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The burden of debt and the crisis: is it time for a unilateral solution?

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Hitherto Latin America's adjustments to debt servicing requirements have taken the form of a contraction of imports and of the economy as a whole, which is producing perverse effects not only in the economic but also in the social and political spheres. In view of these consequences, this process cannot be allowed to continue, and must be replaced by a positive adjustment, based on the strengthening of the region's productive capacity; but this positive adjustment, in turn, will be possible only if appropriate solutions are found for the external debt problem.

In the author's opinion, the "first-best" solution would be a multilateral settlement involving the creditor banks, their governments and the debtor countries; a "public bad" like the external debt problem should be collectively tackled. But a collective solution has a major drawback, inasmuch as the relatively long time that its formulation would take would prevent the debtor countries from obtaining the immediate relief that they need. Accordingly, the author considers two possible "second-best framework which might serve as the basis for a positive adjustment. The first would consist in a bilateral agreement between the debtor countries and the banks, on much more reasonable terms than have been seen so far, while the second would imply unilateral action on the part of the debtor countries for the purpose of imposing a moratorium or converting the debt into long-term bonds. A unilateral solution may involve a high cost for the debtor countries over the medium and long term, but it could become the only available option if reasonable multilateral or bilateral agreements are not reached and if no sustained recovery of the international economy takes place.

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I
Introduction

The current debt crisis in Latin America clearly requires quick remedial action; without it efficient adjustment will become all but impossible. Measures to alleviate the crisis will have to be adopted at the national, international and regional levels. The time dimension will also have to be taken into account, since in sorting out possible solutions it is important to distinguish between measures that can provide immediate relief and those that are longer-term propositions.

The time factor is critical; in Latin America the debt problem has ceased to be a theoretical issue and is now one of great practical urgency. Latin America needs relief from the crisis today; clearly, for large segments of the Latin American population "there is no tomorrow", and consequently socio-economic tensions in the borrowing countries have reached unprecedented levels. As President Osvaldo Hurtado of Ecuador said in his opening address at the Latin American Economic Conference held in Quito in January 1984, "failure to resolve our countries' economic crisis might generate a new source of serious and destabilizing social and political conflicts which will inevitably upset the precarious world balance".[1]

The countries of the region have adopted exceptional measures to achieve the necessary adjustment and meet their commitments with their creditors.[2] But the adjustment has been undertaken in a recessive world economic environment. At the same time, the unbalanced structure of international financial markets renders it unable to supply adequate amounts of anti-cyclical financing in face of the depressive trends in both trade and private finance. Hence the present adjustment can be described as perverse; it has been achieved in essence via a dramatic compression of imports and unprecedented falls in per capita income.

In at least one important respect the adjustment in Latin America may possibly be complete;

[1]See *El Mercurio* (Chile), 13 December 1983, p. B.1.

[2]For data and analysis respecting this subject, see Enrique Iglesias, "Preliminary overview of the Latin American economy during 1983", in the present issue of the *Review*.

after a 41% reduction in the volume of imported goods in 1982-1983 it is difficult to believe that there is any "fat" left in the region's import structure. For this reason it is of paramount importance that Latin America should avoid further reductions of its purchases abroad.

But the problem does not lie only in calling a halt to the squeezing of vital imports. Latin America's rapid adjustment process has been somewhat artificial; it has been motivated by desperation and has been negative inasmuch as it was accomplished largely at the cost of weakening the region's productive capacity. A positive, efficient adjustment is one that comes about by strengthening productive capacity, and this in turn requires, among other things, economic restructuring, investment, reactivation and greater capacity to import.[3]

Unfortunately, the weight of Latin America's debt service —even after the first round of reschedulings in 1982-1983— leaves little or no margin for economic growth and the recovery of international reserve positions. Thus, any type of economic recovery *cum* restructuring would require new and direct remedies to relieve the burden of the debt.

In theory, the best way of tackling the debt crisis is to be found at the international and regional levels, but, owing to political and economic obstacles, such a solution cannot be put into practice promptly enough to provide the immediate relief which Latin America will so urgently need in 1984 and 1985. The borrower countries will therefore have to explore other, second-best solutions.

Two possibilities are considered here. One involves a bilateral arrangement with the banks for a rescheduling on terms consonant with a positive adjustment. The other consists in unilateral action via moratoria or through conversion of the debt into long-term bonds. Each of these alternatives will be analysed so as to evaluate its efficiency in relieving the current burden of the external debt.

II

The first-best solution: a multilateral settlement involving the banks, their governments and debtor countries

1. *The public nature of the debt crisis*

The current debt crisis in Latin America must be viewed as a public problem, or, in technical jargon, as a "public bad". A public bad is one in which a considerable part of the costs of any given situation is borne not by those responsible but by others, i.e., the costs are externalized from the standpoint of the agents producing them. These "negative externalities" are felt both by creditors and by debtors and have important implications for policy.

