

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: Developing Country Debt and Economic Performance, Volume 1: The International Financial System

Volume Author/Editor: Jeffrey D. Sachs, editor

Volume Publisher: University of Chicago Press

Volume ISBN: 0-226-73332-7

Volume URL: <http://www.nber.org/books/sach89-1>

Conference Date: September 21-23, 1987

Publication Date: 1989

Chapter Title: Introduction to "Developing Country Debt and Economic Performance, Volume 1: The International Financial System"

Chapter Author: Jeffrey D. Sachs

Chapter URL: <http://www.nber.org/chapters/c8985>

Chapter pages in book: (p. 1 - 36)

1 Introduction

Jeffrey D. Sachs

1.1 Introduction

The Project on Developing Country Debt undertaken by the National Bureau of Economic Research in the past two years seeks to provide a detailed analysis of the ongoing developing country debt crisis. The focus is on the middle-income developing countries, particularly those in Latin America and East Asia, though many lessons of the study should apply as well to the poorer debtor countries in sub-Saharan Africa.

The urgency of the NBER study should be self-evident. For dozens of developing countries, the financial upheavals of the 1980s have set back economic development by a decade or more. Poverty has intensified in much of the developing world as countries have struggled under an enormous external debt burden. Moreover, the world financial system has been disrupted by the prospect of widespread defaults on the foreign debts of the developing world. More than six years after the onset of the crisis, almost all of the debtor countries are still unable to borrow in the international capital markets on normal market terms.

Table 1.1 shows several aspects of the economic crisis of the major debtor countries in recent years. Since the dramatic outbreak of the crisis in 1982, economic growth has slowed sharply or has been negative. Per capita incomes in the most indebted countries are still generally well below the levels of 1980. And ominously, debt-export ratios are higher today than at the beginning of the crisis.

Future growth prospects are clouded by a sharp drop in the share of capital formation in GDP. At the same time, inflation has risen to remarkable levels throughout Latin America. The mechanisms behind the epidemic of high inflations are basically the same that caused the

Table 1.1 The Economic Crisis in the Heavily Indebted Countries

	Average 1969–78	1979	1980	1981	1982	1983	1984	1985	1986
Per capita GDP (annual change)	3.6	3.6	2.6	–1.6	–2.7	–5.5	–0.1	0.9	1.4
Inflation (annual rate)	28.5	40.8	47.4	53.2	57.7	90.8	116.4	126.9	76.2
Gross capital formation (percent of GDP)	n.a.	24.9	24.7	24.5	22.3	18.2	17.4	16.5	16.8
Debt-export ratio	n.a.	182.3	167.1	201.4	269.8	289.7	272.1	284.2	337.9

Source: All data refer to the fifteen heavily indebted countries: Argentina, Bolivia, Brazil, Chile, Columbia, Ivory Coast, Ecuador, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, Yugoslavia. Data are from the IMF *World Economic Outlook*, April 1987. Inflation refers to the consumer price index.

n.a. = not available.

hyperinflations in Central Europe after World War I, with foreign debts now playing the role that reparations payments played in the post-World War I crisis.

The NBER Project analyzes the crisis from two perspectives, that of the individual debtor country, and the international financial system as a whole. This volume contains the studies of the international financial system as a whole. The country studies are contained in two companion volumes, *Developing Country Debt and Economic Performance: Country Studies* (volumes 2 and 3). A major goal of the country studies is to understand why some countries, such as Argentina or Mexico, succumbed to a serious crisis, while others, such as Indonesia or Korea, did not. Another important goal is to understand why most of the debtor countries have been unable to overcome the crisis despite many years of harsh economic adjustments. To analyze such questions, the NBER commissioned eight detailed country monographs, covering four countries in Latin America and four countries in the Middle East and East Asia. Each study was prepared by a team of two authors, a U.S.-based researcher and an economist from the country under study: Argentina, by Rudiger Dornbusch and Juan Carlos de Pablo; Bolivia, by Juan Antonio Morales and Jeffrey D. Sachs; Brazil, by Eliana A. Cardoso and Albert Fishlow; Mexico, by Edward F. Buffie, with the assistance of Allen Sangines Krause; Indonesia, by Wing Thye Woo and Anwar Nasution; the Philippines, by Robert S. Dohner and Ponciano Intal, Jr.; South Korea, by Susan M. Collins and Won-Am Park; and Turkey, by Merih Celâsun and Dani Rodrik.

The individual country studies can answer only some of the questions about the crisis, since global factors have undoubtedly been key to many of the developments in the past few years. Indeed, as Lindert and Morton stress in their contribution to this volume, international debt crises have been a recurrent part of the international financial landscape for at least 175 years, in the 1820s, 1870s, 1890s, 1930s, and 1980s. It is important to understand the fundamental properties of the international macroeconomy and global financial markets which have contributed to this repeated instability.

The NBER studies in this volume cover a wide range of topics. Peter Lindert and Peter Morton study the history of sovereign debt from 1850 until the present, offering us a sweeping historical panorama and several important new findings. Perhaps most important is their conclusion that some form of debt relief (i.e., a renegotiation of the foreign debt that reduces the present value of the repayment stream below the original contractual level) has been a central feature of most "work-outs" of past debt crises. Barry Eichengreen reviews in detail the history of U.S. capital market lending to sovereign borrowers in the

20th century, and arrives at several conclusions in accord with Lindert and Morton.

Three papers in this volume take up the issues of adjustment problems in the debtor countries. As the country case studies amply document, adjustment to the debt crisis in the 1980s has been anything but smooth! Six years after the onset of the crisis, inflation in Latin America was averaging more than 150 percent per year, and no major debtor country had restored normal access to borrowing on the international capital markets. The papers by Sebastian Edwards, Jeffrey Sachs, and Stephan Haggard and Robert Kaufman, all complement the country studies in shedding some light on the adjustment problems of the debtor countries.

Edwards emphasizes the profound difficulties of combining macroeconomic policies (e.g., reductions in the public-sector deficit) with structural policies (e.g., tariff reductions). Sachs emphasizes the limitations in IMF and World Bank conditionality, and argues that debt relief should play an important role in many of the programs supervised by the international institutions. Haggard and Kaufman focus on the *political* requirements for successful stabilization, and suggest that the political design of adjustment programs is as important as their economic design.

The final three papers in this volume focus on various global aspects of the problem. Paul Krugman examines the relationship of debtor governments and their private bank creditors. Rudiger Dornbusch discusses the linkages of industrial country macroeconomic policies and debtor country economic performance. Stanley Fischer, in the final paper of the volume, examines various proposals for global solutions to the debt crisis.

1.1.1 The Creditor and Debtor Interpretations of the Debt Crisis

The international debt crisis has already given rise to many oversimplified interpretations, most of which can be dismissed on the basis of the studies in the NBER project. Simple ideas abound on this topic, often because they serve particular vested interests. Creditors want to blame the crisis on the policy mistakes of the debtor governments. Debtors want to blame the crisis on the macroeconomic and trade policies of the creditor governments. Both sides are keen to neglect the more nuanced historical record.

The mainstream creditor interpretation (as expressed variously by the United States government, the international institutions, and the commercial banks) can be summarized as follows. The debt crisis emerged largely because of the policy mistakes of the debtor governments. Loans were wasted by inefficient state enterprises, or were squandered in capital flight. "Successful" governments were those like

South Korea, which pursued free-market economic policies, while unsuccessful governments smothered economic growth with government regulations. With sufficient economic reforms, including trade liberalization and an encouragement of foreign direct investment, the debtor countries will be able to grow out of the current crisis.

Most creditors have also maintained that the only proper way to manage the current crisis is to insist that the debtor governments honor their debts in full, since to do otherwise would threaten the international financial system. To grant debt relief to the debtors, they also suggest, would hurt the debtors more than it would help them, because it would cut the debtors off from future borrowing from the world financial markets, and thereby hinder their economic growth.

The debtor perspective of course differs at key points. Debtor governments hold that the crisis erupted because of the rise in world interest rates, the fall in commodity prices, and the collapse of world trade at the beginning of the 1980s. They blame the macroeconomic policies of the creditor governments, particularly the U.S. fiscal policies, for many of the global shocks. Debtor governments typically downplay the role of debtor country policies in the crisis, and often state that advocates of "free market policies" are responding to the crisis by serving foreign interests (e.g., multinational firms) at the expense of domestic interests.

Many debtor governments argue that successful adjustment will require some debt relief. One reason for this pessimism is the view that attempts to honor the debt burden through increased exports would merely promote offsetting protectionist pressures in the creditor economies. Another reason is the view that the austerity required to service the debts on the original terms would generate political and economic instabilities that would be self-defeating, and ultimately detrimental to the creditors as well as to the debtors.

The evidence from the NBER study belies many of the points commonly made by both the creditors and the debtors. The NBER study offers fresh evidence on several important issues: the sources of the debt crisis (and of debt crises in the past); the patterns of economic adjustment in a debtor country after a debt crisis gets underway; the nature of bargaining between debtors and creditors; and the role for public policy in easing or eliminating the global crisis. These subjects are taken up in detail in the following sections.

