefited from a rise in the price of their claims to about 52 percent of par. Each dollar lent was lent at an expected loss of $1 - .52 = .48$, for a total loss of $.25 \times .48 = .12$ per dollar of initial claims; but, by not accepting debt reduction, the new money banks realized a gain of $.52 - .42 = .10$ per dollar of claims. Within the limits of reasonable uncertainty, the new money and debt reduction options were roughly equivalent.

But notice that, in such a scheme, neither the new money nor the exiting banks gain from the buy back. The exiting banks receive the ex ante market price; the new money banks are no better off. Thus, the whole of any official resources provided go to benefit the country. In terms of figure 11.4, the debt reduction from D_2 to D_1 is achieved at the cost $V_2 - V_1$ rather than $V_3 - V_1$.

To the extent that banks differ in their preferences, the limited menu approach has the further advantage of offering some limited accommodation of these preferences.

The main problem with such a scheme is that it is difficult to predict how many banks will choose the new money option and thus how much official money will be needed. If the new money requirement is set too high, few banks will choose it, and the resources needed for buy backs may exceed the available funds. This in effect happened in the Mexican case, creating some serious headaches.

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2. *Thomas O. Enders*

To put the debt crisis in focus, you can look at it from the point of view of the debtors, the commercial creditors, or the creditor governments.

If you are most Latin Americans, the 1980s have been, as they often say, a "lost decade." The whole continent has stagnated, been marginalized. Work available and income earned have fallen. You have been subject to some of the most extreme price rises in history. Violence and disorder in your neighborhood have grown explosively. You have watched the rich, already recipients of a disproportionate share of income, get richer.

If you are a commercial banker, it has been a mixed experience. You made good money up front, but since then you have been coerced by the U.S. government first to lend more, then to write down your claims. Many small debtors and one big one—Brazil—have recently paid you little or nothing. Although some countries are recovering and accessing the voluntary capital markets, the crisis is by no means over. But you have had time to build up capital and loss provisions. The gross flows these last years and the remaining values are well short of pre-1982 hopes, but they are not insubstantial.

If you are the U.S. government, you have given an uneven performance that is turning out well. As Paul Krugman reports, you failed to anticipate the crisis (with the exception of the chairman of the Federal Reserve and a few others). Then you misread it as due to the business cycle, not to a general crisis in the mercantilist growth model standard in Latin America and elsewhere. You got such things as financial engineering wrong and permitted one part of government to take initiatives to preempt others. But the things you feared didn't happen. The money-center banks didn't lose their capital. Latin America didn't throw itself into the arms of dictators of the Left or the Right but made breathtaking steps toward democracy. Instead of confronting Washington, the hemisphere sought its help, first to twist arms for involuntary lending, then to permit/stimulate a rise in official lending, then to force a write-down, and now to negotiate what may be the ultimate solution to the debt problem—North-South free trade. Moreover, you found that you could exercise a leadership role—the initial rescue, the Baker Plan, the Brady Plan, the Enterprise for the Americas Initiative—and relatively easily beat back sporadic attempts by the French or the Japanese to outbid you. And most of the time you did it with other people's money: from the commercial banks, from the multilateral agencies. Your policy was reactive, but that posture made you sought after in a way that you hadn't been since the Alliance for Progress or the Good Neighbor Policy. Indeed, out of the debt crisis there is emerging a remarkably close, confident, and fruitful North-South relationship.

Looked at as a historian might, the results of this debt crisis appear to be the reverse of those of the first debt crisis in the 1930s.

At that time, some countries defaulted early and massively. Few paid more than a few cents on the dollar (Argentina was the main exception). Much foreign investment was nationalized. No government (other than the Mexican) survived the decade. In many cases, military regimes replaced outward-looking, if elitist, republics. Everywhere a new growth strategy emerged that centered on import substitution, was hostile to foreign investment, and exalted state enterprise. The new model often created monopoly opportunities for local capitalists. Unable to tax the monopolies, the governments sought to offset ever wider income disparities by such populist measures as subsidies for food and basic services as well as artificial exchange rates for key imports.

Creditor governments intervened little to enforce bondholder claims, but the crisis set loose xenophobic and specifically anti-U.S. currents in a number of countries.

Thus, while most of the world learned the lesson from the 1930s that autarchy did not pay, Latin America concluded that reliance on foreign markets and capital did not pay.

Indeed, the new growth strategy proved spectacularly successful, yielding continent-wide growth of some 6 percent for three decades to 1980.

It was that record that again attracted massive flows of foreign capital to Latin America in the 1970s. And it was, of course, that record that desensitized bankers and governments to the risks. Had we been watching, we would have seen that foreign money was masking or aggravating the vulnerabilities of the Latin American growth model. Governments, never good at raising revenue, were relying more on borrowed money to cover expenses. Easy availability of resources was fostering ever greater misuse in essentially nonaccountable state enterprises. Local capitalists were exploiting artificial exchange rates to move huge amounts of capital out.