From the debtor's standpoint, the debt servicing problems of a major borrower —i.e., Mexico in mid-1982— created a panic in financial markets; bankers were quick to perceive Mexico's difficulties as a "Latin American problem", and the consequent general restriction of new loans swiftly pulled almost all the other Latin American debtors into the vortex of the crisis. The importance of this negative externality in the development of the crisis comes more clearly to light when it is recalled that in normal market conditions debtors are invariably allowed to repay loans with the contraction of new ones.[4] With

[3]For an analysis of this problem and of a positive adjustment, see A. Gurrieri and P. Sáinz, "Is there a fair and democratic way out of the crisis?", *CEPAL Review* No. 20, August 1983, pp. 127 to 148.

[4]See P. Dhonte, *Clockwork debt*, Lexington, Mass., Lexington Books, 1979, chapter 6; W.A. Lewis, *The evolution of the international economic order*, New Jersey, Princeton University Press, 1977, pp. 65 to 66; and R. Devlin, "External finance and commercial banks. Their role in Latin America's capacity to import between 1951 and 1975", *CEPAL Review* No. 5, first half of 1978, pp. 63 to 97.

the spilling-over of Mexico's negative image of creditworthiness to almost all Latin American countries, these latter lost the very resources (new loans) that had been permitting the smooth servicing of private bank debt for the past 15 years. What is more, until the two big borrowers —Brazil and Mexico— regain their image of creditworthiness, it will be difficult for other debtors in the region to restore normal relations with their creditors, whatever efforts the authorities may make on behalf of adjustment.

From the standpoint of the banks, the negative externalities are equally significant and tend to aggravate the problem. For example, in the present crisis a bank could not extend new credits to a country without knowing whether the other creditors would do the same; otherwise, new loans granted by the bank in question would be applied simply to pay off loans from other institutions that were withdrawing from the market, without much benefit for the borrower and with considerably increased risk for the lending bank. Negative externalities are also present in the so-called "market solution" to the debt problem. Thus, losses on a portfolio that are derived from poor risk assessment by an individual lending institution could very well spark a panic in financial markets, which might have deleterious effects on the viability of other institutions that have not technically erred in the evaluation of their own risks in individual countries. This latter externality was graphically exemplified in the market turmoil of 1974 generated by the bankruptcy of the Bank Herrstatt in Western Germany, an institution of no great importance in the international banking system.

Externalities also abound when one seeks to pinpoint just where the blame, and therefore the costs, should lie. Again, according to the conventional theory which assumes that all decisions by economic actors are made independently, the costs ought to be borne by inefficient lenders, since on the basis of risk assesments they charged premiums to which recourse should be had when the risks materialize. In the real world, however, things are not so simple. As has already been pointed out, externalities will prevent the incidence of losses from being limited to banks which followed poor lending criteria. But what is more, risk evaluation by creditors in the 1970s was not carried out independently. In fact, the governments of the OECD countries strongly encouraged banks to lend to developing countries, both directly —through exhortations to recycle petrodollars— and indirectly, through: i) an expansionary fiscal and monetary policy which produced excess liquidity in the bank system; ii) the discrepancy between tight regulation of home financial markets and total lack of control of international markets; and iii) failure to support international credit institutions such as the World Bank, IDB and the International Monetary Fund, which could have afforded a more appropriate alternative for recycling petrodollars.

Additional negative externalities were generated by the structure of financial markets itself. The banking system has two tiers: the big international banks that search out markets and evaluate risk, and medium-sized and small banks which provide the bulk of the funds and lend largely on the basis of the assessments made by the big banks. Furthermore, the big international banks themselves are locked into an oligopolistic structure and do not make lending decisions independently of what they expect their competitors will do.

Lastly, when looking at the problem from the debtors' viewpoint, it should be recalled that during the 1970s the Latin American countries borrowed on the basis of their own needs and decisions, but were also encouraged to do so by the arguments in vogue in important international technical circles, to the effect that bank credits were "cheap" in real terms and that foreign indebtedness was "good business".

In short, then, a great "public problem" is posed. In terms both of the causes of the crisis and of its own nature, the banks, their governments and the borrower developing countries face important interdependencies which condition all solutions to the crisis and suggest that a sharing of the costs is appropriate.

2. *A public problem demands a public solution*

A *sine qua non* for efficient adjustment in Latin America and a lasting resolution of the crisis is a co-ordinated effort on the part of the OECD governments to reactivate their economies and bring interest rates down to historical levels. If Latin America's terms of trade had been similar to those prevailing in 1980 (25% higher), and if at the same time real interest rates had mirrored those in force at the time when the bulk of the debt was contracted (4 points lower), the region would have at its disposal an additional 25 billion dollars, enough to meet debt service without a dramatic compression of imports and hence of economic growth.[5] Moreover, this is terrain in which debtors, creditors and their governments have strong common interests: economic recovery would reduce unemployment and social tensions both in the North and in the South, while a fall in interest rates would promote recovery and normal debt payments would be resumed without jeopardizing the profits of the lending institutions.