1.2. Origins of the Debt Crisis

The debt crisis arose from a combination of policy actions in the debtor countries, macroeconomic shocks in the world economy, and a remarkable spurt of unrestrained bank lending during 1979–81. The

“unsuccessful” adjusters (all but Indonesia and South Korea among the countries in the NBER study) fell prey to a common pattern of policy actions: chronically large budget deficits; overvalued exchange rates; and a trade regime biased against exports in general, and agriculture in particular. These policies would have hindered economic performance in most circumstances, but they provoked a deep crisis when combined with severe shocks to world interest rates, exchange rates, and commodity prices, in the early 1980s. The crisis was greatly exacerbated because for many years the commercial banks provided financial support for the bad policies of the developing countries, particularly during 1979–81, and then abruptly withdraw new credits starting in 1982.

1.2.1 The Role of Global Shocks

The importance of global macroeconomic changes in provoking the current debt crisis has been widely noted (see Sachs 1987 for a review of this issue). The growth of the Eurodollar market and the OPEC price shocks of 1973–74 put in motion a period of rapid bank lending to the developing countries. During the period 1973–79, the export proceeds of the developing countries boomed, while nominal interest rates on the loans were low, contributing to the happy state of affairs that debt-to-export ratios remained modest despite heavy borrowing by the developing countries. Indeed, for the non-oil LDCs as a whole, the debt-export ratio was lower in 1980 than in 1973, while for the western hemisphere LDCs it was only marginally higher in 1980 compared to 1973, as can be seen in the data in table 1.2.

At the end of the 1970s, therefore, the pace of international lending did not seem to pose a serious danger to the commercial banks or to the world economy. But few observers fully appreciated how much this happy state of affairs depended on nominal interest rates remaining below the growth rate of dollar exports of the borrowing countries (put another way, *real* interest rates remaining below the growth rate of *real*

Table 1.2 Debt-Export Ratios, 1973 to 1986, as a Percentage, Selected Years

(percent)	1973	1980	1981	1982	1983	1984	1985	1986 ^a
Non-oil LDCs	115.4	112.9	124.9	143.3	152.8	148.3	162.0	162.2
Western Hemisphere LDCs	176.2	178.4	207.9	273.1	290.4	275.2	296.2	331.3

Source: International Monetary Fund, *World Economic Outlook*, April 1986 and October 1986 editions.

^aPreliminary.

exports). Even worse, almost nobody foresaw that the era of high export growth and low interest rates would come abruptly to an end at the end of the 1970s:

In the happy case that interest rates are below export growth rates, borrowers can borrow all the money needed to service their loans without suffering a rise in the debt-to-export ratio (since exports will grow faster than the debt). In other words, the borrower does not have to contribute any of its own resources to servicing its debts. Once the interest rate rises above the export growth rate, however, then the country cannot simply borrow the money to service its debts without incurring a sharply rising debt-to-export ratio. Sooner or later, the country will be cut off from new borrowing, and it will have to pay for its debt servicing out of its own national resources, i.e., by running trade surpluses vis-à-vis the rest of the world.

The remarkable fact is how abruptly the interest rate-growth rate relationship was reversed as of 1980, as shown in figure 1.1. Extremely tight monetary policies in the industrial countries, designed to fight inflation, provoked a sharp rise in interest rates, an industrial country recession, and a steep fall in the export prices and terms of trade of the developing countries. The debt crisis followed relentlessly upon the resulting rise in interest rates and the collapse in developing country export earnings. All of a sudden, all of the debt warning signs started to fly off the charts, as seen by the rapid increase in the debt-export and debt-service ratios after 1980. Commercial bank lending dried up once the debt-export ratios started to soar. Total gross bank lending to the non-oil developing countries rose by 24 percent in 1980 over 1979, 18 percent in 1981, and only 7 percent in 1982.

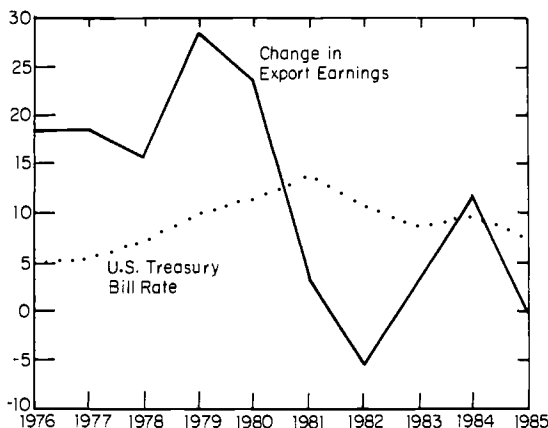


Fig. 1.1 Interest rates and annual change in non-oil export earnings

1.2.2 The Role of Bank Lending Behavior

Few observers perceived the risks of international lending as of the end of the 1970s, least of all the lenders themselves. Lindert and Morton, as well as Eichengreen, suggest that in earlier historical experiences as well, lenders lost sight of the inherent risks of cross-border lending. In the late 1970s, bankers adopted the credo of the world's leading international banker, Citicorp Chairman Walter Wriston, who justified the heavy international lending with the declaration that "countries never go bankrupt." In the mid- and late 1970s, the commercial banks were making enormous profits on their cross-border lending to the developing countries. In Citicorp's case, overall international operations accounted for 72 percent of overall earnings in 1976, with Brazil alone accounting for 13 percent of total bank earnings, compared with 28 percent for all U.S. operations! (Cited in Makin 1984, 133–34.)

The banks had the recent loan experience to back them up. As already pointed out, the combination of high export growth rates and low interest rates meant that debt-to-export ratios remained under control despite the heavy lending. There was no real evidence, of course, that the countries would be willing or able to pay back their loans, or even service them, *with their own resources*, but that did not seem to matter: new lending to repay old loans made sense in the circumstances.

One can fault the banks severely for not looking more deeply into the quality of economic management in the developing countries during this period. Few banks, apparently, were concerned with the question of whether the debtor countries would be willing and able to service their debts if debt servicing had to come out of national resources rather than out of new loans. This issue seemed to be an abstract concern, at least through the end of the 1970s.

What is truly remarkable about the bank behavior is not the lending during 1973–79, but rather the outpouring of new lending during 1980–81, even after the world macroeconomic situation had soured markedly. In table 1.3 we see the astounding fact that in a mere two years, 1980 and 1981, net bank exposure to the major debtor countries nearly doubled over the 1979 level. Thus, in the two years *after the rise in real interest rates*, the commercial banks made about as many net loans to the major debtors as during the entire period 1973–79.

This late burst of lending is all the more remarkable, and difficult to justify, in light of the enormous capital flight that was occurring at the same time, as shown in table 1.4. In the case of Argentina, of the tremendous rise during 1980 and 1981 in the overall gross debt of the country, 84 percent was offset by the outflow of private capital, according to the estimates of Cumby and Levich (1987). For Venezuela, the offset is well over 100 percent. I will discuss the origins of the capital flight in more detail below.

Table 1.3 Net Liabilities of Countries to International Banks in the BIS Reporting Area (\$ billion)

Country	December 1979	December 1981
Argentina	5.3	16.3
Brazil	28.8	44.8
Mexico	22.5	43.4
Subtotal	56.6	104.5
Indonesia	-0.1	-1.5
Malaysia	-1.3	0.2
South Korea	7.2	13.7
Thailand	1.6	1.8
Subtotal	7.4	15.2

Source: Bank for International Settlements, "The Maturity Distribution of International Bank Lending," various issues.

Table 1.4 Capital Flight and Change in External Debt during 1980 and 1981 for the Major Debtors

	Capital Flight (1980 and 1981)	Change in Gross Debt	Ratio: (1)/(2)
Argentina	12.8	10.8	0.84
Brazil	19.8	1.9	0.10
Mexico	35.1	15.6	0.44
Venezuela	7.8	13.0	1.67

Source: Cumby and Levich (1987), tables in data appendix. The capital flight variable is according to the World Bank definition reported by the authors.

New market-based lending by the commercial banks to the developing countries virtually disappeared after 1982. Even where lending continued, the transfer of net resources to the country (i.e., new lending minus total debt servicing on existing debt) was almost everywhere negative: the debtor countries paid more to the commercial banks than they received in new funds. Some countries received so-called "involuntary loans" as part of financial workout packages, usually linked to an IMF program. In such involuntary lending, the banks agreed to contribute new funds on a pro rata basis, relative to their exposure at an initial date. Even in this case, however, the new lending was invariably less than the amount of debt service payments due from the country to the bank creditors, so that the net resource transfer to the country remained negative.

The heavy commercial bank lending, particularly during 1979–81, certainly created the potential for a serious international banking crisis.

As shown in table 1.5, the cross-border exposure of the U.S. money-center banks at the end of 1982 to all of the developing countries equalled nearly three times total capital, and to Latin America alone amounted to almost two times bank capital. This exposure was very highly concentrated: about three-fourths of all U.S. commercial bank lending to more than 40 LDCs was centered in just four countries—Argentina, Brazil, Mexico, and Venezuela. The usual prudential rule of limiting exposure to any single borrower to 10 percent of bank capital was also ignored. The 10 percent rule was skirted by major U.S. banks by counting all different types of public sector borrowers in one country (e.g., state enterprises, central government, etc.) as distinct borrowers, even though they were all backed by the same “full faith and credit” of the central government and therefore reflected nearly identical credit risks.

