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The international financial crisis: diagnoses and prescriptions

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The public in general, and often even economists themselves, feel confused by the wide variety of proposals for solving the international crisis that have been put forward in academic and political circles. The particular interest of this article is that it gives an ordered account of the most important proposals and evaluates their positive and negative aspects.

These proposals fall into two broad categories. On the one hand, there are those that assume that the payment difficulties of the debtor countries are an expression of a conjunctural and transitory situation which will terminate with the recovery of the world economy. In these circumstances, it is claimed, the proper course is to amplify and improve existing mechanisms that will assist the debtor countries in the short-term servicing of their external debt, as for example by increasing the resources of international financing sources, improving the temporary relief mechanisms and reorienting the conditionality criterion of the IMF.

On the other hand, there are those who sustain that the difficulties in question stem from the serious mismanagement of international credit and that a system should be devised that would avoid a repetition of the errors of the past, restructure the debt overhang and redistribute more equitably the costs of readjustment between the parties involved. These proposals suggest various forms of partial or total conversion of the outstanding debt, through market mechanisms, through multilateral public action, or through unilateral measures.

The author concludes that the creditor banks and countries are obtaining handsome benefits from the existing situation, so that they cannot be expected to want to change it; hence any attempt to establish new bases for the problem of external indebtedness will largely depend on the bargaining power that can be built up and applied by the debtor countries.

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Introduction

Since the international financial crisis broke out in mid-1982 it has acquired extraordinary dimensions. When it erupted in Mexico in August of that year it created such alarm in banking circles that its negative effects spread like wildfire to the rest of the market, causing a sudden deterioration in the terms of credit. Thus, the debt-servicing capacity of the other borrowers, already weakened by the difficulties of the world economy, was still further reduced. In barely a year there were over 20 non-industrial countries interested in renegotiating their external debt, which accounted altogether for more than half the portfolio of credits granted by the banks to that group of countries (ECLAC, 1984a).

Although its magnitude gave rise to concern, the renegotiation process was conducted at the outset in a very slow and disordered manner. The problems were dealt with country by country, case by case. When we look at them as a whole, however, we perceive that quite a uniform scheme was applied throughout the world, affecting both the procedures used and their results. This scheme prevented the total collapse of the financial system: an outcome which had been feared when the Mexican crisis broke. Even so, the process of renegotiation has been long and painful for all the parties involved, and no stable and final solution to the problem of external indebtedness has been reached. On the contrary, the situation is one of almost permanent uncertainty, which has considerably hampered the management of the national economies, and even of the international financial system.

This climate of indecision, with its widespread repercussions, was bound to lead to a search for other solutions. Hence, since the onset of the crisis there has been a proliferation of proposals of the most varied nature. This article does not seek to add a further element to such a heterogeneous collection, but merely to review the most outstanding proposals, arranging and assessing them so as to present a clearer idea of the state of research in this field.

The courses suggested for solving the debt crisis are in general confined to two approaches according to the assessment of the current renegotiation processes. One approach considers that the analytical base of these processes is adequate and that it is only a matter of improving it. The various elements proposed for this pur-

pose are discussed in the first part of this study. The other approach calls for a solution of a different kind, namely, the conversion of part or all of the outstanding debt, and is described in the second part of the paper. There follows an analysis of three groups of propositions for put-

ting this concept into practice which differ according to the theoretical framework employed and the resulting importance attributed to market mechanisms for effecting this conversion.¹

I

The enlargement and improvement of existing mechanisms

1. *The theoretical base*

This approach is based on the assumption that the problem is one of short-term liquidity, that is, a temporary conjunctural crisis caused by factors beyond the control of the agents involved. The debtors have suffered the consequences of a variety of contingent elements: the fall in the prices of their export products; the reduction in the volume of their external sales owing to the economic recession in the central countries; the sudden rise in international interest rates, and the deep depression of the world financial markets. Since these elements are held to be the basic cause of the present crisis, it is claimed that this will automatically be resolved when the world economy recovers, since financial equilibrium will then be restored within a few years and normal international credit operations resumed.² In other words, it is assumed that, on recovering their capacity to service the external debt, the developing countries will regain their image of creditworthiness and their former access to the international capital markets. This is the criterion of some economists and, among institutions, of the International Monetary Fund and the World Bank.

¹Conversion means the modification of the securities retained by the creditors. The operation can take very different forms as regards magnitude (conversion of the whole or only part of the debt) and impact (changes which affect the legal form of the security, the value of the principal, the servicing conditions, etc.).

²In several statistical studies it is contended that, among the short-term variables, the reactivation of the economy in the central countries is the most powerful element for overcoming the present crisis more rapidly (*World Financial Markets*, 1982 and Cline, 1983).

According to this criterion, the crisis demands temporary domestic adjustment processes on the part of the debtor countries, but the success of these processes depends, in the first place, on the macroeconomic policies of the industrialized countries, which must seek to attain a firm, lasting and non-inflationary recovery. In the second place, it is essential that the debtor countries' access to the world market should not be restricted, so that they can increase their exports and service their external debt. Thus a fundamental aspect of international co-operation is to keep a watch on protectionism—a practice characteristic of recessive periods which has been applied with singular force in the industrialized countries in recent years—and to seek to eliminate measures of this type which prevent the recovery from being transmitted to the developing countries.

Up to the present, however, the adjustment has been slow and even in the best of cases will require, according to the studies available, at least two or three years. In fact, the world economic recovery does not appear to be pointing in the direction of the high levels of growth typical of a period following a recession. Nor can it be guaranteed that in the near future there will be an upturn in trade, a marked improvement in the terms of trade, or a reduction in interest rates.³

³The projections made by the OECD estimates an annual growth rate of between 2% and 3% for the industrialized countries in the biennium 1984-1985. Their non-petroleum imports are likely to rise by 3% per year, while the developing countries are expected to increase their total external sales by between 5% and 6% annually. In the financial field, stability of interest rates is predicted, with a nominal value of 9% and a real value of 4% (OECD, 1983).

Now, such a slow recovery implies a continued sharp external constraint on the developing countries. In these circumstances a series of measures needs to be defined which will enable the debtor countries to obtain temporary relief for their short-term problems of liquidity. Since the financial crisis broke out in 1982 procedures have been followed in line with the plan described above; what is required in the future, according to the supporters of this position, is a review of the measures applied to date and an assessment of their shortcomings, followed by an attempt to remedy these by improving the mechanisms in force.

2. *The mechanisms and processes in force*

According to the analysis outlined above, the crisis is not one of world stature, since it is confined to a particular group of borrowers. These countries differ greatly as to the factors that have contributed to their problems and the situation and prospects of their external finances (economic structure, relative size of debt, present and future burden of service payments). In view of these basic differences between them it is maintained that there are no general solutions to the problems of the debt, and so up to now the individual cases have been dealt with separately and with relative informality.

Nevertheless, as already mentioned, the method used has come to have similar characteristics and results for the different countries. The first resource employed to meet a payments crisis was the renegotiation of the bank debt. Given the magnitude of the problem, this element was not enough to prevent the generation of serious tensions, and the countries therefore had to resort concurrently to the so-called international financial safety net, in order to obtain temporary help until broader measures could come into effect and the positive results of the recovery could be passed on.

a) *Renegotiation with the banks*⁴

Although the banks have insisted that debt

⁴A more fully documented and precise analysis of these processes is given in ECLAC (1984a).

rescheduling must be carried out case by case, the practical result of the negotiations held in the first two years of this crisis has been a great similarity in the terms granted to the different borrowers.

The main likeness occurs in the time horizon: the rescheduling operations covered only the most pressing maturities. In other words, even in the best of cases the payments rescheduled have only been those falling due in the biennium following the start of the negotiations. Moreover, for all debtors the traditional system was maintained of rescheduling only amortization and not interest payments. The banks refuse to reschedule the latter, partly for accounting reasons, since if they do so they will have to alter their accounts and write off the corresponding loans.

Even so, the debtors have not been able to keep up their debt servicing properly in face of the inordinate increase in their interest obligations on the present onerous terms. The banks have thus been forced to seek another solution, which has generally been that of granting new loans to refinance part of the interest payments.

The final important feature of the renegotiation agreements has been the deterioration in the terms of credit.⁵ Since they are very much the same for every country, the new terms do not take into account each debtor's real capacity to pay, but merely reflect the changes in the banks' assessment of a crisis and the use of their great bargaining power. The tendency to make adjustments in line with the perception of the banking system rather than in keeping with the real situation of the debtor has been characteristic of almost all the renegotiation processes.

b) *The international financial safety net*

From the beginning of the crisis, when Mexico, the second most important client of the banks in the Third World, announced that it could not fulfil its external commitments, it was evident that renegotiation of the bank debt would not

⁵For the Latin American region the terms on which new credits were granted in 1982 implied a deterioration in the negotiated cost of credit ranging between 30% and 18%, according to country, in relation to the conditions prevailing in 1980-1981. The financing cost in itself, however, had increased between 10% and 30% (ECLAC, 1984a).

suffice to prevent the collapse of the financial system. Hence it was necessary to have recourse to the safety net established after the war in order to avoid excessive cyclical fluctuations of the economy.