What we do not know, and must leave to future historians to decide, is whether the import-substitution growth strategy could have survived if Latin America had not borrowed so heavily in the 1970s, or if it had defaulted massively in the 1980s, or if creditors had listened to those few advocating early, large-scale forgiveness. Maybe the collapse would have taken longer, but I personally have no doubt that it was coming.

What is certain is that, just as the injection of foreign cash exaggerated the import-substitution model's weaknesses, the need to service the debt brought it under intolerable stress.

Governments with weak revenue bases had to acquire from their citizens the resources to service the debt. Most ended up doing it by printing money. There resulted a continent-wide inflation, in Argentina and Brazil at Weimar levels, in Mexico and Venezuela at lower but wholly unprecedented levels.

Once again, it will be for historians to determine what finally convinced first Mexico, then Argentina, Venezuela, and Brazil, to attempt the radical liberalizing reform of their economies. I think that it was the searing experience of inflation out of control coming on top of the failure of their systems to respond to the worldwide upswing in the mid-1980s and the failure of official and private creditors, taken together, to come up with net new resources. Radical reform then became the new politics of survival, notably for Mexico's Revolutionary Institutional party.

It would be comforting to think that the call for reform by the United States and other creditors, at first perfunctory, then with more feeling, had an impact. I doubt it. Rather—although it was not their intention to impose runaway inflation on Latin America—creditors did contribute to it and thus finally to the start of serious reform. And, whatever you think of the financial engineering, when the new Salinas government, having already put through an aggressive liberalization program, turned to creditors for a dramatic gesture of support, the fact that the United States responded with the Brady Plan was of enormous importance in consolidating support for change within Mexico.

There remain some important questions.

The ultimate success of the reforms remains in doubt. Mexico, gratified by high petroleum prices, fears a U.S. recession. Two-thirds of its exports are now nonhydrocarbons. And the democratization of the Mexican state must someday be faced. Brazil's structural reforms, which each week bite deeper into one of the few last remaining mercantalist economies, depend for their survival on success in containing inflation. They, too, could fall victim to a world downswing. The debt crisis is unwinding, not over.

Second, as the continent moves toward open markets, the willingness of Latin capitalists to recommit their resources to Latin development is still not confirmed. So far only a small part of flight capital—which may be as much as $150 billion—has returned. Interestingly, people who trade in official Latin debt, as I do, have had little success in persuading Latin capitalists to invest in it. But money is going into private investment as a new pattern emerges: government credit is more or less permanently impaired, while private enterprise expands. To sustain growth, Latin America must attract much of the flight money back.

Finally, what is done, or not done, in trade can be decisive. Latin America, and thus the debt problem, stands to gain much from a successful Uruguay Round. Free trade, first with Mexico, then with others, can be had only at the cost of a major political fight in the United States. But it can be the ultimate way out of the debt problem.

What do I think of U.S. policy on Latin American debt in the 1980s? It was not foresighted or proactive, but it kept us engaged, moved us to respond at critical junctures, and contributed to, rather than thwarted, the historic transformation now under way.

3. *William R. Rhodes*

The adage that hindsight is 20/20 is true only because of the corrective lenses that time provides. While historians will have the final verdict on what transpired during the debt crisis, this is offered as a blow-by-blow account of where the crisis started and where it is today from the viewpoint of a commercial banker who has been in the trenches. It is not my intention to get into the causes of the crisis, but I will offer some general observations on the policies that were followed by the various parties involved, including the creditor governments, the debtor governments, the international financial institutions, and the commercial banks.

Before I get into the specifics, I would like to give you some background in both economic and political terms on Latin America—where the debt crisis hit the hardest. In looking at the past and the present in Latin America, it is important to understand that, during the decade of the 1980s, there occurred the most significant change from military governments to democracies in the history of the region. In other words, all during this very difficult economic period for Latin America, there was a move away from military government toward democracy. And, at the same time—particularly toward the end of the decade—there was a massive opening up of the economies to structural economic reform and privatization. Whether either or both of these two trends prove definitive or not, they need to be kept in mind when thinking about the 1980s and the future of Latin America. It is also interesting to note that what is going on now in Eastern and Central Europe has many similarities to the Latin American experience of the 1980s with the move toward democratic pluralism and economic reform.

Beginning in August 1982, when Mexico decided to call its creditor banks together at the New York Fed, the so-called debt bomb became an international financial crisis without precedent in modern history. Along with the social and political impact felt by tens of millions in the developing world and particularly in Latin America, it resulted in a profound change in the business of international banking. It posed fundamental strategic business questions to thousands of banks worldwide, many of which had only recently ventured into international lending in the late 1960s and 1970s, and certainly threatened the survival of many banking institutions, both large and small. In 1982 and 1983, many people were concerned about what the crisis would do to the international financial system itself.

Other countries certainly had experienced debt-servicing problems before. There were the problems of the 1920s and 1930s, and you can go back to Argentina and the Baring Brothers crisis of the late nineteenth century. Certainly, none of those earlier cases had debts the size of Mexico, Brazil, or Argentina in the 1980s. Thus, those of us who were approached by Mexico to work on the problem in August 1982 had no real road map to deal with anything of this size. However, given the stakes, we had to assume that the crisis could be managed.