The absence of a strong and sustained recovery in the OECD countries, debt service will cloud Latin America's growth prospects and, in the context of the short-leash rescheduling policy applied by the private banks,[6] will continue to take up a disproportionate share of bankers' and developing country authorities' time. Nevertheless, proposals abound to alleviate the problem by joint multilateral public action. A summary of the contents of some of these proposals, based on data prepared by Martine Guerguil is presented in table 1. In addition to these general ideas, specific measures have frequently been suggested in relation to reform of the international financial system. They include the following:[7]

— increasing available long-term financing from the World Bank via a change in the gearing ratio of this institution;
— authorizing direct access by the International Monetary Fund to private capital markets;
— promoting co-financing between the World Bank and private banks;
— eliminating the concept of graduation for middle-income countries;
— modifying the International Monetary Fund's conditionality; and
— stepping up the importance of programme loans by the World Bank.

At the regional level there also are many proposals for assisting Latin America to overcome the crisis. Among these the following are included:[8]

— freezing the level of protectionism and promoting the expansion of regional trade and preference systems;
— broadening and interconnecting the various interregional financial programmes, such as multilateral payments mechanisms,[9] schemes for balance-of-payments support,[10] import credit insurance plans,[11] and institutions dedicated to the financing of projects;[12]
— enlarging the functions of the Inter-American Development Bank; and
— securing an effective, direct and confidential interchange of information with respect to

[5]See Enrique Iglesias, *op. cit.*

[6]In the present crisis the banks have agreed to reschedule only one or two years of maturities with their amortization in only 8 years. The "new" loans intended in practice to refinance part of interest payments have to be negotiated annually. For further background data on the nature of debt renegotiation, see R. Devlin, "Renegotiation of Latin America's debt: an analysis of the monopoly power of private banks", CEPAL *Review* No. 20, August 1983; pp. 101 to 112; and ECLA, *Economic Survey of Latin America, 1982*, Santiago, Chile, United Nations, 1983, Part I.

[7]See also Brandt Commission, *North-South: a program for survival*, Cambridge, Mass., MIT Press, 1980.

[8]For a complete review of this subject see C. Alzamora and E. Iglesias, "Bases for a Latin American response to the international economic crisis", CEPAL *Review* No. 20, August 1983, pp. 17 to 46; and the Latin American Economic Conference, *Declaration of Quito and Plan of Action*, Quito, 9 to 13 January 1984, in the present issue of the *Review*.

[9]Cámara de Compensación Centroamericana, (Central American Clearing-House), Sistema Compensatorio Multilateral de Pagos del Caribe (Caribbean Multilateral Settlement System); and Sistema de Compensación de Saldos y Créditos Recíprocos de ALADI (ALADI, System for Settlement of Reciprocal Balances and Credits).

[10]Acuerdo de Santo Domingo (Santo Domingo Agreement); Fondo Centroamericano de Estabilización Monetaria y Fondo para Financiar Saldos Deudores en la Cámara de Compensación Centroamericana (Central American Monetary Stabilization Fund and Fund for Financing Debit Balances in the Central American Clearing-House).

[11]Latin American Export Bank; Sistema Andino de Financiamiento del Comercio y Asociación Latinoamericana de Organismos de Seguros de Crédito a la Exportación (Andean Trade Financing System and Latin American Association of Export Credit Insurance Agencies).

[12]Central American Bank for Economic Integration; Caribbean Development Bank; Corporación Andina de Fomento (Andean Development Corporation); and Fondo Financiero de la Cuenca del Plata (River Plate Basin Financing Fund).

TABLE 1

SUMMARY OF SELECTED PROPOSALS TO ALLEVIATE THE DEBT CRISIS

Government of Mexico[a]	A new window in the International Monetary Fund that would provide lightly conditional finance to countries facing interest payments in excess of 2% real. This represents an expansion of the concept underlying the Fund's current Compensatory Finance Facility.
Kenen[b]	In this scheme private banks would trade their LDC loans for 10-15 year bonds to be issued by a newly-created OECD-supported international organization. The loans would be traded at a 10% discount and the devaluation of the banks' assets would allow the new institution to reschedule LDC loans on more favourable terms.
Weinert[c]	Private banks would trade their LDC loans for bonds to be issued by the World Bank and the Bank in turn would reschedule the loans on better terms. The trade would be at face value, but the bonds would carry a reduced interest rate; this would distribute losses over a longer period than would be the case under the Kenen plan, with its immediate 10% devaluation of assets.
Zombanakis[d]	The IMF would extend its adjustment programme to 10-15 years. The private banks would then reschedule their loans in a way compatible with the longer adjustment programme and in turn would receive an International Monetary Fund Guarantee for the later maturities of the rescheduling.
Bolin and Del Canto[e]	It is proposed that a new public institution be established to provide loans that bridge the gap between the short-term maturities of private banks and the longer-term maturities of multilateral lenders. A bigger financing role is also envisaged for OECD export credit agencies. As for the fluctuation in interest rates, it is suggested that the World Bank provide residual finance that would effectively guarantee a maximum interest rate for debtor countries.
Lever[f]	On the basis of an evaluation of what constitutes a reasonable current account deficit, countries should have made available to them a maximum amount of finance. This evaluation will be made in conjuction with the International Monetary Fund. Bank loans in this programme also should enjoy OECD government guarantees.
Avramovic[g] Massad[h]	Both propose increases in LDC liquidity via new issues of Special Drawing Rights (SDRs).