This safety net functions on three levels. It is based on the institutions created through the Bretton Woods Agreement, and especially the IMF. Applying its three credit mechanisms,⁶ this institution granted the Latin American region as a whole US\$ 6.5 billion in 1982, and over US\$ 10 billion the following year. Of this total, more than two-thirds is subject to the Fund's conditionality system, which means that the disbursements are gradual and are made subject to the fulfilment of the economic goals established for the adjustment. This principle of conditionality, a special feature of the Fund, increases the influence of the institution: its direct action takes the form of a volume of credit which is really quite limited in relation to the total financial needs. As the satisfactory execution of the adjustment programmes calls for a continuous stream of bank finance on reasonable terms, a basic aspect of the activity of the Fund is to try to ensure that the projected increase of credit takes place.

In practice, the Fund has succeeded in this latter function, since it has played the role of a catalyst in the processes of renegotiation.⁷ Indeed, with only two exceptions (Nicaragua and Cuba), the signing by the debtor of a standby agreement with the IMF has been an essential condition for the banks to agree to reschedule the outstanding debt. In turn, the IMF has been concerned to see that the terms of the banks' new

contracts are in line with its own standby agreements. In general there has been an informal agreement between the big banks and the IMF that the former should grant commercial credit to refinance interest payments in amounts equivalent to around 7% of the debtor's net commitments.

Notwithstanding the foregoing, the procedures for arriving at this type of agreement are always prolonged and in the meantime the problems become increasingly acute. In this situation other institutions form a second line of defence in providing bridging loans as a provisional source of credit until the situation can be stabilized. The Bank for International Settlements, The General Arrangements to Borrow, the Commodity Credit Corporation of the United States and the US Treasury itself have contributed, with this type of credit, to the alleviation of recent financial tensions.

Finally, the central banks of the creditor countries have acted implicitly as lenders of last resort, providing at the international level the same speedy and effective assistance that the banks receive in the domestic markets when they face a crisis of public confidence. For this purpose, since the great crisis of the 1930s, there has been an unofficial but regular exchange of information between central banks and *ad hoc* co-operation, with some co-ordination of action. This policy was more formally pursued as a result of the bank crises of 1974, when the governors of the central banks of the Group of Ten issued a joint communiqué announcing that "means are available for the provision of temporary liquidity and will be used if and when necessary" (Spero, 1980). This commitment, although explicit, has been left undefined so as to avoid an excess of confidence on the part of the banks and consequent lack of caution. Moreover, by definition, this aid must be adapted to the particular conditions and needs of each case, so that it would not be appropriate to incorporate it into an institutionalized and predetermined agreement.

The success achieved in dealing with the Mexican crisis of 1982 bolstered up the idea that this safety net had the efficiency and speed of action needed to cope with unforeseen contingencies. However, the possibility that intolerable tensions will reappear in the near future has

⁶The International Monetary Fund offers three lines of credit to the countries affected by financial problems. The first —the compensatory financing facility— provides immediate liquidity to the countries which have suffered a deterioration in their balance of payments on account of reductions in their main export prices. The second, standby credit, is an agreement by which the IMF supports for a period of one to two years an economic adjustment programme defined jointly by the institution and the country. Lastly, the agreements under the extended Fund facility enable the Fund to assist for a period of three years those countries which need to make structural adjustments in order to achieve a balance of payments which will be viable in the medium term.

⁷The present crisis, which caused payment difficulties to become widespread in Latin America, transformed the role of the Fund from that of a passive catalyst into that of an active promoter of banking funds (ECLAC, 1984b).

motivated some proposals for reinforcing these elements, both in respect of their resources and their mechanisms.

3. *Proposals for expanding and improving existing mechanisms*

a) *Resources*

During the Mexican crisis the resources available for granting emergency credit were increased. At the same time the range of sources was extended, since for the first time the Bank for International Settlements granted bridging loans to several countries of the region amounting to US\$ 3 850 million. However, these sources of finance are kept as a last resource, so that an appreciable increase in their funds is not envisaged.

On the other hand, the crisis made it patently obvious that the resources of the traditional institutions were inadequate. As the restrictive monetary policies adopted by the central countries since 1979 have had repercussions on the international financing agencies, these have not had new resources with which to combat the subsequent recession, in contrast to what happened in 1974. To remedy this situation certain measures have already been taken. In particular the developing countries have been given access to the General Arrangements to Borrow (GAB), the volume of which was increased from US\$ 6.5 billion to US\$ 19 billion, while the IMF quotas were raised by close on 50%.

Thus, over a period of three years the resources available were increased by US\$ 30 billion, that is, by US\$ 10 billion per year. But this is not equivalent to even one-third of the fall in the flow of commercial loans to the Third World, which dropped from US\$ 50 billion to US\$ 15 billion between 1981 and 1982 (Avramovic, 1983). In the following year, bank credit to the countries which had standby agreements with the IMF increased at most by 5% to 7%, thus refinancing only half of the interest payments.⁸

⁸The interest payments of Latin America have risen enormously, growing fourfold between 1977 and 1982 and standing at over US\$ 30 billion in 1983 (35% of exports). To effect these payments the region has had to make a tremendous effort of adjustment; it more than trebled its trade surplus in the course of one year (from US\$ 9.7 billion

Hence there remained a substantial difference between the resources available and credit needs.

The solution most commonly put forward is to seek ways of increasing the resources of the IMF. To avoid the lengthy institutional formalities and consequent obstacles of a political nature, another course has also been proposed, which is to enlarge the operative capacity of the financing agencies. An initial possibility would be for them to obtain private resources. An idea particularly canvassed has been to authorize the International Monetary Fund to procure resources in the international markets. Some authors (Bolin and del Canto, 1983) propose that this task should be entrusted to an Export Development Fund expressly created for this purpose. Greater flexibility in the credit policies pursued by the multilateral institutions has also been called for. Special emphasis has been laid on an increase in their current very low gearing ratio (ratio of paid-in capital to outstanding borrowings),⁹ in order to extend the range of their credit operations.

Finally, in a wider context, it has been proposed that the total liquidity of the system should be raised by an additional allocation of Special Drawing Rights, destined mainly for the developing countries that are in serious financial difficulties (Avramovic, 1983 and Massad, 1983). The aim of this is to earmark resources to grant them preferential long-term loans, thus redistributing the burden of debt servicing and supporting the expansion of international trade and economic reactivation.

to US\$ 31.2 billion between 1982 and 1983). Nevertheless, this adjustment was fundamentally faulty in that it resulted from a radical reduction (29%) in imports and not from an increase in exports (which went down by 1.3% in 1983). Moreover, the value of the net interest payments exceeded the net credit received by the Latin American countries. Hence the slight increase in credit granted by the banks, in so far as it represented a new contract subject to standby agreements with the IMF, besides being concentrated in a few countries (especially Brazil and Mexico), barely sufficed to cover the increased servicing payments resulting from the worsening of the terms of indebtedness. The future outlook is equally unpromising, since the LIBOR rate went up again, from 10.25% in December 1983 to 12.44% in mid-May 1984. According to ECLAC estimates, the maintenance of this rate throughout the year will mean for Latin America an increase of close on US\$ 5 billion in interest payments.

⁹The International Monetary Fund and the World Bank have been operating with one-to-one ratio.

b) *The mechanisms for temporary relief*

At the same time, apart from the enlargement of available resources, it has been proposed to extend and to some extent institutionalize the relief mechanisms, which have been characterized up to now by their *ad hoc* nature and confused application. Since they are temporary mechanisms, they are designed to alleviate interest payments, since the restructuring of amortization commitments is carried out with a longer-term perspective.