Looking back, we had two goals. First and foremost was to prevent the collapse of the international financial system—obviously, the banking system. Second, the countries needed help to eventually return to the private capital markets in order to finance what former Treasury Secretary James Baker liked to call "sustained growth."

If greed often drives people apart, fear often drives them together, and certainly Mexico in August 1982 was an example of the latter. There quickly developed an unusual international working arrangement among competing commercial banks, bank regulators, international financial institutions, creditor countries, and many of the borrowing countries. On the basis of experiences with earlier restructurings in the 1970s (e.g., Nicaragua, Jamaica, Zaire, and Turkey), the commercial banks organized themselves into steering—or advisory—committees, with membership based on the size of exposure and geographic representation. These committees were organized in coordination with each of the debtor countries, and it is important to remember that they were not put together by the banks alone but were requested by the debtor countries themselves.

A major factor in this working arrangement at the beginning was the leadership of people like Paul Volcker at the Federal Reserve and Jacques de la Rosiere at the International Monetary Fund (IMF). A balanced and case-by-case approach was developed, recognizing the fact that each of the restructuring countries had its own particular and peculiar realities.

In the first phase of the crisis, commercial banks, of necessity, assembled short-term emergency financing packages. These involved restructurings to stretch out approximately two years of maturities over five to seven years and new money to meet the immediate cash needs of the borrower countries. The 1982–83 restructurings of Mexico, Argentina, and Brazil were set up along these lines. The countries, in turn, began to adjust their economic policies to reflect, belatedly, the changes that had been occurring over several years in the international economy.

The second phase looked beyond the countries' immediate needs with longer-term packages to buy time. The idea for this type of approach was first put on the table—again by Messrs. Volcker and de la Rosiere—in the late spring of 1984 at the International Monetary Conference in Philadelphia, attended by the chairmen of the world's largest commercial banks. I was asked to attend to represent the bank advisory committees. What emerged was an agreement that the IMF would institute enhanced surveillance or monitoring—something that has now long been forgotten. This meant that the IMF would monitor a country's economic performance over periods substantially longer than normally done under standby or extended fund arrangements and that this information would be made available to the commercial banks.

This allowed the banks to negotiate the first multiyear restructuring agreement (MYRA) with Mexico later in 1984. This stretched out for up to fourteen years all debt maturing over a six-year period, as opposed to the maximums mentioned earlier of seven years and two years. A more market-based approach started in 1984, when we negotiated a clause under which banks could convert debt into equity (the famous debt-equity swaps) as part of this same Mexican MYRA package.

This marked the beginning of the concept of debt reduction. Although unheralded, the "menu of options" approach began later that year, in a package negotiated with Argentina that allowed banks to allocate part of their new money commitment for trade or directly to clients in the country—something that we call *on lending.* In 1985, the Chilean package further enhanced the menu of options idea, by providing for a variety of debt-reduction programs, mostly debt-equity swaps. The result of these programs of debt reduction for Chile has been a total reduction of over 50 percent of its long- and medium-term debt.

Phase 3 was aimed at shifting the focus from short-term adjustment to longer-term growth. It reflected the philosophy—first expressed by Jesus Silva Herzog, the former secretary of finance for Mexico—that the only way out of the crisis for the developing world was to grow out of it. This phase followed Secretary Baker's decision that the U.S. Treasury should be more actively involved in the management of the debt than it had been under his predecessor, Don Regan.

In October 1985, at the IMF–World Bank meetings in Seoul, Secretary Baker announced his plan—the so-called Baker Plan—for world debt. Chief among the points was the emphasis on growth-oriented structural economic reforms by the borrower countries. In response to the countries' economic adjustments, the commercial banks were asked to continue to make available a prudent amount of new loans. What Baker suggested as prudent was $20 billion over three years. One of the major points of the plan was to bring the World Bank into the fray because the debt strategy up to this point had been dominated principally by the IMF and Baker was calling for major involvement of the World Bank in structural adjustment.

Although the Baker Plan is often attacked for not raising sufficient new money, Bill Cline of the Institute of International Economics, who has spent the last seven or eight years studying the debt crisis, estimates that banks disbursed over $13 billion in net new loans to the Baker countries over the three-year period envisioned. Although the $20 billion mark was not reached, this is as much a reflection on the inability of some of the countries to make the structural adjustments that were a prerequisite as it is a reflection on the commercial banks' unwillingness to lend in some cases.