1.2.3 The Role of Debtor Country Policies

In the easy-money period of the 1970s, commercial banks did not seriously consider the policies of the debtor countries. As loans were not serviced out of the country’s own resources, but rather out of fresh borrowing, the countries were never put to the test of whether their loans were well used and their economic policies sound. Nor were there many complaints about the policies of most of the debtor countries, with the exceptions of Jamaica, Peru, and Turkey, which re-scheduled ahead of the rest of the other countries.

It is only with the emergence of the debt crisis itself that banks began to examine the soundness of the earlier borrowing. Which countries

Table 1.5 U.S. Bank Assets in the Debtor Countries, Nine Major Banks

	End-1982	Mid-1984	March 1986
Total Exposure (\$ billion)			
All LDCs	83.4	84.0	75.6
Latin America	51.2	53.8	52.2
Africa	5.6	4.9	3.6
Exposure as Percentage of Bank Capital			
All LDCs	287.7	246.3	173.2
Latin America	176.5	157.8	119.7
Sub-Saharan Africa	19.3	14.3	8.1

Source: Federal Financial Institutions Examination Council, “Country Exposure Lending Survey,” various statistical releases. End-1982 from statistical release of 15 October 1984; March 1986 from release of 1 August 1986. Exposures are calculated using data for “Total amounts owed to U.S. banks after adjustments for guarantees and external borrowing.” Total exposures are calculated for all LDCs (OPEC, Non-oil, Latin America (Non-oil Asia, Non-oil Africa); Latin America (Non-oil Latin America plus Ecuador and Venezuela); and Africa (Non-oil Africa plus Algeria, Gabon, Libya and Nigeria).

could service their debts without a crushing blow to the domestic economy? Which countries would lack the economic or political stamina to maintain debt servicing? To some extent, of course, the answer turned on the amount of the borrowing itself relative to national income. But many other features were of crucial significance: the extent to which the debt was held by the public versus the private sector; the distribution of production between tradables and nontradables; the uses to which the earlier borrowing had been put (consumption, fixed investment, financing of private capital flight); and so forth. In all cases, these various issues depended integrally on the types of policies that the various borrowing governments had been following, and on the motivations for the foreign borrowing in the first place.

The NBER studies suggest that two fundamental dimensions of policy require emphasis: fiscal policy and trade policy. Moreover, the studies suggest that while certain patterns of policymaking were both dysfunctional and deeply rooted, the specific policies pursued during 1980–82 (after the shift in the world macroeconomic environment) were often pivotal. Did the government adjust to the changed international environment effectively, or did it continue to behave as if nothing had happened?

The differences across countries in response to the challenges of 1980–82 are striking. As Collins and Park made clear in their study of South Korea (see the country studies volumes), the South Korean government adjusted strongly to the global shocks after 1979: budget deficits were cut, the exchange rate was devalued, and a policy of heavy investment in highly capital intensive industries was scaled back. Nineteen eighty was a year of economic and political crisis, but by 1981 the economy was already readjusting to the new global environment. Indonesia and Turkey similarly adjusted early on. Indonesia had devalued substantially in 1978, which helped it greatly in the subsequent adjustment. Turkey in fact had fallen into economic crisis already by 1977–78, and political crisis soon thereafter. Strong adjustment measures, backed by the international official community, were already being set by early 1980. When a military coup intervened, the military government continued the adjustment policies that the preceding civilian government had set in motion, and even retained as deputy prime minister Mr. Turgut Ozal, who had originated the reform effort in the previous civilian government.

The contrast with the other five countries in the NBER study could not be more stark. In Brazil, for example, when the planning minister, Mr. Mario Simonsen, began to apply budget-tightening measures in 1979, the policies were vigorously attacked as “recessionist,” and Simonsen was soon replaced by another minister, Mr. Antonio Delfim Netto, whose response to the external shocks was an *acceleration* of

foreign borrowing. Rather than restraining spending at the crucial moment, Brazil stepped on the accelerator, a choice that still haunts the economy today. In neighboring Bolivia, political chaos effectively blocked any coherent response to the global economic shifts. Bolivia had no less than eleven heads of state between 1978 and 1982, as the economy drifted towards hyperinflation.

In Argentina, policies went similarly awry. At almost the moment that world real interest rates began to soar, Argentina embarked on a disastrous policy of pegging the Argentine peso to the dollar, with the result of discouraging exports and encouraging capital flight and imports, and thereby contributing to an enormous bulge in foreign borrowing. In Mexico, the critical period from 1979 to 1982 was approached not with restraint and a sense of caution, but with the greatest increase in government spending in Mexico's entire history. Despite the warning signs in the world economy, the Portillo government increased government expenditure as a share of GNP from 32 percent in 1979 to an astounding 47 percent in 1982, and raised the public sector deficit to 17.6 percent of GNP in 1982.

Finally, in the Philippines, the political business cycle crashed against the international business cycle. The most significant excesses in Marcos's now legendary cronyism were being set in place as the world economic environment seriously deteriorated.

1.2.4 The Role of Fiscal Policy

Many of the policy actions in the debtor countries are not "mistakes" or technical misjudgments, but were the result of deeper political instabilities. The economies in Latin America, in particular, are deeply riven by great inequalities of income, which in turn prompt fierce political conflicts. The chronically large budget deficits in these countries are a reflection of these political conflicts. In some of the cases under study, the governments were too weak to resist the demands for spending from various highly mobilized social groups. In the most pathological cases, the political battle degenerated into a battle of "ins" versus "outs," with the ins using the apparatus of the government for narrow personal gain. The worst excesses of this sort are seen in the Philippines under Marcos, and in several Bolivian regimes in the late 1970s and early 1980s.

At the same time, the governments either could not, or chose not to, raise taxes on the economic elites. On both the spending and revenue sides, therefore, political institutions repeatedly failed to keep the demands for government spending in line with the government's limited tax collections. Foreign borrowing in the 1970s and early 1980s provided a short-term way out of these political dilemmas, by allowing governments to finance large budget deficits without incurring high inflationary costs in the short term. Simply put, the governments could borrow

from abroad, rather than face the monetary consequences of borrowing directly from the central bank. Once the net capital inflows ceased in the early 1980s, and governments had to start making net payments abroad, the inflationary consequences emerged, as governments were not able to reduce expenditures and raise revenues sufficiently in response to the shift from net inflows of foreign capital to net outflows. They instead turned to printing money to make up the shortfall in foreign lending.

One of the most talked about, and misunderstood, phenomena in the debt crisis is that of "capital flight." Capital flight refers to the accumulation of foreign assets by the private sector of an economy, often at the same time that the public sector is incurring sharply rising external debts. As an example, while the Mexican government accumulated debts of approximately \$75 billion to foreign creditors, the Mexican private sector accumulated claims abroad in the amount of perhaps \$40 billion. This phenomenon of heavy public debts and large private assets is mainly a reflection of the loose fiscal policies that we have been emphasizing.

The predominant mechanics of capital flight in the late 1970s and early 1980s were as follows: Suppose that the government increases transfer payments to the private economy. In order to finance these transfer payments, it borrows from the central bank. The central bank financing causes an incipient rise in the money supply as the government spends the borrowed funds. The higher money balances lead to a weakening of the exchange rate as the private sector, flush with cash, attempts to convert some of the increased transfers into foreign currency. This creates the tendency towards higher inflation (the weakening of the currency would tend to raise the domestic prices of imports, exports, and import-competing goods). In order to stabilize the price level, the central bank keeps the exchange rate from depreciating by selling foreign exchange in return for the domestic currency (the excess money balances are thereby drained from the economy). The central bank runs down its reserves, and the private sector increases its foreign asset holdings.

To maintain an adequate level of resources, the central bank itself might then turn to world capital markets for a foreign loan to replenish its reserves. Over time, the result would be the growing foreign debt of the central bank, and growing private sector claims held in the form of foreign currency (and perhaps actually held abroad). The phenomenon is labelled "capital flight," but is simply the consequence of (1) large fiscal deficits, and (2) an anti-inflationary policy of pegging the nominal exchange rate.

As noted below, the fiscal consequences of the foreign borrowing in the 1970s were exacerbated by a common pattern of policy actions after the debt crisis erupted. When the financial crisis hit in 1981 and

1982, many *private* firms that had borrowed heavily from abroad were put into financial distress. In country after country, governments took over the private debt on favorable terms for the private sector firms, or subsidized the private debt service payments, in order to bail out the private firms. This “socialization” of the private debt resulted in a significant increase in the *fiscal* burden of the nation’s foreign debt.

1.2.5 The Trade Regime

To the extent that foreign borrowing finances efficient investment in an economy above the level that would otherwise be financed with domestic savings, the foreign borrowing could well be prudent and welfare enhancing. The key condition is that the investment project yield a return that is above the world cost of capital, when the project’s costs and returns are measured at appropriate shadow prices (i.e., at prices that take into account the distortions in incentives in the borrowing economy). Of course, much of the heavy foreign borrowing did not finance investment at all. It was used, instead, to finance current consumption spending as well as capital flight by the private sector.