In general, the relief of debtors can be effected in two direct ways: by lowering the effective interest rate, or by granting the countries sufficient resources for them to fulfil their payment obligations without having to transfer their own resources abroad. A third more complex way would be to create a mechanism which would serve as a buffer by absorbing the cost of short-run fluctuations in interest rates.

i) *Relief by reduction of the interest rate.* Two economists and bankers have opted for this method. Robert V. Roosa (IMF, 1983) suggests applying some of the procedures used in similar crises at the domestic level.¹⁰ This implies more intervention by the monetary authorities, who will need to take part in defining the restructuring terms and seeking new finance. In particular, the IMF will need to play a more decisive role and intervene directly in the definition of the credit terms, so as to achieve a rate close to LIBOR. For his part, P.P. Kuczynski (1983) proposes a contingency plan for the banks: i.e., to reduce the interest rate for two years, maintaining a spread of approximately one point over the interbank rate. As it seems most unlikely that the banks would willingly accept this reduction in their profits, the plan would only be adopted in emergencies, when the creditor governments themselves would exert strong pressure on the banking system. In this way some relief would be obtained

¹⁰In general, when renegotiating the debt of private firms the banks charge a lower interest rate than that of the market during the adjustment period. In contrast, in the case of sovereign debtors the banks raise the effective rate imposed on the country on the ground that they have to face a greater risk. This argument, however, is not theoretically valid, for the renegotiation diminishes the risk for the creditors, since if a country does not renegotiate its debt it will simply be unable to service it (Devlin, 1983 and Kuczynski, 1983).

for the debtor country without prejudicing the granting of bank credit in the future (which would not be compatible with the adoption of a lower rate than that suggested).

ii) *Relief through an institutional mechanism or service for granting compensatory credit.* Mexico proposed another solution: an increase in the resources available for meeting service payments (see Government of Mexico, 1983). Its proposal is to set up an institutional mechanism destined to relieve interest payments during a period of transition. The proposal assumes that the existing deficit is of a special type, caused by exogenous factors and not by the excessive expansion of global demand which usually leads to payments problems in the developing world. Thus it calls for different treatment from that implicitly linked with the agreements with the IMF.

In support of this thesis, Mexico underlines the similarity with the circumstances which in 1974 gave rise to the creation of the compensatory financing facility of the IMF: an abrupt turnaround in external conditions, reversible after a period of years, and largely attributable to circumstances beyond the country's control. Hence the proposal is to create a special facility for financing balance-of-payments deficits caused by rises in international interest rates.

This facility would enable compensatory loans to be granted to debtor countries during those years in which the interest rates exceed their historical levels (i.e., 2% to 3% in real terms). These credits, like those of the first compensatory facility, would be granted for longer periods than those applied in current agreements. Moreover, they would not be subject to the traditional conditionality of the Fund, since the study proposed is only one condition, namely, some control over the volume of future credits in order to avoid undue expansion of the country's external debt.

iii) *Relief through a buffer mechanism for fluctuations in interest rates.* The basic principle of the mechanism proposed for mitigating the effect of excessive fluctuations in interest rates and giving temporary relief to the debtor countries when these rates become untenable is the creation of a system of compensation between periods when the prevailing commercial rate rises above its historical level and those when it falls below it.

W. Bolin and J. del Canto (1983) have mentioned this proposal as part of a long-term reform of the international credit system, while C. Massad and R. Zahler adopt it as the pivot of their proposed solution for the present crisis (Massad and Zahler, 1984). These economists propose that the debt should be made subject to a reference interest rate, equal to the real long-term average, plus a normal spread for the banks. According to their estimates, this rate would be 2% or 2.5% in real terms. The debtors would pay the interest to their Central Bank in local currency at the current commercial rates. The Central Bank would then pay the creditors up to a maximum equal to the reference rate. It would accumulate the difference in excess of the reference rate when the market rate was above it. On the other hand, it would draw on the accumulated funds when the market rate was below the reference rate, until the funds were exhausted.

In contrast with the foregoing proposal, this plan does not include intervention by the industrialized countries, even through the agency of a multilateral organization. The banking system could avoid some accounting problems, since the funds accumulated by the central banks under this mechanism would be shown as assets in the creditors' balances. Nonetheless, according to the authors themselves, the proposal tacitly assumes that bank supervisors will turn a blind eye to these procedures and that the monetary authorities will take action when problems of liquidity arise.

c) *Reorientation of the IMF conditionality principle*

In the same order of ideas, but on a lesser scale, there has also been a proposal to modify the conditionality applied by the IMF in its standby credits, and to redefine the resulting adjustment programmes.¹¹

¹¹The Fund favours a strategy of automatic restoration of balance-of-payments equilibrium. In order to increase the supply of foreign exchange the aim is to achieve a large trade surplus by restricting domestic demand and encouraging output of tradeable goods. The measures proposed by the Fund for this purpose are highly standardized and rigid, giving preference to indirect instruments of a monetary type. Thus, a ceiling is placed on the volume of domestic credit and on the quantity of money in circulation, while at the same time the liberalization of trade operations and a rapid reduction of the public deficit are demanded (Ground, 1984).

To be sure, none of the authors question the need for an adjustment, and hence for internal economic sacrifices. At present, however, since almost all the countries are renegotiating with the Fund due to their failure to meet their targets, doubts have been raised as to whether the IMF strategy is not too severe for the borrower countries, creating an economic deflation and an excessive contraction of domestic demand, with the ensuing social and political unrest. The adjustment period may be too short in view of the magnitude of the initial imbalances and the difficult world economic situation. It has even been argued that these policies might be aggravating the international recession, since the Fund itself estimates that at least three-quarters of the improvement in the trade balance attained by the Third World in 1983 was due to the contraction of its imports and not to the expansion of its external sales (IMF, 1984). Further, the IMF prescription has been applied in a mechanical manner, with very similar monetary and fiscal goals, without really taking into account the practical situation of each debtor.

Although its theoretical basis may seem valid for use in the case of a single country, its uniform and simultaneous application is open to question, especially when the world economy is in recession.

In view of the frequent failures to comply, and the intolerable political tensions created in the debtor countries, the IMF has shown signs of wishing to change its position. In particular, there has been some increase in credit amounts and periods, with more flexible target arrangements. This change, however, has taken place very slowly, step by step, and the result has been fragmentary and weak.

Many economists insist that the terms should be much more liberal and gradual, with the application of new instruments designed to favour investment and economic growth.

4. *Comments*

The plan for improving the financial safety net may be criticized from various angles. In the first place, there are serious obstacles to its implementation—mainly of a political nature—which concern the procurement of the necessary resources and the orderly functioning of the

plan. Moreover, it might be argued that the mechanism in question is excessively automatic, to say nothing of the analytical deficiencies of the theoretical frame that governs it, which call into question the plan's ability to solve the actual crisis.

a) *The unfavourable setting for its execution*

The approach we have been analysing has evolved in a highly unpropitious external setting and has received practically no support either from governments, the banks or public opinion in general. The tenacious resistance of the United States Congress to increased national support for the IMF is very revealing on this point. Although the Mexican crisis in 1982 helped to modify the position of the United States Government, inducing it to support the action of the multinational agencies, this change of policy was not endorsed by public opinion as a whole, which is reluctant to provide any official aid in this field (Brimelow, 1983).

Another obstacle is the attitude of the banking sector, which in some degree contributes to this lack of political support. The great number of banks involved impairs co-ordination among creditors, and this is aggravated by the frequently capricious behaviour of the smaller banks. Hence negotiations are prolonged to no purpose, representing a high opportunity cost for the debtor.

Up to the present, however, there have been no declarations of moratoria, which would bring about the collapse of the financial system. But this circumstance, fortunate as it may seem at first sight, is very negative in its effects, since it has made the banks underrate the risk of a profound crisis in comparison with their appraisal of the previous year. As the feeling of urgency has faded, the incentives for taking vigorous measures have lost their force, and this situation not only contributes to the present scarcity of resources but also discourages the creation of new mechanisms. Thus, no new approach to the subject can be expected until the system is threatened with another crisis (Devlin, 1984).

b) *Problems of excessive automaticity*

If reasonable efficiency is to be achieved, the system should avoid excessive automaticity. Although the current conditionality of the IMF is

certainly too rigorous, and the rise in bank costs after a renegotiation is clearly exaggerated, it would be a mistake to over-relax the principle of conditionality. Indeed, no emergency aid could come to be automatic, since this would debilitate the functioning of the whole system. This was the main objection to the Mexican proposal. Although in principle an institutionalized compensatory mechanism might prevent serious crises and thereby stabilize the financial system, its application in too automatic a manner could have counterproductive effects: debtors and creditors would be encouraged to pursue incautious policies, knowing they could fall back on a system which would allow the deferment or transfer of the final cost. Moreover, if the conditions of official aid were liberalized, it would lose its character of last resort, and its capacity — particularly that of the IMF — to exert official pressure on the banking sector and obtain its collaboration would be diminished. It seems necessary, then, to tie this type of credit to a number of rigorous conditions; although those currently employed are by no means the most appropriate, the reorientation (or redefinition) of conditionality must not be confused with its suppression.

c) *Deficiencies of the analytical framework*

The criticisms of this approach are not only of a practical nature; there are also analytical arguments that show up the weakness and inadequacy of the measures proposed for reaching a real solution of the problems of indebtedness.