Meanwhile, the role of the market increased with the Argentine agreement of 1987, when the list of options was substantially expanded. This is when you first started hearing about the menu of options. To the bankers involved it was old hat, but to Washington and to the Treasury it was something new on the table. What we did here was to have cofinancings with the World Bank, trade financing facilities, new money bonds, etc. What is often overlooked in this agreement is that this was the first time that we put on the table an exit bond with a fixed below-market interest rate in order to try to stimulate debt reduction. The Argentine exit bond, which was priced inadequately and lacked enhancements, was a failure. Only three banks took it. However, it helped set the stage for the next phase, which was voluntary debt reduction. That was in 1987—the same year Citibank raised its reserves. This action, in turn, stimulated similar action by many banks in the United States, the United Kingdom, and Canada. Obviously, the decision by Citibank was, to a great degree, stimulated by Brazil's declaration of a moratorium on its medium- and long-term debt. Although that was not the only reason, certainly it was a major one that encouraged Citicorp's chairman, John Reed, to go ahead with his reserving. This higher reserve gave banks greater flexibility to manage their loan portfolios through such debt-reduction options as exchanges of debt for equity and cash buybacks of debt.

Following within a few months was the so-called Morgan-Mexico deal, which was another attempt at debt reduction. As you will remember, it was an offer to banks to exchange loans for bonds at a discount, with principal collateralized by U.S. Treasury zero-coupon bonds. This later became the basis for the so-called Brady Plan. The Morgan-Mexico deal did not produce the results that some had hoped for, most importantly because only the principal was collateralized, not the interest. Instead of reducing the debt by \$3–\$4 billion, the deal reduced debt by only \$1 billion; but this certainly was a milestone.

Although never fully implemented by Brazil, the medium-term financing package signed in September 1988 to bring Brazil out of its moratorium demonstrated for the first time that new money and voluntary debt reduction were not mutually exclusive. Both the banks and the countries were now looking toward voluntary debt reduction as a major part of these financial packages. The package itself contained \$5.2 billion of new money. Unlike the earlier attempt in the Argentine deal, it was the first time that an exit bond was successfully put on the table with below-market interest rates (with 6 percent, twenty-five years, ten years' grace). Some hundred banks subscribed to a total of \$1.1 billion of them. If the Brazilians had not initially restricted participation, we probably could have obtained two or three times that amount. One interesting highlight is that, although Brazil later suspended interest payments on its medium-term debt to commercial banks, it never stopped paying interest on its bonds.

This set the stage for the next event in March 1989, when Secretary Brady proposed voluntary debt reduction by commercial banks. I would emphasize commercial banks because he said nothing in his statement about official debt reduction by governments or the international financial institutions. This reduction of debt by commercial banks became the focus of the debt strategy in place of new money. Secretary Brady did mention, however, some six or seven times in his speech before the Bretton Woods Committee the idea that some new money flows were still necessary, but most people did not pick that point up, and it certainly was not emphasized. The Group of Seven subsequently met on several occasions after the speech to work out guidelines, and the IMF and the World Bank for the first time agreed to offer resources to back debt-reduction programs for countries with viable economic programs.

All this set the stage for the Mexican debt package, which was signed in

February 1990. This package included most of the debt-reduction techniques used earlier, such as debt-equity conversions, interest rate reduction, and principal reduction bonds. It also incorporated many of the new money techniques, including bonds, trade finance, and on-lending facilities. In addition, the package introduced two new techniques: collateralized interest for debt-reduction bonds and value recovery. These two innovations have since been incorporated into other packages, including the one for Venezuela.

Where are we now? What follows are a few brief highlights. A number of countries have implemented important economic reforms, including privatizations, and negotiated or completed agreements with their creditor banks. Mexico has put the debt crisis behind it and returned to the voluntary markets, and Chile and Venezuela should soon do likewise. Colombia and Uruguay are also close to regaining market access. However, two of the largest borrower countries—Brazil and Argentina—have yet to reach agreements with creditor banks and have built up large arrearages.

In reflecting on the events of the past ten years, there are some key points that should be mentioned. First, the strategy employed has proved successful, in that the debt problem no longer appears to be a systemic risk situation.

Second, a key decision taken early in the crisis was the so-called case-by-case, or country-by-country, approach, a decision that continues today. It is a decision that is supported by most of the debtor countries. The alternatives were the so-called global solutions, of which we have seen many. The global solutions have two drawbacks: they do not speak to the differing needs of each individual country, which is why the countries have not favored them, and they tend to be forced rather than voluntary, which is why the banks have not backed them. Each country situation is different, and each requires a tailored solution. Also, there was a feeling that this type of solution would impede the countries from eventually getting back to the voluntary capital markets. The case-by-case approach has been followed from the beginning and is certainly a mainstay of the Brady Plan.

Third, the advisory committee system, overall, has functioned well in representing the interests not only of the creditor banks but also of the borrowing countries themselves. The committees have served as an informational pipeline for the borrower governments, who otherwise would find it difficult—if not impossible—to negotiate with the thousand or so interested banks at any one time around the world. These committees will be dissolved as the countries return to the voluntary markets. However, the potential usefulness of the committees to a country was highlighted last year, when a number of commercial banks tried to get the Chilean government to dissolve its committee and the Chileans refused to do so. They wanted to use it one last time, in order to put a package on the table to assure Chile's return to the voluntary markets.