It is well known from trade theory that strongly protectionist policies drive an important wedge between market prices and shadow prices, and thereby tend to lead to important distortions in the allocation of investment spending. In particular, investment is allocated too heavily towards nontradables and import-competing goods, and too little towards exportables. The result is that investments that may be profitable at market prices may be unprofitable at appropriate shadow values. Brecher and Díaz-Alejandro (1977), among others, demonstrated that foreign borrowing to support such misallocated investment is almost surely welfare worsening.

There is considerable evidence from the studies of Bhagwati (1978), Krueger (1978), Balassa (1984), Sachs (1985), and others, that economies with heavily protectionist trade regimes fare less well in overall economic performance than economies with more balanced trade regimes. The superior performance of so-called “outward-oriented” regimes appears to involve not only a better allocation of investment spending along the lines just suggested, but also other factors that are more difficult to quantify (such as improved technology transfer from abroad, higher savings rates, more market competition, and a tendency towards better exchange rate management).

The country studies in the NBER project support earlier findings on the superiority of outward-oriented regimes. By far the most successful performer in the NBER study is South Korea, the quintessential outward-oriented economy. Outward-orientation is generally measured by the overall incentives of the trade regime on the production of exportables relative to import-competing goods. The evidence described

by Collins and Park suggests that the overall effect of trade incentives in Korea is to favor exportables, as opposed to the trade regimes in Latin America which have typically been anti-export (and favorable to import-competing sectors). As shown by Woo and Nasution, the Indonesian trade regime under Soeharto seems to lie between the outward orientation of the South Korean case, and the inward orientation of the Latin American cases. In Turkey, the trade regime became much more outward oriented during the 1980s.

In addition to tariffs and quotas, the management of the nominal exchange rate can have an important bearing on the relative profitability of exports versus import-competing goods. When the nominal exchange rate is overvalued, to the extent that the central bank rations the sale of foreign exchange for current transactions, the result is typically an implicit tax on exports, even if no tariffs or trade quotas are imposed. A black market for foreign exchange results from the rationing, allowing a rise in the domestic price of import-competing goods (which at the margin are imported at the black market rate). Exporters, on the other hand, typically must surrender exchange at the overvalued official rate. The typical result of the foreign exchange rationing, therefore, is to lower the relative price of exports, and to bias production away from the export sector.

As shown in Sachs (1985), and confirmed again by the country studies, the East Asian economies (South Korea and Indonesia in the NBER sample) never allowed a substantial black market premium to develop during the 1970s and 1980s, while the Latin American economies all had phases of substantial black market premia on their currencies.

Another dimension of policy is the balance of incentives between tradables as a whole relative to nontradables (e.g., construction and services). Even when foreign exchange is not rationed, so that a black market premium does not arise, the failure to devalue the nominal exchange rate in line with domestic inflation can result in the fall in tradables prices relative to nontradables prices, with the result that production of both exportables and import-competing goods (at least those import-competing goods not protected by quotas), are hurt relative to the production of nontradables. The Korean authorities clearly managed the nominal exchange rate throughout the 1970s and 1980s with a close eye on maintaining a rough constancy in the price of tradables relative to nontradables. Indonesia, as well, stands out as a rare case in which devaluations of the exchange rate (in 1978, 1983, and 1986) were undertaken explicitly in order to keep tradables goods in line with rising nontradables goods prices, even before a balance of payments crisis occurred.

Turkey provides a particularly interesting example regarding the trade regime, as documented by Celâsun and Rodrik. During the 1970s, Turkey

was afflicted by a chronically overvalued exchange rate (with a large black market premium), import rationing, and an overall anti-export bias. After the onset of the debt crisis at the end of the 1970s, the government moved to a strategy of export-led growth. This policy was based initially on a significant depreciation of the nominal exchange rate, which succeeded in raising the relative price of tradables, and of nearly unifying the black market and official exchange rate. Later, during the 1980s there was a progressive liberalization of the trading system. The results were impressive: nontraditional export growth was rapid, and provided the basis for overall growth of the economy in the 1980s. In their paper, Celâsun and Rodrik discuss at some length the contribution of the Turkish policy changes versus other special factors (e.g., the Iran-Iraq war) in promoting the export boom.

As already noted, the Latin American regimes have all been characterized by a considerable degree of import protection and general anti-export bias. In many cases, the exchange rate was allowed to become severely overvalued in real terms (with a considerable black market premium on foreign exchange), with the exchange rate moved only in the midst of an extreme balance of payments crisis. As with the budget, the exchange rate policy appears to reflect political conditions in Latin America as much as technical mistakes. The chronically overvalued exchange rate favors urban workers and the protected manufacturing sector at the expense of the agricultural sector, which has been politically weak in most countries since the Great Depression.

There are some additional lessons regarding the trade regime that are raised by the country studies. Contrary to a common view, outward orientation in the NBER sample of countries is not at all the same thing as a free-market trade policy (see Sachs 1987 for a further elaboration of this distinction in the experience of the East Asian economies). The outward-oriented countries in the study, South Korea, Indonesia (to some degree), and Turkey in the 1980s, all had successful export growth with continued import restrictions and heavy government involvement in managing trade. The key instruments in stimulating exports was not import liberalization, but rather (1) a realistic and unified exchange rate; (2) heavy investment in the exporting sectors, often spurred by government subsidies and direct credit allocations; and (3) an array of additional financial incentives for exporters.

More generally, the South Korean case belies the simple position often taken by the United States government and the IMF and World Bank, that "small" government, as opposed to effective government, is the key to good economic performance. As the study by Collins and Park makes clear, the government of South Korea played a leading role in organizing economic development. The government was sufficiently powerful, however, to be able to generate significant budget surpluses

to finance domestic investment, and to pursue a long-term policy of export-led growth. Also, given Korea's relatively equal distribution of income (the result in large part of extensive land reform in the late 1940s and early 1950s), the government was able to devote its attention to matters of efficiency rather than redistribution.

Another interesting aspect of the experience of South Korea and Turkey is the blurring of the distinction over time between import-competing firms and exporting firms. It is notable that in both countries much of the export boom of the 1980s was based on investments during the 1970s in heavily protected industries, which became profitable for exports in the 1980s. Moreover, at the time that the investments were made, they were decried by economists as an inefficient allocation of investment spending, with the incorrect argument (in hindsight) that such industries could not be expected to export in the foreseeable future. As it turned out, productivity improvements together with a modest depreciation of the real exchange rate and an export-promoting regulatory environment were enough to make these sectors profitable for export in the 1980s.

This finding is both good news and bad news for those who are hoping for a major export boom in the Latin American debtor countries. On the one hand, formerly protected industries can probably become exporting industries with only moderate changes in the real exchange rate. On the other hand, export promotion did not come out of thin air in South Korea and Turkey, but rather out of heavy investment expenditure during the 1970s. Since the burden of debt servicing is now causing a major drain on investment spending in the heavily indebted countries, the base for future export promotion is jeopardized. The authors of the studies for Argentina, Bolivia, Brazil, and Mexico all highlight this dangerous situation with regard to current investment spending.

1.3 Adjustment to the Debt Crisis

The NBER case studies examined in great detail the process of adjustment once a debt crisis begins. The patterns of adjustment in the eight countries under study certainly belie the easy optimism of the creditor community in the years after 1982. An external debt crisis sets in motion a process of economic deterioration that is extremely difficult to limit in the short term. Early optimistic forecasts of a rapid recovery in the debtor countries, such as by Cline (1984) or by Rimmer DeVries, relied on models that projected debtor country performance purely on the basis of external variables (e.g., world growth, interest rates, etc.). These studies entirely neglected the internal economic disarray in the debtor countries that is caused by a sudden cutoff in foreign lending,

combined with a sharp fall in commodities prices and a sharp rise in world interest rates.

The creditor community forecast a relatively smooth transition for economies that fell into debt crisis. Since the inflow of net capital declined sharply after 1982, the debtor economies had to shift from a position of current account deficits (i.e., net foreign borrowing) to a position closer to current account balance. Initially, it was felt, this would be brought about through a reduction of imports; subsequently, exports would grow over time in line with the growth in the markets in the industrial economies. The debtor economies would shift smoothly to a trajectory of export-led growth. Along this path, exports would exceed imports to the extent necessary to finance interest servicing on the foreign debt.

According to forecasting models such as Cline's (1984), the success of this strategy depended centrally on the external variables facing the debtor country: industrial country growth, world commodity prices, and world interest rates. Assuming an adequate trajectory for these variables (3 percent OECD growth, gently rising commodities prices, and gently declining world real interest rates), the recovery would take care of itself. Economic growth and world interest rates turned out to be close to Cline's estimates, though the economic recovery in the debtor nations did not materialize. Part of the discrepancy in Cline's forecast and the actual historical outcomes may have resulted from the decline in commodities prices after 1984, but a much larger part of the failure of Cline's model resulted from his neglect of the internal economic effects of an external debt crisis.

Remember that the debtor economies were hit by three simultaneous shocks: a cutoff in lending, a rise in world interest rates, and a fall in most commodities prices. The cutoff in new lending required that the current account balance move from deficit to near balance, and that the trade balance move from deficit to surplus (with the surplus required to finance the sharply higher interest payments on the foreign debt). Cline stressed the required adjustment in trade flows, but not the equivalent required shifts in savings and investment. Since the net foreign capital inflows before 1982 were financing domestic investment in excess of domestic savings, the cutoff in lending required a fall in investment relative to savings. As was shown in table 1.1, the common pattern was a sharp fall in the national investment rate after 1982. This fall in investment expenditure was bound to have deleterious effects on future growth prospects.