Recourse to a financial safety net as a way out of the existing crisis assumes that the recession is contingent, essentially caused by exogenous factors, i.e., the fall in export revenues and the rise in interest rates. This criterion takes no account of longer-term problems; to be more exact, it does not consider the exceptional dimensions of the crisis, its unusual aspects, or its possible future repercussions. A strategy has been selected with the sole aim of counteracting the difficulties that are currently affecting the world financial system. Its hopes for the future are based on a sustained recovery and less protectionism on the part of the OECD countries, on the adoption of lower interest rates, and on strict but efficient adjustment programmes in the debtor countries.

This basic hypothesis as to the future trend of the world economy may be criticized as over-

optimistic, or even unrealistic. Indeed, while some economists contend that real interest rates will probably remain for a long time above historical levels, others see in the present crisis the beginning of a long period of stagnation. Hence it would not be reasonable to hope for a dynamic recovery even in the medium term (Sunkel, 1984). From this viewpoint, the criterion on which the safety net is founded would appear to be faulty from its very base since the essential condition for its efficient functioning is precisely the reactivation of the world economy.

Even without such a pessimistic projection of world economic trends, the safety net may seem deficient because it does not tackle the problem with suitable instruments. The measures proposed, although they include some degree of institutionality, remain for various reasons fragmentary and imprecise. It is still proposed to settle the problems case by case, country by country, without acknowledging the global dimension of the present crisis. Apart from ignoring the real magnitude of the crisis, the lack of definition and co-ordination leads to the application of market criteria (such as the concept of short-leash financing)¹² and the apparent protection of the value of bank assets, when in fact the market has dwindled to nothing and operations are now the result of isolated negotiations (Devlin, 1983; Langoni, 1983). Even though these measures prevent the declaration of a moratorium, with the consequent disarray of the international financial system, they do not give rise to viable and definitive solutions.

The financial safety net has another defect, this time in connection with the payment term allowed. One of the lessons learnt from recent experience is that it will take much longer to settle the debt problems than had been originally assumed, and therefore the financial crisis will last much longer than was foreseen for situations of this type when the IMF was created. The guiding principle of this institution was to provide relief until the countries with problems, after having only temporarily departed from the

norm, returned to the *status quo ante*. According to this principle, only a very short time needs to be allowed for this recovery: the IMF grants financial relief for only one to three years, while the rescheduling covers no more than the immediate maturities. The agreements in force, both those concluded with the IMF and those reached with the banks, are characterized by these short maturity periods.

However, recent experience seems to suggest that such measures are only the first step in a long process of future negotiation, in which it will be the rule, rather than the exception, to amend the earlier agreements. The countries are involved in a process of almost permanent refinancing, and keep on borrowing merely to pay the interest.

These defects in the instruments used institutionalize to some extent a weakness in the system which, according to initial assumptions, should have been only transitory. For the debtors this creates a marked distortion in economic policy, since financial and short-term aspects acquire undue weight in decisions, to the detriment of productive criteria (Ffrench-Davis, 1983). At the same time, though the IMF continues to produce collective public goods (services of co-ordination and supervision of the financing processes), these turn out to be more useful to the creditors than to the debtors. In fact, the IMF procedures have isolated the debtors, while facilitating joint action on the part of the creditors (Lipson, 1981). Despite this, confidence has not been restored, nor has the credit market resumed operations on an adequate basis. Hence the financial safety net would appear, at best, only to be able to prevent the total collapse of the system and permit the continuance of a precarious *status quo*, without solving the fundamental problems.

In these circumstances, the international financial system would lose its role of lubricant of the engine of growth, to be transformed into an instrument whose chief function would be the maintenance of the present levels of indebtedness. This suggests that the problem should be considered from another angle, with a view to attaining solutions that would be less burdensome, more in keeping with the situation, and more permanent.

¹²The concept of short-leash financing is that which imposes a short time horizon for the renegotiation of the debt.

II

Criteria for the conversion of the outstanding debt

1. *Common aspects of the various proposals*

There is a second set of proposals with a common aim (though they differ considerably in the means chosen to achieve it), which is to eliminate the obstacles to the normal functioning of the financial system and enable it to maintain its traditional role of financing development. They also agree on the diagnosis, namely, that the exogenous factors —previously regarded as the basic cause of the current problems— merely accelerated and aggravated a latent crisis. According to this approach, the present problems are solely the result of an imprudent and excessive expansion of international credit during the previous decade, so that a safety net could hardly provide a solution to the existing difficulties. On the contrary, as such a measure would perpetuate the errors of the past and thus transform the outstanding debt into a dead weight on the countries, it would hamper the return to normal credit operations. This analysis has given rise to efforts to define a strategy —at once rational, expeditious and efficient— aimed at restructuring this debt overhang.

The consequent proposals coincide in attempting to replace the present individualized method by one which is more global and systematic. They provide a basic standard framework, with clearly defined reference criteria, within which the national cases could be considered. At the same time, they propose a better distribution of adjustment costs, since they consider that the existing principles governing their distribution between debtors and creditors, besides being manifestly unfair, could turn out to be counter-productive even from the creditors' point of view.

The current renegotiation exercises transfer most of the cost to the debtors. This procedure, however, has no economic justification, since all the agents involved bear some degree of responsibility for the present problems: the banks for having failed to pay attention to the volume of their loans to each country, the governments of the industrialized countries for hav-

ing tolerated (or even, with their monetary policies, favoured) this situation, and the debtor countries for having pursued imprudent policies of indebtedness. Consequently the authors who support this approach insist that all the parties should help in the search for solutions and share the burden of readjustment, accepting their portion of loss. Finally, these economists use the same argument to justify the conversion of the outstanding debt: they point out that to reject this aspect would be tantamount to ignoring the reciprocity of interests between the parties. On the one hand, the tensions caused by the present adjustment process threaten the internal stability of the debtor countries, which could be driven to such extremes as declaring a moratorium, thus provoking a serious fall in banking assets. On the other hand, it may be assumed that the cost to the banks of sharing the burden of adjustment would be much lower in the end (Devlin, 1983). At the same time the industrialized countries have an interest in the affair, since a moratorium would be prejudicial to their economies, both internally (in respect of credit, production and employment) and externally (owing to the concomitant instability of international relations). Without taking the projection so far, it has been argued that the debt crisis has slowed down recovery in the United States owing to the considerable fall in its exports to Latin America.¹³

2. *Differences between the proposals*

Despite these similarities, the proposals to be analysed advocate very different paths for arriving at the same goal. The main differences are in the degree of efficiency attributed by the authors to the market mechanisms for surmounting the cri-

¹³It can be estimated that the reduction in sales is directly responsible for a drop of 0.3% in the GDP of the United States in 1982 and the loss of 225 000 jobs (Dhar, 1983). The potential effects on the United States economy of a moratorium declared by the larger Latin American Debtors have been well analysed by Wyss and Napier (1983).

sis and the flexibility and resilience capacity attributed to the banking sector.

Regarding the first aspect, the authors either favour or reject the intervention of the monetary authorities in the debt conversion process. To rely entirely on market mechanisms would restrict the action to the banks and their clients, with the monetary authorities excluded from the process. On the other hand, some authors point out the presence of basic defects in the functioning of the international credit market and therefore favour public intervention.¹⁴

To the classic problem of intervention, however, there is added another dimension, since it is not easy to define the public authorities that ought to take action. The debtors themselves are sovereign nations and possess widely recognized discretionary power in the economic sphere. But this sovereign power is limited, by definition, to the domestic economy of the country. In the international market these same countries are merely agents acting in competition with other agents (many of them private) and have to comply with the laws of the market.

If it is conceded that public intervention in the economy is characterized, broadly speaking, by the discretionary power of the respective authorities and the absence of any legal right of appeal against their decisions, the only form that this sovereign power can assume on the international plane is multilateralism.

Consequently, three different courses are proposed, depending on the conceptual frame adopted (see annex). The first favours the free play of the market, and proposes its use to surmount the present crisis. The second, in contrast,

emphasizes the public dimension of the problem (in the traditional economic sense of the word), and advocates a multilateral approach to regulate the international credit market. The third position distrusts the two above-mentioned approaches, whether because of their inadequacy or the irksome delay they imply, and prefers unilateral non-commercial action on the part of the debtors.

The first viewpoint, favouring the free play of market forces, does not recommend the exclusion of public bodies in trying to solve the debt problem: its objection is to discretionary multilateral action.