Fourth, although the commercial banks have been criticized for not being sufficiently supportive, I believe that they have generally met the financing needs of the restructuring countries with either new money or debt reduction, and certainly they have done so for those countries that have instituted viable economic reform programs. For example, since the Brady Plan was announced in March 1989, the banks have completed or arrived at preliminary packages with substantial debt reduction and/or new money for Mexico, the Philippines, Costa Rica, Morocco, Venezuela, Chile, and Uruguay, along with a refinancing for Colombia with a new money tranche. I think that the process has been flexible and has evolved over the years. For example, we have had the introduction of a longer-term menu of options through the voluntary debt-reduction mechanism, including debt-equity exchanges, cash buy backs, and interest and principal reduction bonds. I think that these innovations have bought time for the countries to institute the necessary structural economic reforms, including privatization.

One of the major conceptual errors from the beginning of the debt crisis was the idea that the countries were in a short-term liquidity situation and that all that was needed was short-term stabilization programs of eighteen to twenty-four months. The results of this view were programs that lasted a maximum of two to two and a half years. The countries often ignored the need simultaneously to make basic structural economic reforms, including privatizations, in order to lay the basis for investment and growth.

Many people did not understand the important point that, if the countries did not change basic structures and open up their economies and privatize, one stabilization program after another would end in failure. Certainly that was the case in Brazil, Argentina, and even with the initial programs in Mexico. As an example, Brazil had about seven letters of intent with the IMF over a four-year period. What you ended up with was a vicious cycle because the necessary economic structural changes were not being made.

Even in the case of Mexico, it was not until late 1985, under President de la Madrid, that the country finally decided to join GATT. At the same time, the government began putting in place the necessary mechanisms to reduce the role of the public sector through privatizations and the closing of a number of inefficient and money-losing state institutions, such as Fundidora Monterrey. I think that one of the hopeful things that we are seeing today is that most of the governments in Latin America are beginning to recognize that stabilization alone is not good enough, that you must have basic structural changes, including privatization.

I hope that the importance of structural reforms will not be lost on the countries of Eastern Europe. While Poland quickly initiated a courageous stabilization program to combat inflation, only recently did it begin its structural adjustment program centered around privatizations. The delay in adopting structural adjustments has made it difficult to create markets for labor and capital and has cost the country needed investment.

I am also concerned about the Brady Plan's emphasis on voluntary debt reduction alone, with little interest in new money flows from commercial banks. Debt-reduction programs, particularly those involving debt principal reduction, often encourage banks to end their lending relationships with the countries. However, in order to grow, there will still be a need for some flows of new money from at least a core group of banks—that is, if a country is pursuing its program of structural reform and privatization and is becoming competitive and creditworthy. Despite the skepticism of some that banks would not lend, even where there were proper conditions, examples of the willingness to lend new money are the recent agreement with Venezuela and, most important, the return of market access for Mexico.

A growing impediment to bank lending, however, is the substantial amount of overdue interest owed by some countries. These arrearages to commercial banks from restructuring countries worldwide amount to nearly $24 billion at the end of the third quarter of 1990, with Brazil and Argentina accounting for more than half. Arrearages undermine confidence in a country, not just among banks, but among other potential investors, local and foreign. Funds are not likely to flow to those countries that fail to regularize their financial obligations. Bank arrearages have also encouraged arrearages to the IMF and the World Bank. But I would put to you that part of the problem was in these institutions themselves because in many ways they encouraged the countries to use arrearages as a form of external finance. Certainly, there are those people who believe that that was implicit in the Brady initiative. I do not think that the secretary meant that. But it is only recently that the U.S. Treasury has come around to recognizing the importance of this issue, and, if you read the G-7 statement at the September 1990 IMF–World Bank meeting, you will see that they finally understood that the arrearage problem is a serious one.

The progression in the use of debt reduction also concerns me. It was first used by the commercial banks, then appeared as the focus of the Brady Plan, and then was proposed for President Bush's Americas Initiative. One of the dangers in this progression is that new money flows could be diminished or, in some cases, even halted. An interesting question, therefore, is, To what extent should debt reduction be viewed in the context of new money?

When we look back at this crisis, there is still one question that I believe needs further review. I am referring to the criticism directed toward the banks in the 1980s for overlending, by the regulators, and by officials of the international financial institutions, saying that banks did a poor job in the two recycling efforts of the 1970s. One could ask, however, where was the G-5, and the official sector in general? They were not prepared to lead the effort, so the commercial banks took it on. What would have happened if the major industrialized countries had decided to step in and head the recycling effort, using, among other things, the international financial institutions more actively than they did to achieve this goal? Under the circumstances, the banks did a reasonable job—perhaps not good enough in some cases—but nobody else stepped forward.

Summary of Discussion

Paul Krugman began the discussion by asking about the real effects of reserving. Reserving appears to an economist to be simply a relabeling of some of a bank's assets with no real consequences. In particular, a decision to increase reserves appears to have no impact on either the present or the future cash flow of the bank. Yet financial markets view decisions to reserve as important events. Why?