The cutoff in lending had particularly destabilizing effects since most of the foreign funds had been financing government deficits. All of a sudden, governments had to start making significant net resource transfers abroad. The sudden shift *in the public sector* from positive to

negative net resource transfers is shown in table 1.6, and is most dramatic for Argentina, Bolivia, and Mexico. The shift for Brazil is delayed until 1985–86, as is the case in Indonesia and the Philippines. (Note that the shifts in net transfers would tend to be higher if short-term debt were also included in the calculations.) Governments were therefore required to cut their non-interest deficits sharply, or to shift the method of their finance. Most of the governments undertook harsh cuts in public sector investment, but dramatic as those cuts were, they were insufficient to eliminate the financing gap left over by the shift from net capital inflows to net capital outflows.

Governments shifted to new forms of financing. Increased domestic bond finance tended to raise real interest rates substantially, while domestic money finance tended to raise inflation. Usually, governments struggled with some combination of lower public-sector investment, higher internal real interest rates, and higher inflation. These adverse developments often undermined the fiscal situation even further. Higher inflation reduced the real value of tax collections, while higher real interest rates increased the burden of servicing the stock of internal public debt. As recessions developed in the debtor countries, under the weight of higher real interest rates, reduced commodities prices, and falling public spending, the tax base fell in line with shrinking national income.

By 1987, as a result of a pandemic fiscal crisis, very high inflation was deeply entrenched in the major debtor countries in Latin America. In Argentina, Brazil, Mexico, and Peru, inflation was well into the

Table 1.6 Net Resource Transfers to the Public Sector (medium- and long-term debt, public and publicly guaranteed)

Country	Averages for period, percentage of GNP:		
	1981–82	1983–84	1985–86
Argentina	2.2	– 1.5	0.1
Bolivia	0.0	– 5.1	0.6
Brazil	0.2	0.8	– 2.2
Mexico	1.8	– 3.5	– 0.8
Indonesia	1.4	1.9	– 0.4
Philippines	2.0	2.0	– 0.6
South Korea	1.3	0.7	– 1.6
Turkey	0.0	– 0.4	– 0.6

Sources: Net resource transfers are defined as net loans minus interest payments, on medium- and long-term debt on public and publicly guaranteed debt. Data are from the World Bank, *World Debt Tables, 1987–88*, and earlier for 1979–81. GNP data are from the IMF, *International Financial Statistics Yearbook, 1987*. Note that the shift from positive to negative net transfers would tend to be even larger if short-term debt were included in the calculations.

triple-digit levels, as shown in table 1.7. In Bolivia, a hyperinflation during 1984–85 was brought under control, in part through a suspension of interest servicing on the foreign bank debts of the Bolivian government. Even countries that had traditionally maintained very low inflation rates, such as Venezuela, were suffering with inflation many times the country's norm.

The adverse effects of the cutoff in lending were greatly exacerbated by the simultaneous deterioration in the terms of trade for most of the debtor countries. It *cannot* be claimed, as some have tried, that the commodity price decline was the major cause of the debt crisis, since some countries such as Bolivia and Mexico fell into crisis even though commodity prices were strong by historical standards. Nonetheless, for almost all countries, prices for commodity exports fell in real terms after 1981, and thus exacerbated the capital market shocks. The decline in export prices lowered national income, and further squeezed government revenues, since the revenue base in most of the debtor countries was either directly or indirectly tied to commodity exports (directly through exports by state enterprises, as in Bolivia and Mexico; indirectly through export taxes, as in Argentina).

A successful strategy of debt servicing with growth requires the development of new exports. In general, however, major new export sectors require heavy investment. A devaluation can sometimes produce a rapid increase in exports (as happened in South Korea and Turkey after 1980, and Brazil after 1983), but only if there is substantial excess capacity resulting from earlier investments (or if there is a sharp domestic recession, which may free up domestic capacity for export

Table 1.7 Inflation Rates, 1985–87, Selected Latin American Debtor Countries

Country	Inflation Rate ^a		
	1985	1986	1987 ^b
Argentina	385.4	81.9	175.0
Bolivia	8,170.5	66.0	10.5 ^c
Brazil	228.0	58.4	366.0
Ecuador	24.4	27.3	30.6
Mexico	63.7	105.7	159.2
Peru	158.3	62.9	114.5
Venezuela	5.7	12.3	36.1

Source: Economic Commission for Latin America and the Caribbean (ECLAC), "La evolución económica en América Latina en 1987," January 1988 (Santiago, Chile).

^aConsumer Price Index, variations of December over December of previous year.

^bPreliminary.

^cNovember to November.

if the country produces tradables that are consumed domestically). Also, increasing the capacity of export industries often requires both public and private investment. New export sectors generally require new infrastructure in transport, communications, and perhaps port facilities, that usually are in the domain of public investment. Unfortunately, public sector investment has been among the hardest hit areas of government expenditure in the crisis countries of Argentina, Bolivia, Brazil, Mexico, and the Philippines.

1.3.1 Further Adverse Feedbacks in Adjusting to the Crisis

Adjustment to the external shocks has required enormous relative price changes within the debtor economies, but contrary to simple theory, those relative price changes have often intensified the crisis itself—at least in the short term. The inevitable effect of the cutoff in foreign lending, higher world interest rates, and adverse commodity price shocks, was a significant decline in domestic demand in the debtor economies, and therefore a sharp fall in the price of nontradable goods relative to tradable goods (i.e., a sharp depreciation of the real exchange rate, defined as the price of tradables relative to nontradables). This rapid shift against nontradables is, in principle, the motive force behind the desired shift in resources to tradables production. In practice, however, the rapid collapse of nontradables production had several highly deleterious effects in the economies under study, that in fact may have impeded the longer term reallocation of resources.

Most important, the collapse of nontradables prices led to financial distress for much of the nontradables sector. Not only did the profitability of nontradables production suffer when the real exchange rate depreciated, but nontradables firms that had incurred dollar-denominated debts found themselves unable to service their debts (the decline in the relative price of nontradables meant that nontradables output prices failed to keep pace with the rising cost of foreign exchange, which has to be purchased to service the debts). In many cases, the domestic commercial banks had borrowed internationally and then relent the borrowed funds in dollar-denominated loans in the domestic capital markets to firms in the nontradables sector. When firms in the nontradables sector could not pay back their debts, much of the banking system was put in jeopardy in Argentina, Bolivia, and Mexico. Note that firms in the tradables sector were typically better prepared to service their dollar-denominated debts, since tradables output prices moved in tandem with the price of foreign exchange.

In turn, the collapse of the banking system disrupted financial intermediation more generally. With banks at risk, domestic residents demanded a significant risk premium over foreign interest rates in order to maintain funds in the national banking system. Several governments

in Latin America were forced to take over many banks directly, or at least to take over the bad loans of much of the banking system. With many large conglomerates (known as *grupos* in Latin America) in financial distress, even the export-sector parts of the conglomerates were unable to attract new credits. (See Galbis 1987 for a further discussion of the role of the *grupos* in the Latin American financial system.)

Note that the central government faced the same problems as an overindebted firm in the nontradables sector. Since the public-sector debts were heavily dollar-denominated, while much of the tax base was effectively linked to nontradables production, the shift in the terms of trade against nontradables tended to exacerbate the fiscal deficits. Put another way, the domestic currency value of the government's external debt rose sharply relative to the domestic currency value of the government's tax revenues. Thus, in Brazil, for example, what looked like a moderate fiscal burden of foreign debt suddenly became enormous after the real exchange rate depreciations during 1980–82.

Once a government's fiscal situation has seriously deteriorated, a fiscal crisis can become self-fulfilling, as argued recently by Guillermo Calvo (1987). The fear of high future inflation, for example, can raise nominal interest rates, and thereby raise the interest costs for the government. Higher interest costs in turn widen the fiscal deficit and make inevitable the high future inflation. This kind of adverse feedback has apparently contributed to the sustained high interest rates in many of the debtor countries in recent years.

Despite the centrality of the public-sector budget in the origin and development of the crisis, there are profound difficulties in measuring and forecasting the fiscal position. Even the IMF auditing of the fiscal accounts, as recorded in the IMF's *Government Finance Statistics*, are inadequate to the task.

There are several kinds of measurement problems, many with economic significance. First, actions with fiscal consequences (e.g., actions that increase the public debt or the money supply) are made not only by the central government, but also by regional governments, parastatal enterprises, development banks, and the central bank. Often, the finance minister has little ability to measure, much less control, the consolidated public sector accounts. In most of the countries under study, the various governmental entities outside of central government can gain direct access to the central bank, or can get government guarantees for foreign borrowing, without the authorization of the finance minister.

Another problem is that private-sector obligations often quickly become public-sector obligations when a financial crisis hits, a point that we have already noted several times. Domestic firms cry for bailouts,

and foreign creditors often insist as well that the central government make good on the private-sector debts. The government takeover of the debt can be partially disguised (or at least hard to measure) if the takeover comes in the form of special exchange rates for debt repayments, subsidized credits, or other off-budget means of bailing out private debtors.