In a more pragmatic analysis, the choice is also influenced by the resilience capacity assumed for the banking sector: if the banks are considered to have a flexible and rational attitude there is no need for a catalyst or a buffer for the adjustment process. On the other hand, the opposing theory points to the rigidity that has hitherto characterized the banks and their dangerously high level of exposure in each country, contrasting these with the public dimension of the current crisis (Devlin, 1984). Hence, multilateral public action is proposed, the type and magnitude of which will be linked with the estimated resistance capacity of the banks. On this latter assessment, then, will depend the share of the adjustment that will fall on the industrialized countries.

On the choice between private and public action depends, in the last instance, the form of the adjustment; recourse to market mechanisms only brings about a reduction in the negotiable value of the debt (i.e., a fall in the value of bank assets), while public intervention may also have an effect on interest payments, removing them from a purely commercial context and bringing them into line with the actual needs of development.

For their part, the advocates of the unilateral conversion of the debt, while recognizing the inadequacies of the market, also doubt the efficiency of public regulation in the present conditions. In particular they claim that collective action would take so long to achieve any result that it would not compensate for the cost accumulated by the debtors. They therefore recommend the adoption, once for all, of a solution

¹⁴Traditional economic theory indicates some cases in which the free play of market forces is not sufficient to ensure the achievement of a socially optimal equilibrium, either because of the particular nature of the good in question or through a chronic defect in the corresponding market. In such cases equilibrium can only be attained by non-market means. This intervention is usually conducted by the State and hence it is called "public intervention". In a modern economy, however, the State has considerably enlarged its economic role and frequently acts like any other agent, complying with the rules of the market. Thus the word "public" has a double meaning and might lead to misinterpretations. In the following pages the term will be used in the classic sense of economic theory: it implies a reference to a market situation, but not to the legal status of the parties involved.

without commercial criteria, that is, the unilateral conversion of the debt.

Although the various proposals for conversion of the outstanding debt spring from a common dissatisfaction with current practice, they recommend totally opposed solutions for surmounting the crisis. The reasons given by the authors for the existing inefficiency can be divided into mutually contradictory categories:

one side puts the blame on excessive public intervention and proposes to suppress it, leaving the market free to convert the debt into capital; the other side criticizes the public role as insufficient and recommends a broadening of its scope in order to transform the debt into public bonds. A third current of opinion rejects both the market mechanisms and public control and proposes a non-commercial unilateral solution.

III

Debt conversion by market mechanisms

1. General definition

The supporters of debt conversion by market mechanisms criticize a practice which has been fairly common during the period since the war: i.e., the use of public intervention to regulate the functioning of the market and thus avoid socially destabilizing crises. This criticism forms part of a more general analysis, developed especially in the 1970s, which calls into question the entire role of the State in the economy.

With regard to the debt crisis, attention is drawn to the erroneous policies pursued by the debtor countries, in which the concentration of investment decisions in the hands of public bodies caused a distortion in the allocation of resources and inefficient use of the credits obtained.¹⁵ This familiar criticism is extended to the international economy, in which public intervention assumes the form of multilateral management. In the financial sphere, the advocates of a return to the free play of the market roundly condemn the system created by the Bretton Woods Agreement. According to them, the organization established in 1944 was rendered obsolete by the trade and monetary evolution of the 1970s, but like all public structures it exhibits a marked inertia and capacity to persist.¹⁶ The

Bretton Woods institutions, it is claimed, did not develop in consonance with their external environment and thus prevented the necessary adjustments that the free working of the market would have produced.

In particular, the International Monetary Fund is accused of hampering adjustment by its injections of funds, which discourage the banks from recognizing their book losses. Hence, despite the deterioration of their portfolio of loans, they end up with ever larger profits. This paradox, it is claimed, will probably persist as long as public intervention continues to mask the market signals or to weaken them with the illusion that there will be a public guarantee in the last resort.

The maintenance of this public control, say the supporters of this analysis, has its cost, since resources are assigned to it to the detriment of production. The cost is unjustified as long as the measures applied do not provide a viable way out of the crisis. They consider it more expedient, in these circumstances, to allow the free play of the market and return to traditional banking practices. These authors underline the similarity between domestic and international financial crises and propose the extension of the measures commonly applied by the banking sector in the domestic market to overcome the difficulties in the international sphere. All these proposals include, in the short run, the recognition of their

¹⁵Although the analysis is broadly known, a clear and analytically representative exposition will be found in Meltzer (1983).

¹⁶The economist Milton Friedman, opposing in the United States Congress the proposed increase in that nation's

IMF quota, remarked that "international bureaucratic organizations never die nor fade away". Quoted in Brimelow (1983).

book losses by the banks. Nevertheless, they can assume varied forms with a greater or lesser degree of complexity (see annex).

2. *Creation of a secondary market*

The simplest and most spontaneous market solution consists in the creation of a secondary market, where the banks can trade their debt securities (*The Economist*, 1983). This was more or less the method used to deal with the financial crisis resulting from the recession of the 1930s. The same idea was put into practice, at least in part, in the year following the Mexican crisis of August 1982: a secondary market has been operating in London, where securities on loans to countries of the Third World considered at risk by the banks are traded, although in a covert way and in fairly small amounts.¹⁷

The essential feature of the method is its simplicity. In effect, the securities are not modified in form but in mobility. The mechanisms of the international capital market will themselves define more accurately the terms of the adjustment. This is why this adjustment only affects the amount of the principal. The price (i.e., the interest rate) continues to be determined by the market according to the fluctuations of supply and demand. Hence the proponents of this type of solution reject the artificial reduction of interest rates as an adjustment measure, since it would cause distortion in the assignment of credits.

The cost of the adjustment, for its part, falls solely on the direct agents, i.e., the banks and the debtor countries. For the latter the issue is rather a continuation of the painful process of internal adjustment, with some relief in service payments and possible improvements in future financing. In contrast, the banks will have to suffer further considerable losses.¹⁸

At all events, according to this criterion, the division of the cost between debtors and creditors

is the result of the assessment of risk made by the market and should not be influenced by discretionary decisions.

3. *Conversion of the debt into productive capital*

Within the same concept of market primacy but adding a more complex conversion process, there are two proposals for transforming the debt securities into productive capital bonds. This suggestion is justified by the claim that, since a country's solvency ultimately depends on the situation of its real productive assets, the creation of a clear nexus between these and the outstanding debt would provide a rapid and effective way out of the present crisis, since only in cases of patent insolvency (which presumably will be few) would substantial losses be sustained.

As in a secondary market, this loss (equivalent to the banking cost of the adjustment) affects in the first place the value of the principal, and is determined by the assessment of the market, since it involves negotiable bonds. However, in contrast with the previous proposal, another part of the adjustment affects the revenue yielded by the bonds. Whereas in the secondary market the holders continue receiving regular principal and interest payments according to the variation of the commercial rate, in the new conditions they receive dividends which fluctuate according to the true profitability of the real assets they represent. Of course, this is a considerable difference. In no way, however, is it due to discretionary action, or to the distortion of the market mechanisms. In effect, to determine the profit, one market (that of credit) is replaced by another (that of goods and services).

a) *Conversion into shares*

Of the two proposals mentioned, the simpler is the conversion of debt securities into shares in the national enterprises (Meltzer, 1983).¹⁹ Allan

¹⁷At the end of 1983, Latin American loans traded between 75% and 87% of their book value (Brimelow, 1983).

¹⁸According to various bank estimates, the securities will be negotiated on average at a price 25% below their book value. For the nine leading banks in the United States a fall of this magnitude in the value of their loans to Argentina, Brazil and Mexico would be equivalent to losing one-third of their capital (Brimelow, 1983).

¹⁹This idea is not so very novel, since the practice is quite common in the domestic markets of various countries: when an enterprise is undergoing serious payment problems, the bank frequently converts its debt securities into capital for the enterprise. Its extension to the international credit crisis is certainly novel, since it places sovereign bodies in the position of debtors. It would particularly affect public enterprises, which in the Third World have a considerable productive capacity.

Meltzer proposes, in particular, the inclusion of the Mexican petrochemical enterprises and the Brazilian hydroelectric power plants. He also recommends that this process should be applied only to part of the debt and should take into account the depreciation already suffered by the bank securities. The shares issued would then have a lower value than the initial book value of the loan. The amount of this reduction would be decided by negotiations between the country and its creditor banks, assuming in the first place that the banks are willing to negotiate. Meltzer states that, despite the book losses they would have to accept, the banks might collaborate in a system of this type, always provided that the discount was less than the real fall in the market value. In this way, besides avoiding heavier losses in case of delay in payment, they would improve the composition of their portfolio with safer and more stable securities.