Source: Data from M. Guerguil, "La crisis financiera internacional: diagnósticos y prescripciones", ECLA, Economic Development Division, mimeographed text, November 1983.

[a] "Facilidad para el financiamiento del déficit de balanza de pagos provocado por las altas tasas de interés", mimeographed text, August 1983.

[b] P. Kenen, "A bail-out for the banks", *New York Times*, 6 March 1983.

[c] R. Weinert, "Banks and bankruptcy", *Foreign Policy*, No. 52, Spring 1983, pp. 138-149.

[d] M. Zombanakis, "The international debt threat: A way to avoid a crash", *The Economist*, 30 April 1983, pp. 11-14.

[e] W. Bolin and J. Del Canto, "LDC debt: beyond crisis management", *Foreign Affairs*, Summer 1983, Vol. 61, No. 5, pp. 1099-1112.

[f] H. Lever, "The international debt threat: A concerted way out", *The Economist*, 9 July 1983, pp. 18-20.

[g] D. Avramovic, "The debt problem of developing countries at end-1982", *Aussenwirtschaft*, March 1983, pp. 65-86.

[h] C. Massad, "The external debt and the financial problems of Latin America", CEPAL *Review*, No. 20, August 1983, pp. 149-163.

the terms on which the said countries' external debt is refinanced and rescheduled.[13]

In spirit and intent, all these proposals are along the right lines; public problems do indeed demand public solutions. But their efficacy is handicapped by the aforementioned time element: most of the proposals are at best medium-term propositions. It must be recalled that an economic system based on private markets tends to underproduce public solutions (i.e., public "goods"). Furthermore, pressures for a public solution are usually minimal until the external-

[13] See Alzamora and Iglesias, *op. cit.*; and Latin American Economic Conference, *op. cit.*

ized costs of a problem are internalized by the system's major economic agents. So far, the ability of the banks and their governments to reschedule debts on terms highly favourable to themselves has enabled the North to keep the costs of the debt crisis externalized; in other words, the debtor countries have had to bear them while any benefits have largely accrued to the creditors.[14] Another disincentive to action is the opinion held by some OECD governments that the crisis has already been resolved by the first round of reschedulings and by the recovery of the United States economy. Only if the developing countries begin to enter into non-negotiated moratoria will the cost become a reality in the North, and it would be then that OECD governments could be expected to take rapid and concerted action aimed at achieving public solutions. The moral of this story is simple: modern market economies tend to privatize profits and socialize losses; until the threat of losses is felt to be real, public solutions are unlikely to materialize on any significant scale.[15]

Solutions at the regional level also encounter formidable obstacles. The main difference, however, is that the costs of the crisis have already been internalized by the region's most important economic actors, thus giving greater impetus to regional solutions. But in any event, time remains an important factor and regional agreements cannot be expected to provide immediate relief from the debt crisis.

III

The second-best solution: Bilateral or unilateral action?

A public solution to the crisis, while entirely desirable, does not seem feasible in the near future. This reduces the field of action to the national level, where a response could be: i) a bilateral agreement between the borrowing country and its creditor banks involving a rescheduling of the debt compatible with a positive adjustment process; or ii) unilateral action taken by the borrower to relieve the burden of debt service. Which of the two solutions is the second-best for the debtor country will depend upon the hypotheses adopted with respect to the world economy, the characteristics of the debt problem and the current disposition of the banks.

Latin America must reduce its external vulnerability by restructuring its relations with foreign creditors and adopting new development and indebtedness strategies.[16] Nevertheless, the region presumably will seek and need future external financing. The merit of a bilateral settlement involving a rescheduling on terms consonant with a positive adjustment process is that it is less conflictive than unilateral action and thereby serious negative repercussions on future access to credit may be avoided. But a bilateral rescheduling solution —even if on terms favourable to the region— is not sufficient to secure future financing: if the world economy does not enter upon a sustained expansion and if interest rates do not come down to normal levels, there will be little chance of a restoration of autonomous payment capacity in most countries, no matter how hard they try to adjust. Thus, servicing problems on past debt accumulation will recur, making net resource transfers from the banks in the future very problematical indeed. This latter situation, in turn, would greatly reduce the opportunity cost of unilaterally imposing on creditors a type

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[14] A recent study by A. Fishlow points out that the nine biggest United States banks obtained excess profits totalling between US$ 70 and US$ 130 million in 1983, as a result of the renegotiations with the Third World. See *El Mercurio* (Chile), 16 January 1984, p. B.1.

[15] For example, the current United States administration for a long time opposed any expansion of the International Monetary Fund quotas. Only when Mexico was on the verge of financial collapse (and hence so were some United States banks) did it support an enhancement of the Fund's role in Third World financing.

[16] See the article by Gurrieri and Sáinz, *op. cit.*, which outlines some relevant ideas.

of very long-term development-oriented repayment scheme that probably would be impossible to put into effect in a framework of bilateral negotiations.