The net result of this fiscal complexity is that many countries are forced to rely heavily on inflationary finance even when the measured central government budget seems close to balance. Cardoso and Fishlow discuss, for example, the data problems in Brazil, where several years of triple-digit inflation were accompanied by measured deficits near zero. The small measured deficits led some to conclude that the inflation was purely an “inertial” phenomenon. This view was tested in the ill-fated Cruzado Plan, which attempted to use a wage–price–exchange rate freeze to break the inertia. After the collapse of the Cruzado Plan, most observers now concede that large fiscal deficits are the driving force of the high Brazilian inflation.

1.4 Renegotiating the Foreign Debt

The historical record, and the country experience, speak strongly on another point. To get out of a debt crisis, countries have almost always required a sustained period of time in which the debt-servicing burden is sharply reduced or eliminated. This financial “time out” has come about through a combination of a negotiated reduction of payments (as in the case of Indonesia during 1966–71), a substantial increase in official lending (as in the case of Turkey during 1979–81), or a unilateral suspension of debt-servicing payments (as in the case of Bolivian commercial bank debt, 1986–87). In recent years, most countries have not been able to achieve a significant “time out” through conventional negotiations. The Turkish bailout in 1979–81, for example, is a key exception that proves the rule. The generous official lending to Turkey during 1979–81 came mainly because of Turkey’s geopolitical significance as a NATO ally on Iran’s border, rather than as the result of conventional debtor country negotiations.

The NBER historical studies also make clear that debt relief has played an important role in the resolution of earlier crises. Relief has come in many forms (e.g., debt repurchases at a discount and conversions of debt into new debts with a lower servicing burden) that might prove to be relevant in the present circumstances. The studies by Lindert and Morton, and Eichengreen, both demonstrate that previous debt crises have usually ended in some forgiveness. A compromise is typically reached in which the debtors service some, but not all, of the debt that is due. *A partial writedown of the debt is the norm,*

not the exception. In the past, the compromise was typically reached as the result of bilateral negotiations between debtors and creditors. Lindert and Morton suggest that the involvement in the 1980s of third parties (mainly the creditor governments and the international financial institutions) has hindered the effective (though often messy) process for arriving at a solution to excessive debt.

The creditor view that debt relief would be harmful even for the recipient debtor countries, because these countries would be closed out of capital markets for many years in the future, is not supported by the historical experience. Both Lindert and Morton, and Eichengreen, find that countries that have achieved partial debt relief have not lost access to the markets to any greater extent than countries that continue to pay their debts. In the aftermath of global debt crises, neither “good” debtors nor “bad” debtors have been able to borrow. To quote Lindert and Morton,

Defaulting debtors were not consistently punished. Only a few cases of countries trying to default in visible isolation led to direct sanctions and discriminatory denial of future credit. Most of the defaults occurred in the worldwide crises of the 1930s—and possible the 1980s—when uncooperative debtors suffered no more than cooperative ones.

Eichengreen similarly concludes that, “If there were costs of default, they did not take the form of differential credit-market access in the first postwar decade.”

History offers many clear examples why. Argentina, for example, was the only country in South America to service the federal debt in the 1930s, under terms laid down by onerous treaties with Great Britain. The nationalist backlash against foreign influence helped to sweep Peron into power. Peron’s populist policies more than undid any beneficial reputational effects that Argentina might have garnered from its debt repayments in the 1930s.

1.4.1 Debt Management during 1982–87

The management of the crisis since 1982 has so far differed from the historical experience, at least in the sense that negotiated debt relief has so far played little role in the resolution of the crisis. Indeed, because of creditor government fears over the possibility of an international banking crisis, the whole thrust of creditor government policies since the crisis began has been to *avoid* debt relief, by pressuring the debtor countries to remain current on their interest servicing. (See Sachs 1986 for an elaboration of this interpretation of creditor government policies.)

The standard form of debt management was set in the aftermath of the Mexican crisis in mid-1982. The events in Mexico prompted strong

and almost immediate actions in support of Mexico from the official financial community, under the leadership of the United States. Within days of Mexico's announcement that it would be unable to meet its debt-servicing obligations, the U.S. government arranged for several forms of emergency official finance. On the other hand, the United States pressed hard on Mexico to maintain interest servicing to the commercial banks. In November 1982 an agreement was reached between Mexico and the IMF.

One novelty of the Mexican agreement was to link the IMF financing with new "concerted" lending from Mexico's bank creditors. The IMF declared that it would put new money into Mexico only if the existing bank creditors also increased their loan exposure. The requisite agreement with the commercial banks (involving a loan of \$5 billion, which covered a portion of Mexico's interest costs in 1983) took effect in early 1983. Additionally, the Mexican debt was rescheduled. Crucially, while the rescheduling called for a postponement of repayments of principal, the rescheduling also provided for *the continued and timely payments of all interest due*. In fact, the spread over LIBOR (The London interbank offer rate for dollar deposits) on Mexican debt was increased in the agreement, so that in present-value terms, there was no sacrifice by the banks in the debt-rescheduling process.

The Mexican agreement was quickly improvised, but it nevertheless became the norm for the dozens of reschedulings that followed. Like the Mexican program, virtually all of the debt restructurings have had the following characteristics:

1. The IMF has made high-conditionality loans to the debtor government, but such loans have been made contingent on a rescheduling agreement between the country and the commercial bank creditors.
2. The commercial banks have rescheduled existing claims, by stretching out interest payments, but without reducing the contractual present value of repayments.
3. The debtor countries have agreed to maintain timely servicing of interest payments on all commercial bank loans.
4. The banks have made their reschedulings contingent on an IMF agreement being in place.
5. The official creditors have rescheduled their claims in the Paris Club setting, and have also made such reschedulings contingent on an IMF agreement.

In the original conception of the debt management strategy, the concerted lending was to play a key role in guaranteeing that countries receive an adequate amount of international financing in order to stabilize and recover. In fact, after 1984, the amounts of concerted lending

dropped off sharply. Moreover, as shown in table 1.8, only the *largest* debtors, with the greatest bargaining power vis-à-vis the commercial banks, have been able to obtain concerted loans with any regularity. In the table, Sachs and Huizinga (1987) measure the size of concerted loans in a given year as a proportion of disbursed debt at the end of the preceeding year. On average, this ratio is far higher for the large debtors (Argentina, Brazil, Chile, and Mexico) than for the rest of the countries. Indeed, the fifteen smallest debtors in the table had 3.4 percent of the debt at the end of 1983, but received only 0.3 percent of the concerted loans during 1984–86.

We should stress as well that the whole notion of “new” money in the concerted-lending agreements is misleading, in the sense that most “new money” packages after 1982 have involved considerably less in new loans than was due to the same creditors in interest payments. Thus, even when Mexico or Argentina gets a new concerted loan, the check is still written by the country to the creditors, since the new loan only covers a fraction of the interest that is due to the creditors. The fact of negative net resource transfers points up one of the fallacies in a popular argument as to why debtor countries should not default. It is sometimes said that if a country defaults, it will not be able to attract new bank money. This is obviously not a major concern to a debtor country if the reduction in interest payments achieved by default systematically exceeds the amounts of new money that the country is able to borrow by not defaulting.

1.4.2 The Default Decision

It remains to ask why the debtor countries have by and large continued to service their debts fully in the 1980s, despite the fact that this has resulted in large net resource transfers to the creditors, at considerable economic cost to the debtor countries. In part, the answer may be simply one of time. In the first years of the crisis, most countries accepted the creditors’ arguments that the crisis could be quickly resolved. As that has not come to pass, more and more countries are taking unilateral actions with respect to debt servicing. By the end of 1987, several Latin American countries had unilaterally suspended at least part of the interest servicing of the debt, including Bolivia, Brazil, Costa Rica, Dominican Republic, Ecuador, Honduras, Nicaragua, Panama, and Peru.

Another aspect of the debt servicing policies involves the balance of power between debtors and creditors. Debtor governments fear the retaliation of the commercial banks, especially in the form of a cutoff in trade credits. In fact, many of the countries that have suspended interest payments in recent years (e.g., Brazil, Ecuador, and Peru), have been able to maintain their trade credit lines, though often at the cost of a sharply higher risk premium on the short-term borrowing.

Table 1.8 Medium-Term Concerted Lending as a Percentage of Debt Outstanding and Disbursed from Financial Markets^a

	1983	1984	1985	1986	Average 1983–1986
Argentina ^b	12	18	0	0	8
Bolivia	0	0	0	0	0
Brazil	11	14	0	0	6
Chile	35	16	9	0	15
Colombia	0	0	29	0	7
Congo	0	0	0	9	2
Costa Rica	0	0	0	0	0
Dominican Rep.	0	0	0	0	0
Ecuador	20	0	0	0	5
Gabon	0	0	0	0	0
Guatemala	0	0	0	0	0
Honduras	0	0	0	0	0
Ivory Coast	0	0	4	0	1
Jamaica	0	0	0	0	0
Liberia	0	0	0	0	0
Madagascar	0	0	0	0	0
Malawi	0	0	0	0	0
Mexico	11	6	0	8	4
Morocco	0	0	0	0	0
Nicaragua	0	0	0	0	0
Nigeria	0	0	0	4	1
Panama	0	0	3	0	1
Peru	16	0	0	0	4
Philippines	0	18	0	0	5
Senegal	0	0	0	0	0
Sudan	0	0	0	0	0
Togo	0	0	0	0	0
Uruguay	18	0	0	0	5
Venezuela	0	0	0	0	0
Yugoslavia	41	0	0	0	10
Zaire	0	0	0	0	0
Zambia	0	0	0	0	0

Sources: World Bank, *World Debt Tables, 1986–87*; IMF, *International Capital Markets, 1986*. Taken from Sachs and Huizinga (1987).