For the debtors it implies a radical change in the servicing conditions. With the capitalization of the outstanding debt amortization payments disappear and interest payments are transformed into remittances which are not tied to the fluctuations of the international capital markets but to the real profits of the enterprises.

b) *Conversion into financial securities with rights over the resources of the country*

With the same adherence to market mechanisms, the option propounded by Norman Bailey (Bailey, Luft and Robinson, 1983) seems a compromise between the two previous proposals. It includes a conversion process which, although inspired by the measures usually applied in dealing with internal payment problems, attempts to adapt them to the fact that the debtors involved are sovereign. This United States economist proposes to convert the existing debt securities into a new financial instrument, known as an "exchange participation note", issued by the Central Bank of the debtor country. It does not bring about such sudden changes in the financial relations between the countries and their creditors; it does not constitute a title of ownership of the national resources; nor does it represent full capitalization of the outstanding debt. It is assumed, besides, that there will be no modifications as regards interest payments.

The real change affects the payments of capital, which would be based on a fixed percentage of the country's annual foreign exchange income. Hence the author rejects as a basis the value of exports of goods, since numerous countries receive a substantial part of their foreign exchange through services (tourism) or transfers (emigrant workers). Although the system involves a great deal of statistical work it is only in this way, says Bailey, that the amount payable will be adapted to the real payment capacity of the country.

4. *Comments*

The three strategies described above have a common aim, which is to revive the confidence of the financial system so that it will once again fulfil its original role of financing development. They seek to achieve this in different ways. The fact that the securities are negotiable enables the risk to be spread by increasing the number and diversity of the creditors. With the elimination of the debt overhang the current financial agreements can be dispensed with and time and resources freed for financing output and trade. The conversion of the debt into capital also fosters a background more favourable to economic growth, by linking the credit flows with productive efficiency and trade.

The attraction of these prospects is evident, but the problems they raise must not be ignored. To begin with, the data on which the analyses are based err on the side of optimism as regards the capacity of the system to react to sudden changes. There is no reason to believe that the banks can absorb the losses involved, nor that the debtors will be able to sustain their difficult internal situation for the time required. The tensions generated might cause panic in the international capital markets, with all the ensuing economic, political and social upheavals.

Moreover, these plans do not provide incentives to offset the risks and induce debtors and creditors to agree to carry them out. Even the setting up of a secondary market (the simplest proposal among them) seems almost unattainable, since there appears to be neither demand nor supply for these transactions. To negotiate their securities openly would mean a loss of prestige and authority for the banks.

Thus, they prefer to keep their loans on their books at the initial book value, although it does not represent the real market value. The advantages of these plans seem to lie in the distant future, so that they do not carry much weight in the banks' assessment for more immediate periods.

Nor do these proposals offer very encouraging prospects for the debtor in the immediate future. The conversion of the debt into negotiable securities is not enough to provide real relief in service payments. The creation of a secondary market does not in any way affect them, and Bailey's proposal serves only to alleviate amortization payments, when it is the payments of interest which have reached untenable levels. Meltzer's proposal, on the other hand, solves the servicing problem, but at a high political cost, since it demands, after years of restriction of direct foreign investment, the abrupt elimination of a practice now well established in the Latin

American mind.

Likewise, the use of securities tied to the resources of the debtor country, despite its more beneficial aspect, poses similar difficulties, since it would compel the banks to interfere excessively in the domestic affairs of the country. The problems encountered by the private banks in Peru (Devlin, 1980) show how difficult it could be to exercise the control required for the orderly functioning of the system.

A final obstacle is that of organization. It is not clear how creditors and debtors could coordinate their actions, since the financial market does not provide an adequate framework for spontaneous adjustments. A conversion process of such magnitude, scope and complexity requires certain bureaucratic rules, which are precisely what these authors reject. To apply this rigorous market criterion to the present debt crisis would in effect be not only utopian but completely unrealistic.

IV

Conversion of the outstanding debt by collective action

1. *Theoretical basis*

This approach is based on a different theory; its advocates consider that the crisis of indebtedness has always been a public problem, since along with its exceptional scope and magnitude, its costs are regularly externalized by the agents that produce them (Devlin, 1984).²⁰ This hampers co-ordination among participants, and the lack of a permanent solution tends to generate even higher costs for the future. Hence a public solution is recommended, in the form of tripartite action in which the participants are the banks, the

debtor countries, and some international public agency. Regarding the last-named, there is little real difference of opinion among the advocates of this criterion, since the alternatives are to create a new body or enlarge the functions of one already in existence.

They also agree on the global pragmatic framework in which these proposals fit. In the first place, they recommend a more equitable distribution of benefits and costs. The banks dispose of their weaker loans and acquire safer assets at the cost of an accounting loss. The debtor countries obtain servicing terms more suited to their current situation, but they must initiate a process of internal adjustment. The international agency involved would, in principle, act only as intermediary, in order to help place the system on a sound basis. According to this plan, the industrialized countries would only provide their guarantee for the process. In the event of unforeseen difficulties (default by a debtor, bankruptcy of a bank, or any conjunctural

²⁰This conclusion corresponds in theory to a social market economy, in which the public authority should intervene to regulate the market, forestall serious crises and produce structural changes when necessary. But the public solution on the international economic plane implies collective action, since a unilateral decision on debt conversion by country is merely a discretionary and non-commercial act on the part of a market agent who decides to withdraw from the transactions. This latter case will be analysed in more detail in Part v.

problem), however, they would have to provide financial backing.

Various methods have been proposed for putting into practice this scheme of collective intermediation. Two have been examined in greater detail (see annex). Their difference lies in the degree of public intervention favoured, which also affects the magnitude of the ensuing conversion process. One proposes the integral conversion of the outstanding debt into international public bonds, which calls for direct, broad and persistent collective action. The other favours a form of public intervention limited to the granting of an official collective guarantee; this would not constitute a radical change in the securities, but would, according to its advocates, modify some of their basic features, such as maturity, value and interest.

2. *Conversion into international public bonds*

A frequent proposal has been to convert the outstanding debt into international public bonds. Three United States economists have published articles on the subject and the Ministry of Economy of Argentina proposed a plan on these lines to the creditor banks. Professor Kenen (1983) recommends the transfer of the bank securities to a multilateral agency, which would swap them for longer-term bonds (10 to 15 years) with a value 10% lower than that of the present bonds. This discount would enable the new creditor to grant more favourable service terms to the debtors, i.e., lower interest rates, a longer grace period and the rescheduling of maturities.

The proposal published by Richard Weinert (1983) is similar in its general lines but differs from the foregoing in the practical aspects of its execution. He rejects the creation of a new official agency, and proposes the World Bank as the intermediary; he does not favour a reduction in the total value of the debt, but a reduction in the interest payments, since as it is a question of a conversion into public bonds, the rate offered should be lower than the going market rate. The author contends that this would give the banks the impression of a smaller loss, since it would be gradual, scheduled over time, and would affect bank profits rather than assets (it is argued that the latter might even rise in value, through seem-

ing to be more stable and secure). The banker Felix Rohatyn (1983), noted for his efficient handling of the New York City financial crisis in 1975, invoked the same argument, proposing a very similar plan of debt conversion under the aegis of an international agency, but with a new element: in his scheme the debt services should not exceed 25% to 30% of the exports of the debtor country, which would imply much longer maturity periods (between 15 and 30 years) and an interest rate of around 6%. Moreover, Rohatyn insists on relaxing bank regulations so as to enable the banks to right down their losses over a longer period, thus protecting the stability of their assets.

Finally, Bernardo Grinspun, Minister of Economy of Argentina, proposed that the countries should issue bonds for the total amount of their debt (*El Mercurio*, 1984). These securities would be transferred to the Inter-American Development Bank (IDB), which then issues its own bonds for the same value as the former, but with a long maturity, a grace period and a fixed interest rate. These bonds would finally be delivered to the creditor banks. As the IDB received payment for debtor countries, it would proceed to make installments to the creditors banks.

Rohatyn's proposal is the only one which describes in some detail the new conditions offered to the debtors for the servicing of their debt to their new creditor. In contrast, various options are put forward for the terms offered to the banks. The Argentine proposal seems the most general, since it does not include either the terms of the offer or the subsequent supervisory machinery. The other plans advocate a more limited but more flexible system. Their authors propose the intervention of some public body, but insist on presenting their schemes to the banks and debtor countries merely as an optional solution, tied to the acceptance of specific conditions: namely, that the debtor countries must apply domestic adjustment policies under the supervision of the IMF, and the banks must accept a reduction in the value of their assets.

At the same time, an attempt is made to define the practical modalities of the conversion process. Professor Kenen is concerned to prevent the banks from distorting the process for their own benefit. Hence he favours strict, precise and non-negotiable conditions, as regards

both the time during which the offer would be valid, and its scope.²¹ In contrast, Richard Weinert favours differentiation according to the profitability of the loans, hoping thereby to keep part of the external debt on a commercial basis so as to maintain bank financing in the future. To the same end, the only limitation he accepts is to forbid the banks to convert the whole of their securities in respect of a particular country, since this would completely isolate that country from the commercial financing system.