William Rhodes said that Citibank's 1987 decision to increase its reserves had been based on a recognition on their part that they had not seen the progress that they had hoped for since 1982. They had recognized that times had changed and wanted to be more flexible with their portfolio. This basic rationale had been somewhat lost in the theatrics of the press coverage, but Rhodes emphasized that Citibank had certainly not chosen to increase its reserves by so much in order to put other banks in a more difficult position.

Rhodes believed that Citibank's decision had had a large effect on the financial markets because of the bank's long-standing leadership role in international lending. Citibank was the largest international lender, so many people thought that Citibank's increase in reserves indicated a widespread recognition that American banks were underreserved and undercapitalized in the face of the LDC debt problem. Another possible effect of the reserving decision was that many developing countries wanted to reduce their own debt balances in line with the discounting of their debts on banks' balance sheets.

Martin Feldstein summarized Rhodes's description of reserving as a combination of a public admission of the seriousness of the LDC debt problem and a reaction by developing countries that they should pay the banks less money. But that combination should have lowered the value of Citibank stock, not raised it, as actually happened.

Rhodes said that Citibank had been quite surprised that the stock price had risen temporarily because they had expected it to fall themselves. In any case, however, the change in stock price had not been the focus of their attention.

Thomas Enders asserted that Citibank's reserving decision had involved a much more precise allocation of capital to the risks on its balance sheet. This effort to identify the bank's problems had been viewed by the market as an important step toward better management of the bank's assets, thus boosting the value of the stock.

William Poole offered another explanation for the rise in Citibank's stock price. At the time, the U.S. government had been coercing many banks into lending additional money to the developing countries, and banks with higher net worth were more likely to be coerced. When a bank transferred capital into its reserves, it became more difficult for the bank to be put into a position where it would have to put up—as the market saw it—good money after bad.

Rhodes said that this had not been a consideration for Citicorp because they had been the leaders in the effort to encourage new lending to the developing countries. He admitted that this issue may have played a role in other banks' subsequent reserving decisions.

Robert Litan maintained, however, that Poole correctly explained how the market had perceived Citibank's action.

Krugman then shifted the discussion to the Brady plan [named for Treasury Secretary Nicholas Brady]. Rhodes described the Brady plan as a *voluntary* debt-reduction plan, which is the way that Brady's original speech had described it. But the biggest Brady deal to date, involving Mexico, had not been a voluntary plan; although the creditors had had some choices, doing nothing had not been one of them.

Rhodes said that, although the Treasury Department had pushed the banks to participate in the Mexico plan, most of them had been prepared to participate anyway. One reason is that, unlike Brazil and Argentina, Mexico had never defaulted on its interest payments. A second reason is that Mexican President Carlos Salinas had been implementing a structural reform package that the banks had liked. So, although it had been possible for the banks to challenge the Treasury plan publicly, all but a few banks had believed that Mexico deserved support anyway.

Feldstein said that, of the five major changes in U.S. debt policy that Krugman had described in his paper, the introduction of the Brady Plan had been the most dramatic one. Feldstein wondered what had caused this change and whether the banks had been involved in the change before it was publicly announced.

Rhodes answered that an important motivation for the Brady plan had been the political situation in Mexico. President Salinas had emphasized to President Bush the importance of debt relief, and Mexican Finance Minister Pedro Aspe had visited Brady several times to make the same point. So it was Rhodes's understanding that the Brady Plan had not been just Brady's idea but had had the full backing of the president because of the situation in Mexico.

Rhodes continued that Treasury Undersecretary David Mulford and his staff had consulted with a few bankers before the public announcement, but not with very many. Rhodes said that he had spoken with Mulford before the announcement and had stressed two issues. First, he had argued that the debt reduction should be voluntary, not mandatory. He had thought that a mandatory plan would be of doubtful legality and would not induce the cooperation of the international banking community in the way that a voluntary plan would. Second, Rhodes had argued strongly that there should be a continuing flow of new money to countries that were creditworthy and were implementing appropriate economic reforms. Unfortunately, this issue did not receive much attention at the time, which the Treasury now regrets because they realize its importance.

Feldstein added that the Brady Plan had been developed at the Treasury Department with little input from either the rest of the executive branch or from the Federal Reserve. Feldstein also hypothesized that the introduction of the Brady Plan may have been due to a new Treasury secretary wanting to make his mark, not to any change in the fundamentals of the debt situation or in the thinking of other people at the Treasury Department.

Michael Mussa suggested that the introduction of the plan had been deferred until after the election, along with other bad news like the savings and loan disaster. *Feldstein* did not think that announcing the Brady Plan a year earlier would have cost any votes.

Charls Walker said that Brady had been scheduled to make a speech to the Bretton Woods meeting and that people had known in advance that it was supposed to be a major policy announcement. Thus, Brady had told the president that they could not back down from the plan at the last minute.

Rhodes believed that Mulford's views on debt reduction had in fact changed by the time of the Brady Plan, but he also agreed with Feldstein that Brady had wanted to take a fresh look at the problem when he became Treasury secretary. Rhodes reiterated, however, that the primary motivation for the plan had been the political situation in Mexico.