There are two other situations in which unilateral action might prove to be the preferred solution. The first, when there is unexpected intransigence on the part of private creditors. As pointed out elsewhere,[17] the extremely burdensome terms imposed by the banks in the 1982-1983 reschedulings generate what are tantamount to monopoly rents obtained in a non-competitive capital market thanks to strong bargaining power that the banks acquire by negotiating *en bloc* with the borrower, through the mechanism of the banking advisory committee. This being so, the most appropriate frame of reference for the debtors' action *vis-à-vis* the creditors would be a bilateral monopoly with the two countries negotiating the sharing-out of the losses on a very weak bank portfolio. If countries took this situation into account —instead of behaving as if they were rivals— both theory and practice suggest that Latin America could in all likelihood make better use of its bargaining power to strike rescheduling terms compatible with a positive adjustment process —all this with no very serious negative repercussions on access to credit. Nevertheless, should the banks, for whatever reason, prove unbending in their bargaining stance, a country which needs relief now might then have no alternative but to take unilateral action to reduce the debt burden and stimulate its economic growth.

The second situation involves countries which face severe internal constraints on raising repayment capacity. These countries are, for all practical purposes, insolvent, and even a recovery in their terms of trade would be insufficient to restore repayment capacity. Once again the future prospects for positive net transfers from the banks would be meagre, possibly making the cost of imposing a very long-term repayment scheme on the banks less prohibitive.

1. *The bilateral approach*

a) *The general strategy*

As a point of departure, the general hypothesis adopted is that to relieve current political tensions and to protect the stability of the international financial system, not only must Latin America's per capita income not fall farther, but it must now rise, and begin to recoup the severe losses incurred during 1981-1983.[18] It would be eminently reasonable to set a minimum growth target of 5% per annum for 1984-1986. Assuming a rather conservative marginal import coefficient for Latin America of 1.3 (that reigning in 1967-1973), imports would have to expand at the very least by 7% per annum in real terms. International reserves would also have to rebound from today's critically low levels.

The options open can be depicted in the following simple external resource equation:

$$X - M - R = L + L_a - iD - A$$

X = exports
M = imports
L_a = arrears on debt service
R = change in reserves
L = new loans
i = average interest rate
D = external debt
iD = interest payments
A = amortization payments

Let it be assumed that imports (M) and reserves (R) must rise. This can be achieved in a situation of external resource balance by a compensatory expansion of exports (X); or by some combination of increased new loans, accumulation of debt service arrears, lower interest rates on the debt outstanding or rescheduling of amortization (A) and/or interest payments (iD) on the debt in question. In the current world economy where export demand is sluggish and protectionism is rampant, it is fair to assume that export growth will be problematical and relatively exogenous to the region's internal efforts. In present conditions it will also be difficult to

[17] See R. Devlin, "Renegotiation of Latin America's debt...", *op. cit.*

[18] See E. Iglesias, *op. cit.*

obtain new autonomous loans and the prospects for lower interest rates are not very promising in the immediate future. Thus, in the near future a rise in imports and reserve cover will probably have to be achieved via arrears or reschedulings.

Bankers have displayed great concern about avoiding accounting losses on their portfolio. This is reflected in their reluctance to declare defaults and their willingness to reschedule amortization payments and extend loans to facilitate payments of interest, thereby disguising from bank supervisors the non-performing nature of their assets.[19] Unilateral action on the part of borrowers involving long-term repayment of the debt would expose this tactic as it would saddle the banks with the book losses that they so desperately try to avoid. Latin America's bargaining strength lies in exploiting this preference and allowing the banks to go on in the same way, always providing they agree to rescheduling on terms that facilitate a positive adjustment in Latin America. The time may be ripe for putting such a strategy to practice, inasmuch as increasing pressure at the international level, in certain influential circles in the banks' own countries,[20] and consternation in the borrower countries, have apparently helped to predispose the banks to soften repayment terms (and reduce monopoly rents) in the second round of reschedulings for Mexico and Brazil, in 1984.[21] Moreover, there may be room for nudging the banks farther on this point.[22]

The basic premise for a bilateral solution is that the costs for the banks of a settlement favourable to debtors' interest should be obscured; i.e., attempts should be made to avoid accounting losses for the banks, even while imposing real losses upon them. The reasons for this strategy will become clearer in the subsequent analysis of unilateral action; suffice it to say now that the goal of such a strategy is to preserve prospects for future financing from private creditors.

How to disguise or obscure the losses for the banks? The answer is to push out all payments into the future without hardening lending terms —indeed, the terms must be softened. The banks make sacrifices in two respects. First, in rescheduling loans on relatively less favourable terms, they become locked into assets which offer less returns than would be available from alternative opportunities. Secondly, by softening terms in relation to the original conditions of the loan, the present value of the future income stream is reduced. Even though the banks are worse off than before, they need not suffer accounting losses if the revised terms of credit meet the *minimum* requirements for the transaction to be successfully disguised as commercial. The reschedulings must have a "commercial flavour" in order

[19]Interest rates are so high that the burden of interest payments alone would suffice to create a financial crisis. For example, in 1982-1983 over 35% of the value of the region's exports was absorbed by payments under this head, and in some countries the coefficient reached 50% or more (see E. Iglesias, *op. cit.*, table 14). In these circumstances, the mere rescheduling of amortization payments —the traditional relief mechanism— would not have been enough to restore debt servicing capacity. However, by rescheduling interest payments, the banks incur the risk that their government bank authorities may classify the loans as non-performing assets and cause a write off of part of the value of their portfolio. Accordingly, the banks resort to the indirect expedient of refinancing interest payments through new loans, thereby evading losses (see R. Devlin, "Renegotiation of Latin America's debt...", *op. cit.*).