^aFor each year t , we calculate the ratio of the concerted loan CL_t , to the disbursed debt in year $t - 1$, $D_t - 1$.

^bIn 1987 Argentina received a concerted loan amounting to 6 percent of its 1986 outstanding loans.

Another kind of retaliation that is feared is a reaction by the creditor governments (especially the United States), either within the financial sphere or more generally in other areas of foreign relations. Countries fear that if they suspend interest servicing, they may lose access to support from the IMF, the World Bank, the Paris Club (for a rescheduling of debts with official bilateral lenders), foreign aid agencies, and

export credit agencies. Moreover, debtor governments fear that the leading creditor governments might withdraw other forms of foreign policy support (e.g., involving trade policy, security assistance, etc.), and might even back political opponents of the regime.

The United States government has repeatedly warned would-be recalcitrant debtors that nonpayments of interest on the foreign debt constitutes a major breach of international financial relations, and a major breach of normal relations with the United States. Countries that choose default with their bank creditors are forced into the position of simultaneously choosing a hostile action vis-à-vis the United States government. Most finance ministers, and their presidents, do not have the stomach for such a confrontation, which takes steady nerves and a considerable capacity to explain the crisis to the domestic populace.

A final, and often overlooked reason that countries do not default involves the domestic political economy of the debtor country. In the case of a unilateral suspension of debt payments, some sectors and classes of the economy will tend to gain and others will tend to lose. Gainers from tough bargaining will usually include the nontradables sectors, urban workers, and landless peasants producing for the domestic market. Losers will include the tradables sectors (both because of repercussions on the exchange rate, and because of possible retaliation), and the domestic financial community, which has a stake in harmonious financial relations with the foreign banks. Left-wing governments, such as Alan Garcia's in Peru, are therefore more likely to please their working class constituency by taking a hard line on the debt than are governments oriented to exporters and the banking community. Most developing country governments, however, have sufficiently close ties with leading bankers (domestic and foreign) and leading exporters, that they are unwilling to run the risk of an overt international confrontation.

1.5 New Approaches to Managing the Debt Crisis

The unsatisfactory economic performance of most of the debtor countries in the past five years has led to continued suggestions for new approaches to international debt management. The NBER studies by Fischer, Krugman, and Sachs consider several alternatives that have been widely discussed, as well as some new proposals. Edwards and Sachs discuss the appropriate role of the international institutions, and the appropriate kinds of policy reforms, for overcoming the crisis.

All of the authors stress that a workable solution to the debt crisis will differ across countries. Some countries, such as Bolivia, Sudan, or Zaire, clearly can service only a small fraction of their debt on market terms. When Bolivia tried to meet its debt-servicing obligations during

1982–84, the result was a hyperinflation (the links between debt servicing and hyperinflation are explained by Morales and Sachs). Other countries can service some, but perhaps not all of their debts at normal market terms. Thus, a real case-by-case approach would recognize the need for substantial debt relief for some of the poorest and weakest economies, and perhaps some lesser degree of relief for the other debtor countries.

1.5.1 The Case for Debt Relief

Krugman and Sachs both illustrate the efficiency case for debt relief (See also Sachs 1988 for a further analysis). A heavy debt burden acts like a high marginal tax rate on economic adjustment. If the economy successfully imposes austerity, much of the benefit accrues to the foreign creditors. Partial debt relief can therefore be Pareto improving (i.e., to the benefit of *both* creditors and debtors), by improving the incentives for the debtor country to take needed adjustment actions. In political terms, partial debt relief can strengthen the hand of moderates, who would pay some but not all of the debt, against the hand of extremists, who would like to service little or none of the debt.

Debt relief is extremely difficult to negotiate, for several reasons. First, because each debtor country has many types of creditors, and the various creditors have the incentive to let the *others* grant the debt relief while they individually try to hold on to the full value of their claims. Second, the linkage between debt relief and improved economic policies is not sufficiently tight to make debt relief an obvious proposition for the creditors, a point stressed by Sachs. Even if creditors understand that the existing overhang of debt acts as a major disincentive to policy reform in the debtor countries, they might be skeptical that debt relief alone would be sufficient to lead to policy reforms. The creditors tend to view debt relief as throwing away money, i.e., giving up the potential of getting fully repaid, with little tangible benefit. As Sachs points out, the strongest case for debt relief can be made if the relief can be explicitly conditioned on particular policy reforms in the debtor countries.

Fischer offers an analysis of a broad range of proposals for modifying the current management of the crisis, dividing his analysis between those alternatives that would merely restructure the debt, and those that would effectively cancel part of the debt. In the first group, he considers debt-equity swaps, and echoes the conclusions of Krugman that debt-equity swaps are unlikely to be a major vehicle for resolving the crisis. Indeed Krugman shows how such swaps can very easily be detrimental to the debtor country.

Among proposals that would offer partial forgiveness to the debtor countries (i.e., an explicit write-down of part of the present value of

the debt), Fischer focuses heavily on the idea of creating an International Debt Discount Corporation (IDDC). The IDDC would buy developing country debt from the banks in exchange for claims on the institution, and in turn collect from the debtor countries. The basic idea is that the IDDC would buy the debt at a discount, and then cancel some of the debt due from the debtor country. Calculations in Sachs and Huizinga (1987) show that the IDDC, far from hurting the commercial banks, could actually raise their market value, because the bank stock prices have *already* been deeply discounted in view of their LDC debt exposure.

Fischer stresses, however, that the most likely scenario is that partial relief will result from bilateral negotiations between creditors and debtors (as in the historical examples described by Eichengreen, and by Lindert and Morton) rather than through a single international relief operation.

Krugman analyzes in detail one purported remedy to the current crisis: the use of so-called debt-equity swaps. Upon close analysis, these transactions are much less attractive to the debtor country than they first appeared when the debt-equity schemes were introduced. In a typical debt-equity swap, a foreign direct investor purchases, at a discount, some sovereign debt in the secondary debt market (e.g., it pays a commercial bank \$50 for \$100 in face value claims on the government of Mexico). It then returns the debt to the central bank of the debtor country, in return for local currency that must be used for a direct investment in the country. The price that the central bank pays for the debt will generally lie between the second market price, expressed in local currency, and the full face value of the claims. To the extent that the central bank pays more (in the local currency equivalent) for the debt than the secondary market price, the government is effectively offering a subsidy to the firm making the foreign investment that is equal to the spread between the secondary market price and the repurchase price.

In essence, then, the debt-equity swap amounts to a cash repurchase of debt by the government combined with a fiscal subsidy for foreign investment in the country. The main problems with debt-equity schemes are (1) that either piece of this transaction (the debt repurchase or the investment subsidy) might be disadvantageous from the country's point of view and (2) the debt-equity schemes link these two pieces, often in a confusing and arbitrary way, even though the country might be better off to pursue just one aspect of the policy (e.g., to repurchase its debt, but without a link to foreign direct investment).

A cash repurchase of debt may or may not make sense. On the one side, it may well be highly inflationary, since a large cash outlay is made to repurchase debt that would otherwise have been rescheduled (and therefore not amortized for several years). The advantage of un-

dertaking such a repurchase depends on the price of the repurchase. If the debt can be repurchased at a deep discount, it might make sense for a government to repurchase its debt.

In typical debt-equity programs, however, the price paid by the central bank for the debt has been close to the face value of the bonds, so that the foreign direct investor rather than the debtor government gets the spread between the secondary market price of debt and the face value. In effect, the discount on the bonds is used as a subsidy for direct investment. This is almost always a subsidy that the debtor country can ill afford, since almost by definition, the government is strapped for cash, and is very ill-placed to be offering a large subsidy to foreign firms for direct investment. Like most subsidy schemes, this kind of arrangement is likely to give most of the subsidy to firms that *would have invested in any case*, so that the incremental investment that is generated by the subsidy is likely to be very small.

From the country's point of view, therefore, it may make sense to engage in repurchases of debt, but it is less likely to make sense to link such repurchases to foreign investment in the country. However, as Krugman points out, there may be contractual barriers to a government's repurchase of its own debt, in which case a debt-equity scheme may be a way to overcome such contractual barriers. In such cases, however, it still makes sense to design the scheme to emphasize the debt repurchase (by having the central bank repurchase the debt at the secondary market price), and to play down the investment subsidy component.