Enders added that, whatever the reason that the Treasury had decided to take some action on the LDC debt problem, the Brady plan was possibly the only approach that met the critical test of not requiring government money.

Litan turned the discussion to the origins of the LDC debt crisis. Rhodes said that, because the leading central banks and the international organizations had been playing no role in recycling petrodollars, the large commercial banks had had no choice but to do that recycling by lending funds to the less developed countries. This description made it sound as if the banks had made these loans out of a sense of civic obligation. It is also possible, Litan argued, that the U.S. government, and the Federal Reserve in particular, had coerced the banks into making these loans. Or maybe the banks had simply entered into LDC lending in search of higher profits. Litan asked to what extent the Fed had been encouraging the banks to recycle, taking a hands-off approach, or warning the banks to be careful about this kind of lending.

Rhodes said that the banks had not been coerced or pushed into making LDC loans. Citibank Chairman Walter Wriston and other leading international bankers had felt that this lending was somewhat of a crusade to help both the international financial system and the developing world, and the speeches of senior bankers during the 1970s had been replete with comments about the banks performing a needed public function because nobody else was doing it. Rhodes said that the U.S. government and many Western governments had praised the banks for their actions, but, in the end, it had been bankers' decisions to make those loans; no one had forced them.

William Taylor said that he did not know what the regulators' views about LDC lending had been in the early and mid-1970s but that, by the late 1970s, the banks were being cautioned about their overexposure in the developing countries.

Enders noted that the issue of recycling petrodollars had been a major preoccupation of the U.S. government in the early 1970s. He thought that there had been great applause for the banks' willingness to receive the deposits and invest them but that, despite this substantial encouragement, there had been no coercion.

Geoffrey Carliner alluded to Enders's previous assertion that the LDC debt crisis of the 1980s had worked out better than the debt crisis of the 1930s because of the involvement of the U.S. government. Was it a widely shared view that the crisis would not have been resolved as well if the government had taken a hands-off approach during the 1980s, as it had during the 1930s?

Rhodes discussed two reasons why the debt problems of the 1980s had been resolved in a better way than the debt problems of the 1930s. First, the Bretton Woods institutions had not existed in the 1930s. It had made a big difference in the 1980s to have an International Monetary Fund that could bring together debtors and creditors and provide useful information as well as money. Rhodes said that both Volcker and Jacques de la Rosiere had worried that, if the debt problem had not been managed promptly and with the help of the Bretton Woods institutions, a financial crisis could have ensued.

Second, the 1930s debt had been almost entirely in the form of bonds, while, by a "stroke of fortune," the 1980s debt had been almost entirely in the form of bank loans. The resulting concentration of creditors had made it possible to renegotiate the terms of the debt in ways that would have been impossible with a diffuse and anonymous group of bondholders.

Feldstein wondered whether the concentration of creditors really had been a stroke of good fortune. Because the loans were concentrated in the money center banks, a default on the debt could have triggered a true financial crisis. If the debt had been securitized, however, with bonds dispersed around the world in many separate portfolios, a default on the bonds would not have triggered a financial crisis. Feldstein said that a decline in the value of LDC debt of $100 billion would have represented only 2 percent of the value of the New York Stock Exchange. While this would have meant a significant loss to some bondholders, it would not have imperiled the financial system as a whole.

Rhodes responded that the ability of the debtor countries to buy time, which had been greatly facilitated by the debt being in the form of loans, had been important. *Taylor* added that the developing countries had been able to work out their loans, while they would have been forced to simply default on any bonds.

Feldstein wondered if the debtor countries would be able to reenter the financial markets more quickly because there had been workouts of the old debt rather than defaults on it. He added that the 1980s debt crisis might not have arisen at all if the debt had been in the form of bonds because the bonds would probably have paid fixed interest rates. Thus, the sharp increase in interest rates from 1979 to 1982 would have reduced the value of the outstanding bonds, but it would not have forced the developing countries to default on their payments.

Jeffrey Frankel said that the 1980s debt problem had been worsened by the widespread acceptance in the 1970s of the view that changes in inflation rates were reflected one for one in changes in short-term interest rates. If the interest rates on the debt had been linked to commodity prices rather than to other short-term interest rates, the debt problem would have been much less severe.

Krugman pointed out that economic growth in the Latin American debtor countries had been relatively strong in the 1930s in the face of a disastrous world economy but had been very poor in the 1980s with a fairly strong world economy. So it seemed bizarre to argue that there had been a better outcome to the 1980s debt crisis.

Rhodes responded that virtually none of the 1930s debtor counties had been able to return to the financial markets until after World War II, which showed the high cost of defaulting. He also believed that the decline in the value of LDC bonds in the early 1980s would have been much larger than the $100 billion mentioned by Feldstein. Finally, he thought that the actions of the money center banks had been the only realistic way to recycle petrodollars during the 1970s, especially considering that the G-5 countries in particular, and the official sector in general, were not prepared to lead the effort.