3. *The collective official guarantee*

In a solution of more limited scope, public intervention is restricted to a collective official guarantee on the outstanding debt, while the forms and conditions of the reprogramming continue to be subject to direct negotiations between debtors and creditors. Thus the authorities do not intervene directly but merely seek to establish a more propitious framework for a process that must continue to be ruled by market forces.

Two ways of applying this concept have been indicated. One follows a very cautious path, since it proposes to use the existing agencies as a channel for the guarantee, with only slight modifications in their procedures. The other is more ambitious, since it employs the guarantee as a direct instrument for reducing the interest on the outstanding debt.

a) *Adaptation of existing mechanisms*

Two economists have developed this idea. Lord Harold Lever (1983) suggests enlarging the field of action of the national export credit and insurance agencies which already exist in the in-

dustrialized countries and which, according to him, should also deal with capital movements. He proposes to group them into a central organization that would assess, with IMF collaboration, the maximum (reasonable and sustainable) amount of external credit that each country should receive. If this amount is calculated on the basis of the deficit on current account, a figure will be obtained which would enable the debtor to fulfill his development needs and also face his payment commitments. Then, each agency would give an official guarantee in respect of the credits granted by the corresponding national banks, always provided that the total remained below the ceiling specified.

The banker Minos Zombanakis (1983) regards the IMF merely as a channel for the guarantee. He proposes the extension of the adjustment programmes (to periods of 10 to 15 years), and the inclusion *ex officio* of the Fund in the restructuring negotiations (which is already occurring, but unofficially). A novel element is the proposal for the Fund's guarantee of the payments falling due in the last years of the period.

According to both these economists, the official guarantee is intended to establish a set of incentives that will favour the orderly functioning of the credit market by infusing greater stability into the system.

The debtors would enjoy longer maturity periods and thus might introduce more steady reforms (so as not to lose the benefit of the guarantee). For their part, the banks would maintain their accounting intact, since their securities would not really be converted into public bonds. Nonetheless, since the securities are as viable and safe as public bonds, their maturity can reasonably be modified in the same way, together with their terms of servicing and refinancing.

Finally, the industrialized countries are asked to contribute by either increasing the resources of the export insurance agencies (Lever) or granting lines of credit for a central fund to back up the IMF's guarantee (Zombanakis). As in the preceding schemes, however, these resources would only be mobilized in extreme cases. The cost of the system would be equivalent to the guarantee of last resort which in any case the countries themselves have tacitly accepted.

²¹The first risk that he points out would be postponement of the conversion by the banks until the real market value of their securities had declined far more than the fall allowed for in the plan. He therefore considers it necessary to give a fairly short and non-renewable period for deciding on the solution described, after which the offer would be withdrawn. Nor would it be desirable for the banks to restrict the conversion only to the bad debts in their portfolio, thereby preserving the gains on their profitable loans while socializing their losses (i.e., passing them on to the community). To prevent this, he proposes the inclusion of uniform numerical criteria for fixing the limits of the process (e.g., the conversion should cover a certain minimum percentage of the total portfolio of the bank, without distinction between countries).

b) *Guarantee on minimum interest payments*

The proposal published by SELA (1984) is also in favour of a collective official guarantee as an incentive for the banks to reduce their interest rates. However, it does not specify the institutional arrangements for this guarantee, which according to SELA's study, could be provided through an existing multilateral agency, a fund created for the purpose, or even the central banks of the industrialized countries. It is only pointed out that it might be counterproductive to extend the guarantee to all the bank securities for a country, since in that case no commercial relationship would remain.

On the other hand, SELA's proposal includes much more precise and far-reaching changes regarding the new terms of credit, and particularly the interest rate. According to the authors, it would not be advisable to fix this rate much in advance, since it should fluctuate to adjust to the real payment capacity of the debtor country, which depends on its external sales and the trend of the terms of trade.

In no case should a country devote more than 20% of its export revenues to the servicing of its external debt, since this could jeopardize its possibilities of growth and development. Consequently, the interest rate paid by the debtor should be calculated every year, once the exact amount that the country can assign to its debt service is known.

The fluctuations of the rate would have a maximum (the rate originally agreed) and a minimum (the rate required to maintain bank liquidity). When even at the minimum rate the service payments would exceed 20% of the debtor's export revenues, the difference would be paid by the guarantor.

4. *Comments*

In the comments made on these proposals, the main objection has been the absence of an international body with sufficient power and prestige to enable the system to function efficiently. This lack creates difficult problems when it comes to deciding on the degree of public intervention advisable. Nor should it be forgotten that the banks continue to be tenacious defenders of the free market concept, and flatly reject any public

intervention in their domain. Even an optional system such as that advocated by Kenen and Weinert smacks to them of nationalization. Likewise, the plans for outright conversion involve obvious banking losses, which cannot be welcome to the sector.

All these proposals would in any case create serious accounting problems for the banks. To reduce the value of the assets implies a loss, but this is not the most disturbing aspect, since reserves have been set aside for this contingency. The modification of the credit terms would have more radical and unpredictable effects, especially if the interest rate were to be reduced. Hitherto the banks have shown themselves even less willing to reduce their profits than to tolerate a fall in the value of their assets.

The importance traditionally attributed by the banks to the maintenance of interest payments reflects their concern not to tarnish their image of solvency in the eyes of their national supervisors or of their shareholders. A fall in the interest rate below the one originally agreed would force them to regard the corresponding loans as non-performing and would call into question the management of the bank portfolio. However, as long as the new rate remains equal to or greater than the marginal cost of procuring funds (LIBOR plus an operating spread), all that would be needed to avoid extreme tensions would be for the supervisory bodies to ignore the situation. On the other hand, a fall below LIBOR could jeopardize not only the image of solvency but also the liquidity of some banks. Such an event would call for much more extensive intervention by the monetary authorities of the creditor countries, even though this is not explicitly included in the proposals.²²

The plans for the integral conversion of the debt, or for radical changes in the longer-term credit conditions, might prove counterproductive by provoking an even more severe and lasting contraction of bank lending to the develop-

²²Except in Rohatyn's proposal, which points out the need to have more flexible accounting regulations to safeguard bank confidence. Despite this, it does not seem very certain that this collaboration of the authorities in the accounting field would succeed in counteracting the destabilizing effect on the financial system that would result from a drop in the effective interest rate to only 5%.

ing countries, which is precisely what the proposals sought to avoid. At the same time, it may be assumed that the international agencies would find it more difficult to place bonds in the capital markets, since they would be overburdened with assorted debts which would impair their creditworthiness. Thus they would not find it easy to channel private resources towards the Third World, whose liquidity problems would be increased. Owing to this probable rejection of the plans by the private sector, as Professor Kenen himself acknowledges, the conversion of the debt into public bonds would only serve as a final resort, when the other alternatives had failed.

Indirect and more limited action, such as the establishment of an official guarantee, only represents the other side of the coin. In this case the danger is not a negative reaction on the part of the banks, but their indifference and apathy,

since it is by no means certain that the public guarantee would succeed in motivating the banking sector to grant the concessions which they have hitherto rejected. Even if some improvement in servicing conditions were obtained it might not be enough to provide relief for the debtors.

At the same time, it must be borne in mind that the acceptance and application of any decision of this kind involves a long delay, owing to the internal obstacles of the industrialized countries on the institutional and political planes. Lord Lever's proposal, by openly favouring the exporting sectors of the central countries, might be able to count on some degree of public support. But there remains the problem of imperfect co-ordination on the international plane, which would hamper the implementation of any of the aforesaid proposals.

V

Conversion of the outstanding debt by unilateral action

1. *The theoretical basis*

This third and last approach to the conversion of the outstanding debt is largely an attempt to remedy the shortcomings of the above-mentioned proposals. In the first place, it points out that these do not appear to open up very attractive prospects for the debtor countries. Under any of these schemes they must go on paying a high price for maintaining their access to the international financing market, although in practice this does not enable them to obtain a sufficient amount of credit. Nor do the said plans seem very favourable for other agents. This is why there has been no progress as yet on any of the proposals analysed, and it seems very unlikely that there will be a *volte face* in this respect in the near future. This continuing indecision has an extremely high opportunity cost for the debtors in the economic, social and political spheres, without holding out any prospect of compensatory benefits in the future. As a way out of this morass,

some economists have proposed the unilateral conversion of the outstanding debt.²³

In addition to the reasons of equity, social welfare and domestic policy invoked to justify this type of action there are also theoretical arguments. The implicit collusion on the supply side calls for corresponding collusion on the demand side. The serious defects of the present process constitute an overriding justification; Langoni

²³This initiative, although emanating from a national public agency of a debtor country, would not be equivalent to public intervention in the broad theoretical sense of the term as used in economics. The activating entity would be a mere participant in a market, without having any discretionary or regulating power over it. Nor would the organization of a debtors' club—a widely publicized proposal—represent collective action in the sense employed above. It could rather be interpreted as an attempt at partial collusion among agents on the demand side. At all events, however, the two positions are unilateral, since they are not the outcome of an agreement between the parties, or even of a joint resolution by one of them, but merely of the decision of one or more participants.

points out that both debtors and creditors find themselves today in a no-market situation (Lanconi, 1983), while Devlin (1983) adduces that a large proportion of banking profits in these conditions is tantamount to a monopoly rent. Thus the traditional patterns of renegotiation of the debt no longer suffice. As long as no efficient and expeditious solution of another nature presents itself, unilateral action by the debtors, no matter how controversial, would seem to be preferable to the *status quo*.