1.5.2 Breaking the Cycle of Failed Reforms

We have stressed that policy "mistakes" in the debtor countries are often not mistakes (in the sense that the government misunderstands the implications of its actions). Rather they are often symptoms of deeper political or economic problems in the debtor countries. The diagnosis that a budget deficit is too large, and therefore should be reduced, is not a complete diagnosis. In the abstract, most finance ministers understand that excessive inflation, or excessive foreign borrowing, result from excessively large budget deficits. At the same time, they are often unable or unwilling to do much to reduce the deficits. In order to improve the design of stabilization programs, and to improve the effectiveness of conditionality, we must therefore give greater emphasis to why the political process produces the excessive deficits. The papers by Haggard and Kaufman, Sachs, and Edwards, as well as the country monographs in the companion NBER volumes, all emphasize the political context in which various economic policies are pursued.

The basic ideas in most stabilization programs supported by the IMF and World Bank are quite straightforward, and aim to reduce budget deficits, achieve a real exchange rate depreciation, and open the economy

to international trade. The sobering point is that programs of this sort have been adopted repeatedly, and have failed repeatedly, in the countries under investigation during the past 30 years. A major goal must be to understand why such programs typically fail.

Consider the cases of Mexico and Argentina, for example. As the Mexican case study by Buffie and Krause makes clear, the "standard" package has been attempted in 1971, 1977, and 1983. In the first two cases, at least, major parts of the package were abandoned early on. Similarly, in Argentina, the "orthodox" package has been tried under Peron, in 1951; Onganía, in 1967 (the so-called Krieger-Vasena program); Viola, in 1977–81 (with Martínez de Hoz as finance minister); and to some extent, Alfonsín, since 1985. Again, the staying power of the orthodox program has been very weak in Argentina. (In late 1987 this weakness was again underscored, by the electoral losses of Alfonsín's Radical party, and the electoral resurgence of the Peronists.)

We have already noted that part of the problem with program implementation lies in the deep political and class cleavages that afflict most of the countries under study, combined with weak political institutions and fragmented political parties that fail to keep pace with rapid increases in political and social mobilization. The result, as pointed out by Samuel Huntington in an influential treatise, is that "cliques, blocs, and mass movements struggle directly with each other, each with its own weapons. Violence is democratized, politics demoralized, society at odds with itself" (Huntington 1968, 262). This is certainly an apposite sketch of Argentina, Bolivia, Brazil, the Philippines, and Turkey at various times in recent history. In the end, governments alternate rapidly between civilian and military regimes, and budgets are exploited for short-term political advantage rather than long-term economic strategy.

Interestingly, Huntington suggested that political stability in modernizing societies can best be achieved through an alliance of an urban ruling elite with the rural masses. Ideally, according to Huntington, that alliance is cemented through agrarian reform and the organization of party support in the countryside. Among the countries under study in the NBER project, Indonesia and South Korea most closely fit Huntington's characterization, as the governments have sought stability through an important base of rural support. (In the case of Indonesia, however, Soeharto's stress on his rural constituency was combined, early in his rule, with violent repression of his rural opposition.) In none of the Latin American countries in the NBER study have governments recently looked to the rural sector as the principal locus of political support. An apparent exception to this rule in Latin America is Colombia (unfortunately not studied in the NBER project), which is also the only major South American economy to have avoided a debt crisis.

Haggard and Kaufman identify several other features of the political landscape which affect a government's capacity to carry out necessary economic adjustments, including the administrative capacity of the governments, the pattern of trade union organization, and the susceptibility of the political institutions to electoral business cycles.

Sachs stresses that the normal problems of carrying out a reform program are greatly exacerbated by the overhang of foreign debt. Not only is the economic adjustment process made more difficult, but the political difficulties of reform are deepened as well. To the extent that the reforms serve mainly to raise the amount of foreign debt servicing, and so act as a tax on the domestic economy, they will find little political support domestically. Indeed, the government will be heatedly attacked for caving in to the interests of the foreign creditors. Adding debt relief as a part of the package of reform and adjustment could greatly enhance the likelihood that the economic program will in fact be carried out and sustained.

Sachs also explores whether changes in the nature of IMF/World Bank conditionality could increase the chances of compliance with programs monitored by these institutions. He argues that the nature of negotiations between the IMF and the debtor countries seems almost programmed to undermine the political legitimacy of Fund programs, thereby reducing their chance of success. In recent years, IMF programs have been unrealistically harsh, as they reflect the priorities of the private creditors rather than the realities of economic adjustment. Though the IMF has not yet acknowledged the possibility, there are times when debts to private-sector creditors cannot or will not be paid in full. Automatically designing programs based on the opposite assumption is bound to lead to frustration and failure.

Moreover, the style of negotiations seems problematic. Most IMF programs are negotiated between a technocratic team in the debtor government and the IMF staff, under conditions of secrecy. The letter of intent with the IMF is generally not made public by the debtor government. The result is that the agreement with the Fund often has little internal political support, and calls for actions by parts of the government (e.g., the legislative branch) or the private sector (e.g., the union organizations) that were not parties to the agreement. Since the actions are typically things that the government must do "down the road," the programs are signed, and then not adequately implemented.

With regard to the substantive design of adjustment programs, Edwards disputes the notion that dramatic liberalization is helpful in the context of a debt or stabilization crisis, suggesting that dramatic liberalization has little basis in either theory or history. Edwards argues that rapid trade liberalization is likely to generate adverse employment effects in the short term, as occurred in the liberalization programs in

Argentina, Chile, and Uruguay in the 1970s. Similarly, abrupt devaluations are likely to result in output losses and unemployment in the short run.

1.5.3 The Global Macroeconomic Setting

Even with debt relief, political resolve in the debtor countries, and well-designed economic reform programs, the chances for economic recovery in the debtor countries will depend on an adequate international economic environment. Dornbusch suggests that the probability of a "soft-landing" as the United States reduces its external deficits is rather low. In Dornbusch's view, a successful adjustment path for the U.S. will require a period of progressively tighter fiscal policy combined with expansionary monetary policy, with a strong likelihood of rising inflation in the U.S. as the dollar continues to weaken. Dornbusch suggests that "the monetary authorities would have to be sufficiently accommodating and impervious to inflation, and asset holders would have to be patient, sitting out the dollar depreciation without a stampede." He concludes that "this does not seem to be a high-probability scenario."

Dornbusch's emphasis on interest rates and monetary policies suggests one point of optimism regarding the debt crisis in future years. The crisis broke out decisively in the early 1980s when interest rates shot up above export growth rates. There are some good reasons for believing that real interest rates may now be in a steady decline (because of declining U.S. budget deficits, a fall in U.S. consumption spending, and the apparent room for continuing ease in U.S. monetary policy, as of late 1987). If this turns out to be the case, the fall in interest rates could significantly meliorate the crisis, in the same way that the sustained rise in real interest rates at the beginning of the 1980s was a decisive international shock that helped usher in the crisis.

References

- Balassa, Bela. 1984. Adjustment policies in developing countries: A reassessment. *World Development* 12 (September): 955-72.
- Bhagwati, Jagdish. 1978. *Anatomy and consequences of exchange control regimes*. Cambridge, Mass.: Ballinger Publishing Company.
- Brecher, Richard, and Carlos Díaz-Alejandro. 1977. Tariffs, foreign capital, and immiserizing growth. *Journal of International Economics* 7(4): 317-22.
- Calvo, Guillermo. 1987. *Servicing the public debt: The role of expectations*. Philadelphia, Penn.: University of Pennsylvania. Mimeo.
- Cline, William. 1984. *International debt: Systemic risk and policy response*. Washington, D.C.: Institute for International Economics, July.
- Cumby, Robert, and Richard M. Levich. 1987. On the definition and magnitude

- of recent capital flight. NBER Working Paper no. 2275 (June). Cambridge, Mass.: National Bureau of Economic Research.
- Galbis, Vicente. 1987. La liberalización del sector financiero bajo condiciones oligopólicas y la estructura de los holdings bancarios. In *Estabilización y ajuste estructural en América Latina*, ed. Santiago Roca. Lima, Peru: IDE/ESAN. [English language version is published in *Savings and Development* 21 (1986), Milan, Italy.]
- Huntington, Samuel. 1968. *Political order in changing societies*. New Haven, Conn.: Yale University Press.
- Krueger, A. 1978. *Foreign trade regimes and economic development: Liberalization attempts and consequences*. Cambridge, Mass.: Ballinger Publishing Company.
- Makin, John. 1984. *The global debt crisis*. New York: Basic Books.
- Sachs, Jeffrey. 1985. External debt and macroeconomic performance in Latin America and East Asia. *Brookings Papers on Economic Activity* 2: 523–73.
- . 1986. Managing the LDC debt crisis. *Brookings Papers on Economic Activity* 2: 397–432.
- . 1987. Trade and exchange-rate policies in growth-oriented adjustment programs. In *Growth-oriented adjustment programs*, ed. Vittorio Corbo, M. Goldstein, and M. Khan. Washington, D.C.: International Monetary Fund and The World Bank.
- . 1988. The debt overhang of developing countries (paper presented at memorial conference, WIDER, Helsinki, Finland, 1986). In a conference volume in memory of Carlos Díaz-Alejandro, ed. Ronald Findlay and Jorge de Macedo. Forthcoming.
- Sachs, Jeffrey, and Harry Huizinga. 1987. The U.S. commercial banks and the developing-country debt crisis. *Brookings Papers on Economic Activity* 2: 555–601

This Page Intentionally Left Blank