[20]For example, in a new Act of the United States Congress respecting an increase in that country's IMF quota, it is proposed that under economic adjustment programmes short-term debts at high rates of interest should be converted into long-term debts, at rates appreciably lower than those prevailing in the restructuring of bank debts negotiated between August 1982 and August 1983, for countries receiving help from the Fund intended for economic adjustment programmes with a view to minimizing the burden of adjustment for the debtor country. See Organization of American States, "Extracto de la Ley Pública 98-181 del Congreso de los Estados Unidos titulada: Ley de Viviendas Nacionales y de Recuperación Internacional y Estabilidad Financiera", OEA/SER H/XIV/CEFYC/4, 10 January 1984.

[21]Brazil is known to have obtained a softening of debt terms: provisional data suggest that the renegotiation for 1984 implies a reduction of the spread over LIBOR from 2.5% to 2%, and of commissions from 1.5% to 1.0%. Mexico, for its part, will pay 1.5% over LIBOR and a commission of 0.625% on its "new" loan of US$ 3.8 billion; these figures are lower than the 2.25% over LIBOR and commissions of 1.25% settled for its additional loans in 1983. A 10-year maturity will be granted, with a grace period of 6 years, as compared with the 6-year maturity (3 grace years) for the new loan in the year before.

[22]The fact that Brazil managed to obtain softened credit terms at the very time of an aggravation of its crisis and an accumulation of debt service arrears to the tune of US$ 3 billion is an empirical indication of the monopoly rents tapped by the banks in the first round of reschedulings.

that they may fall into a "gray area" that will give the regulatory banking authorities of the OECD a legitimate way to turn a blind eye rather than classifying the loans as non-performing assets. And this, in all likelihood, is what they will do, if the alternative is an international banking crisis.

b) *The terms of an agreement*

Assuming that whatever world economic upturn that may materialize will have more gradual effects on Latin America than has normally been the case in recoveries since the Second World War, and assuming likewise that in the near future nominal and real interest rates will remain exceptionally high, rough and ready estimates would suggest that for Latin America to grow at an average annual rate of 5% in the triennium 1984-1986, and begin a modest recuperation of its international reserves, it will need to reschedule all its amortization payments, and on average have 80% of its interest payments rescheduled or refinanced.

In this light, bankers and debtor countries should devise a rescheduling package that at a minimum would cover the triennium 1984-1986, although ideally the two should pursue a restructuring of the entire stock of debt owed to the banks. It is absolutely essential to eliminate the traumatic yearly rescheduling exercises which waste so much of the government authorities' and bankers' time, create uncertainties, and inhibit restoration of a normal credit environment for Latin America. Thus, a debt relief package providing a definitive once-and-for-all arrangement for upcoming payments is called for. Incidentally, the new debt relief package could coincide with the International Monetary Fund's extended adjustment programmes, thus affording bankers the backing of the Fund's conditionality.

Amortization of debt, however, is really not the problem, as bankers have shown a disposition to reschedule. The real bottleneck to recovery in Latin America, and where the focus of attention must lie, is the payment of interest. The banks —under pressure from IMF— have been refinancing about 50% of interest payments. Even so, the countries' gross domestic product continues to fall, inasmuch as large foreign trade surpluses have to be generated (in the face of external constraints on export performance) to cover the outstanding balance of interest payments, which is very large on account of the exceptionally high level reached by nominal interest rates. Accordingly, *ceteris paribus,* formulas must be found for still further reducing these interest payments on a cash flow basis.

Therefore, as an integral part of the rescheduling agreement creditors should provide an *ex ante* guarantee of 80% refinancing of interest payments[23] during the period 1984-1986. This could very well involve a front loaded sliding scale, e.g., 90% in 1984; 80% in 1985, and 70% in 1986, to take into account the possibility of a gradual improvement in the world economy and somewhat lower international interest rates. A historically useful instrument called a "bisque clause" also could be inserted into the agreement to provide for less automatic refinancing of interest payments in the event of a dramatic and unforeseen change for the better in the world economic situation and/or a plummeting of interest rates.[24]

The rescheduled amortization payments and refinanced interest should bear a repayment schedule that pushes against the limit of what could be considered a commercial transaction. Evidently this should involve maturities of at least 10 to 12 years (with a 6-year grace period), since a 10-year amortization period (with 6 grace years) was agreed to in the second round of the Mexican rescheduling and 12 years was awarded to Nicaragua in 1980; all this with no negative repercussions or sanctions on the part of the creditors' local banking authorities. But an even more acceptable goal would be 15 years (with a 6-year grace period), a maturity plan that banks extended with some frequency on loans during

[23]This guarantee, of course, would be tied to compliance with IMF adjustment targets, which might be less severe, since countries would have more financing at their disposal as a result of the greater rollover of interest payments.