The simplest form of unilateral action is the moratorium, or suspension of payments. Although several countries have applied it in practice, it would be a bold step to adopt it openly as a reasoned policy. It should be emphasized, however, that the proposals for a moratorium do not imply repudiation of the debt, which would contravene tacit international norms with consequent loss of prestige for the debtor.²⁴ Hence, recourse to a moratorium has been envisaged not as an end in itself, but as an instrument to put pressure on the banks and compel them to make concessions.²⁵

2. Integral conversion of the debt into bonds

In the proposal for conversion of the debt into bonds of the debtor country a more detailed suggestion for unilateral action was formulated. The best-known plan, presented by Dornbusch (1983) for Brazil, proposes that the Central Bank should issue bonds to cover the country's external debt on the following terms: a maturity of over 15 years, a five-year grace period, and an interest rate of 2% in real terms. According to this economist, this measure would be highly advantageous for the debtors in the short term. To begin with, there would be a prolongation of the maturity term and an implicit and amplified period of grace for the amortization payments (which are deferred until the end of the period). This simplification of the refinancing process, besides providing the very necessary short-run.

²⁴Lipson states that up to now no country has repudiated its debt, not even after a radical change of government such as occurred in Nicaragua in 1979 (Lipson, 1981).

²⁵It was in Brazil that the idea of a moratorium was most widely canvassed, and several economists and politicians have advocated this type of initiative (Furtado, 1983).

financial relief, would give more stability to the external payments situation and enlarge the economic policy horizon.²⁶

The advocates of the plan assume, besides, that the banks would be satisfied, since their profits would also become more stable. Dornbusch considers that his plan confers a great benefit on the banking sector, since the rate of 2% is higher than the real rate of United States Government bonds during the period 1930-1980.²⁷

3. Comments

The criticisms levelled at these proposals have centered on their conflictive aspects and the probable tensions they would produce in the short term. Attention has been particularly drawn to the legal reprisals which the banks could take against the countries, with a possible embargo on national assets and the immediate suspension of all bank intermediation, which would also compromise basic commercial operations. These possibilities, however, cannot be quantitatively assessed, since there is no precise international law or precedent on the subject. It is probable that diplomatic and strategic considerations would carry more weight, so that the repercussions would depend rather on international policy.

On the economic plane, the accounting effect of the plan on the banks is an important consideration: the conversion of commercial loans into bonds would affect the equilibrium of the bank portfolios, and since the bonds are negotiable, they could produce losses in their assets, while the change in the servicing conditions could result in the rearrangement of the portfolio, causing some loans to be written off. This plan would then have the same destabilizing effect on the financial system as some of the

²⁶The use of fixed interest rates also helps to stabilize the payment situation. On the other hand, rates defined in real terms are an advantage for the banks, and in general for the financial system as a whole. It seems likely that the current high rates contain a premium for uncertainty about world macroeconomic conditions in the future. To offer a real rate enables this premium to be eliminated, and might contribute to a drop in the nominal rate, with a stabilizing effect on capital markets.

²⁷The bank profit would be even higher in periods of accelerating inflation, when real commercial rates are actually negative.

programmes discussed earlier. In this case, the dimension of the crisis would depend on the number of countries affected, and on the volume of their debt in relation to the total assets of the banks concerned.

Finally, the plan could involve a high cost to the debtors in the long run, through a radical reduction in future bank financing. The banks have already shown that they have a long memory as regards their accounting losses. An open

conflict between them and certain debtors would presumably leave deep and lasting scars and it would take a long time for credit relations to be renewed between the international private sector and the developing countries. To arrive at a more precise appraisal of the repercussions of unilateral conversion, a new and radical assessment would have to be made of the development strategy, and the role attributed to external indebtedness in that process.

VI

Conclusions

It is clear from the analysis of all these varied proposals that none of them offers an ideal solution. It might even be claimed that no such ideal solution exists, since the number of participants and the diversity of interests involved turn the external debt crisis into a tangle of conflicting aims.

Although an awareness of this situation by no means justifies leaving things as they are, it certainly puts some limits on future action. In the first place, the traditional economic reasoning does not meet the case. The existing imbalances will not automatically correct themselves. The academic rationale might indicate desirable results, and it would not be difficult to reach agreement as to these: the granting of short-term relief to debtors and enough credit not to impede their development, while maintaining bank liquidity and the stability of the financial system. But the economic analysis no longer provides efficient instruments for achieving these goals. The instruments depend on the power relations between the participants, which makes it difficult to quantify them and express them in a formal proposition. All the plans analysed have a defect in common: they do not say whence the impulse will come to put them into operation.

This is all the more true of multilateral action, although this would be more likely to reach a viable compromise. Nonetheless, two of the participating groups (the banks and the creditor countries) are obtaining sufficient benefit from the current procedures to prefer the *status quo*. So

it is for the debtors to give impetus to the move.

At first these countries were rather passive in their approach, and did not make full use of the bargaining power they might have had by acting together. Since then, however, with their domestic, economic and social tensions becoming ever more acute, the debtor nations have been gradually adopting a more active stance, with a view to making the process more flexible and reducing the costs of renegotiation. In this respect the international and regional meetings organized on the subject made a valuable contribution. The text published at the close of the Latin American Economic Conference, in January 1984, was an important step forward, since, without overlooking the individual features of the different nations, it defined common criteria to guide the new renegotiation process followed by each country.

The final declaration of the Cartagena meeting, signed by eleven Latin American countries in June 1984, marked a further advance in the same direction. This document affirmed the growing convergence among the countries of the region in proposing clear guidelines for the policies of debt restructuring and external credit. At the same time, it announced the creation of consultation and follow-up machinery which would facilitate the taking of new measures when necessary.

These proceedings were intended to increase the bargaining power of each country, and to some extent practical results have been achieved.

The renegotiations recently concluded have resulted in credit terms somewhat more favourable than those of earlier agreements. Nevertheless, it must be stressed that these new conditions continue to be onerous for the debtor countries and the latter's access to external credit remains

restricted. Hence it is necessary to proceed along the same course by way of regional co-operation. And although prudence may seem called for in order to avoid trouble in the future, we must not forget the daily cost to the Third World of the present conditions of renegotiation.

Annex

SUMMARY OF PROPOSALS FOR CONVERSION OF THE OUTSTANDING EXTERNAL DEBT

	Partial conversion	Integral conversion
<i>Through market mechanisms</i>	Creation of a secondary market	<p><i>N. Bailey</i>: conversion into a financial instrument whose amortization is tied to the annual foreign exchange income of the debtor country</p> <p><i>A. Meltzer</i>: conversion into shares in the ownership of the debtor's public enterprises</p>
<i>Through multilateral public action</i>	<p>Granting of an official collective guarantee on the loans:</p> <p><i>Lever</i>: the national export credit agencies guarantee the loans as long as the debtor country does not exceed the maximum indebtedness fixed for it by the IMF</p> <p><i>Zombanakis</i>: the IMF increases the duration of its adjustment programmes to over 10 years and guarantees the service payments for the final years</p> <p><i>SELA</i>: the countries devote a maximum of 20% of their export revenues to the servicing of their debt, while an international body guarantees payment of a minimum interest rate to the creditors</p>	<p>Conversion into long-term international public bonds with new servicing conditions:</p> <p><i>Kenen</i>: 10% discount on value of loan</p> <p><i>Weinert</i>: lower interest rate</p> <p><i>Rohatyn</i>: new conditions are made which prevent the servicing from representing more than 25% to 30% of the debtor's export revenues</p> <p><i>Argentine proposal</i>: period of grace and fixed interest rate</p>
<i>Through unilateral action</i>	<i>C. Furtado</i> : moratoria for the adjustment period	<i>R. Dornbusch</i> : conversion into public bonds of the debtor country, with 15 years maturity, a 2% real interest rate and a five-year grace period

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