Enders contrasted the continued involvement of developing countries with financial institutions during the 1980s with the default and subsequent withdrawal of developing countries from world financial markets during the 1930s. He asserted that this continued involvement in the 1980s, made possible by the use of loans rather than bonds, had meant that pressures could build up within the developing countries that are now resulting in fundamental economic reforms.

William Niskanen said that most of the debt policies of the U.S. government had seemed designed to cost money to either American banks or American taxpayers. He asked whether it was clear that those policies had been on net beneficial.

Enders said that both the Federal Reserve and the Treasury Department had made substantial use of so-called swap lines at various points in the LDC debt crisis and that, if there had been defaults on those loans, there would have been real losses for American taxpayers. But the use of the swap lines had been very important—for example, they had played a critical role in the recent Mexican agreement—and in fact there had been no losses for taxpayers.

There had, of course, been great losses incurred by the banks, and the central question was whether those losses would have been larger or smaller without the involvement of the government. Enders believed that the actions of the government and of the international organizations had helped keep the banks engaged with the developing countries until the countries had been ready to undertake serious reform. In the end, this reform will give the banks an opportunity to recoup more of their original investment than if the debt problem had been left solely to market forces.

Enders added that Volcker and others in the Federal Reserve had had a stronger sense of the importance of the developing countries to the United States than had most other people. If there had been a different Fed chairman at that time, the history of the debt problem might have been quite different than it was.

Rhodes added that Volcker and de la Rosiere had been instrumental in "bringing order to a process that was being driven by fear." He thought that those two people in particular had been important catalysts in creating a global framework for dealing with the debt problem. After that framework had been set, however, he believed that it had been right to allow the banks and countries to negotiate between themselves.

Mussa argued that a key reason that the petrodollars had been recycled through the international banking system had been the perception of several parties that the governments of the developed countries would intervene to protect their interests. The people with funds to deposit had assumed that the governments would in some way guarantee the value of those deposits, and the bankers had assumed that the governments would help the banks collect on their outstanding loans. Mussa believed that this de facto intervention by the governments had represented a serious distortion of the international allocation of capital.

As for government intervention after the crisis began, Mussa conceded that there was an argument for government intervention to prevent a financial crisis. But he wondered whether an early default and an immediate writedown of banks' assets, as with creditors in a typical bankruptcy resolution, would have been preferable to the long, dragged-out process through which the same end had been achieved gradually.

Feldstein noted that some people in Washington had been suggesting a more lenient treatment of debtor countries well before the Brady plan had been adopted. Would it have been better if the Brady Plan had been adopted earlier, or was it right to wait until countries like Mexico had initiated significant economic reforms?

Enders responded that, if the U.S. government had produced more resources or induced more debt forgiveness at an earlier point in the crisis, it would have greatly eased the developing countries' short-term problems but also greatly prolonged them. Enders explained that, when the debt crisis began, he had been very worried that Latin America was a political tinderbox, and he thought that the Treasury and the Federal Reserve should have taken a more lenient position for foreign policy reasons. But, when the international institutions proposed a variety of sensible policy actions and made their loans conditional on policy performance in the usual way, very little changed in the debtor nations. In the end, fundamental economic reform was instituted only when the people had become desperate. In Mexico, for example, it was the runaway inflation that had ultimately persuaded the country to start the reform process. So more debt relief at an earlier time would simply have prolonged those countries' underlying economic problems.

Enders emphasized that he was not opposed to the small amount of aid that had been given at an early point in the crisis. In fact, he had been strongly in favor of making those resources available and of encouraging coordinated lending by the banks. He thought that it would actually have been damaging, however, to have made large quantities of aid available through an early Brady Plan.

Rhodes responded to several previous comments. First, he addressed the merits of an early Brady Plan, arguing that neither the banks nor the debtor nations would have benefited from it. In 1982, the banks did not have sufficient capital or reserves to cover the asset writedowns that were required for significant debt reduction. By 1989, they had increased their capital and reserves sufficiently to make the Brady plan possible. Also, Rhodes said that he shared Enders's view that the debtor countries had not started to implement basic structural reforms until 1985. Their previous reforms had consisted of a variety of short-term stabilization programs—based on adjusting the exchange rate in an attempt to build trade surpluses—that did not address their fundamental economic problems. When banks had tried to "prime the pump" for reform in Argentina by lending money in advance, Rhodes felt that it had actually exacerbated their problems.

Second, Rhodes said that, although he could not speak for any other banks, Citibank at least had not thought that the U.S. government was going to stand behind their loans to developing countries. If mistakes had been made, they were the bank's own mistakes and had not been made on the assumption that someone would bail them out. Rhodes said that he sometimes believes that commercial bankers are driven by fear, greed, and ignorance, but he hoped that some lessons had been learned in the 1980s. In fact, he thought that the future problem would be, not profligate bankers lending money to everybody, but rather a dearth of banks that lend to the developing world.

Enders concluded that the LDC debt story was ending reasonably well, although maybe for the wrong reasons. The U.S. government had not devoted a lot of resources to the problem, but, because major political upheavals had been avoided, there is a good chance of improved economic growth in Latin America.

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