[24]Bisque clauses were employed by the United States Government in the case of some of its post-war loans. For example, in 1945 the government made a US$ 4-billion loan to the United Kingdom, to be repaid over 50 years, in which a bisque clause allowed the repayment schedule to adjust to the economic conditions of the borrower. See G. Abbott, "The case for cancellation", *Inter-Economics*, No. 7, July 1975, pp. 217-221.

the 1970s.[25] On the other hand, a 20-year amortization period, repeatedly proposed in Latin American forums, risks crossing the threshold of tolerance of local banking supervisors, since it represents a period that is traditionally beyond the bankers' business horizon and enters the terrain of institutional investors. While OECD government guarantees on the tailend maturities could obviate this drawback, such a scheme would overstep the constraints —self-imposed here— of a bilateral arrangement.

The margins over LIBOR —another of the elements determining the negotiated cost of credit— that would be charged on rescheduled debt and refinanced interest payments, would have to be as low as possible, yet satisfy the requirements of commercial practice. This would involve spreads well below those charged in the first round of 1982-1983 reschedulings,[26] and in most cases below those originally negotiated. The limits to be defined here are part of the vagaries of the "cat and mouse" game characteristic of the negotiating framework of a bilateral monopoly. But even within the banking community itself there have appeared proposals to the effect that while the banks could not accept a spread below their (marginal) cost of funds (which is LIBOR), a 1% spread would be feasible as a temporary measure.[27] An even better arrangement, however, would be either a 1% spread, or the margin originally negotiated on the debt to be rescheduled or refinanced, whichever were lower. This would allow countries like Mexico, with traditionally excellent images of creditworthiness, to approach their normal negotiated cost of credit (which is below 1%); most of the other countries, for their part, would enjoy a spread somewhat lower than that originally agreed upon. There is, moreover, a precedent for this inasmuch as in the bank restructuring of United States and Canadian corporate debts special "soft" market rates of interest were applied. Indeed, eminent experts in the OECD area have recommended that this strategy for problem debtors in domestic markets be extended to the international plane.[28]

As for commissions, in principle they should not be charged in the rescheduling/refinancing package, since this is a case of administration of existing debt on which commissions were paid at the time of obtaining the loans. However, in keeping with normal banking practices there is no reason why payment of commissions could not be agreed to in exchange for an interest spread somewhat lower than that proposed here.

Lastly there is now a consensus in world forums to the effect that the cost imposed by the private banks in the first round of debt renegotiations was unduly high. Debtors could demand an adjustment of this cost through new agreements under which credit terms may be settled on more liberal principles along the lines suggested here.

c) *Co-operation among debtor countries*

Achieving the above rescheduling conditions is a question of bargaining power. As noted earlier, the banks' ability to impose conditions may have been somewhat eroded by negative reactions in certain influential circles of the centre and the periphery against the overly burdensome charges on reschedulings.

The Latin American countries could bring additional pressure to bear by two means. The simplest and least controversial measure would be an exchange of information among the countries concerning the bargaining tactics of the banks. This idea, which was proposed by the Executive Secretaries of ECLA and SELA in a Plan

[25] Such 15-year loans were common in the early phase of the expansion of bankers' activities in developing countries, that is, in the first half of the 1970s. See World Bank, *Borrowing in International Capital Markets*, Supplement EC 181, Washington, D.C., August 1976, annexes.

[26] I.e., between 2.25% and 2.50% over LIBOR. See R. Devlin, "Renegotiation of Latin America's debt...", *op. cit.*, table 3.

[27] See P.P. Kuczynski, "Latin American debt: act two", *Foreign Affairs*, Autumn 1983, Vol. 62, No. 1, pp. 118-138. Moreover, Robert Roosa —financial expert, partner in the Brown Brothers Harriman investment bank, and formerly a high official of the United States Treasury— has declared that interest rates for reschedulings ought to approximate the LIBOR and that in future IMF must concern itself not only with the granting of new loans by the banks but also with their terms. See "Robert Roosa delivers Struc Memorial Lecture emphasizing a broader role for the Fund & Bank", *IMF Survey*, 15 December 1983, p. 374.

[28] See R. Roosa, *op. cit.*, and R. Weinert, "Banks and Bankruptcy", *op. cit.*, pp. 138-149.

of Action presented to President Hurtado of Ecuador in 1983,[29] would help to counterbalance the advantages enjoyed by the banks which exchange information through the banking committee as well as through a new institute recently organized by them in Washington, D.C. In the first round of reschedulings, borrowing countries negotiated in relative secrecy, to little advantage, as witnessed by the fact that the terms of the agreements are practically identical for all the different countries. The establishment of a credit information system in an existing regional institution might prove to be an easy way to enhance the Latin American countries' bargaining power.

A second measure, considerably more complicated and controversial, implies direct co-operation among borrowers in negotiating with the private banks. Even if a borrower recognizes that the correct negotiating framework is that of a bilateral monopoly, for diverse reasons there could be considerable asymmetry in the bargaining power of the parties. Likewise, for some borrowers, particularly those with a politically less than favourable international image, the cost of being the first to break new ground in the pattern of reschedulings might be very high as banks might retaliate harshly, just to set an example and discourage similar action by other countries. Joint action would help to obviate these drawbacks. While the proposals for a regional cartel would almost certainly be impracticable, because of the cumbersome administration it would involve and the reluctance of most countries to participate, there is no reason why one or several smaller groups of countries with similar negotiating interest should not voluntarily join forces *ad hoc* in order to pressure the banks into a more rational relief package. While it is true that each country's circumstances are different, it is no less certain that all have a common interest in better terms for the restructuring of debt.

d) *Stabilization of interest payments*

The average 80% refinancing of interest payments means that cash payments to the banks would represent a low percentage of debt outstanding. This is quite reasonable, inasmuch as even cash payments equivalent to a "normal" real interest rate of 2% would be very burdensome in the current abnormal world economic conditions. For example, in the case of Brazil, after refinancing of interest payments, the balance of interest paid on a cash basis in 1983 amounted to roughly 2% of its bank debt in real terms. To make this payment, the per capita product had to fall by 7%. Thus, in the short-term interest payments in cash must be well below 2% real. Nevertheless, as a proposal for the future, if and when the world economy returns to some degree of stability, it would be constructive to establish a real rate of interest ceiling around a "normal" rate —say 2% real— on bank loans, with any balance over that being capitalized with interest by creditors.[30] This would provide debtors with a measure of stability in interest payments. Moreover, the international financial markets would then have an "automatic" mechanism to roll over interest payments and thereby avert the trauma and the uncertainties that excessively high interest rates generate in financial markets via their negative and transitory effects on the borrowers' debt servicing capacity.

2. *The unilateral approach*

Mention has been made of three situations in which a bilateral rescheduling agreement on quasi-commercial terms might not prove to be the preferred solution for the borrower: 1) a rigid bargaining stance on the part of the banks that unduly delayed implementation of a new rescheduling framework compatible with positive adjustment; 2) failure of world economic recovery and persistence of high interest rates; and 3) a very serious structural disequilibrium within a country.

The first situation is more or less self-explanatory. The second is not conducive to a bilateral commercial agreement, since even if the countries could negotiate a margin as low as 1% on a rescheduling, this would imply an effective interest rate of 11%, assuming a LIBOR of around

[29]See Alzamora and Iglesias, *op. cit.*

[30]In the 1960s the banks often established ceiling and floor rates for loans with a floating rate of interest; but no capitalization mechanism existed and the system therefore lost its attraction for the banks.

10%. If 80% of these payments were refinanced, debt would grow by at least 9% per annum. This growth of debt would only make economic sense if Latin American exports were to recover their dynamism over the period 1984-1986. Without renewed dynamic export growth —which would necessitate strong economic expansion in the OECD area— or a sharp drop in interest rates (which would reduce refinancing requirements and therefore debt expansion), Latin America would just sink deeper and deeper into the quagmire of having to reschedule on commercial terms. As regards the third situation, a country facing severe internal supply constraints might also find difficulty in meeting the commitments of a commercial rescheduling, since its capacity to export —and hence its opportunity to take advantage of better terms of trade— would be limited. In these circumstances, it would be worthwhile to explore the possibilities of imposing a non-commercial repayment programme.

The two unilateral solutions most discussed in Latin America are a moratorium[31] and unilateral conversion of debt into long-term bonds.[32] The two solutions are very similar, since the proponents of a moratorium are not suggesting repudiation of the debt, but rather a temporary halt in current commercial repayment schedules and their replacement by very long-term debt service programmes. In this context, too, there would be no need to submit to an International Monetary Fund adjustment programme.

While the precise terms of repayment differ among the various proponents of these schemes, they are much alike in principle. Payment on interest and principal would be halted for a period of 2 to 5 years, the principal being reimbursed over 20 to 30 years. Interest rate proposals vary from less than market rates to 2% real.[33]

The immediate value of these plans is that they would: 1) provide considerable and instant relief from the burden of debt; 2) offer a repayment stream that is a good deal more compatible with development than any commercial scheme that would conceivably be acceptable to the banks; and 3) eliminate the need for endless multiple reschedulings with their ensuing waste of time and resources.[34] In other words, they would extricate the countries once and for all from the so-called debt trap. Also, faced with any of the three above-mentioned conditions, such plans would allow a borrower to take the inevitable step —free itself from an insupportable debt service burden— without being accused of repudiation of foreign obligations.

Another potential benefit, often cited by proponents of unilateral debt conversions into bonds, is that such an emission would help to create a secondary market for Latin America debt paper. On the one hand, this would allow the banks to rid themselves of unwanted assets by selling them off in such a market. On the other hand, countries would gain valuable information on their creditworthiness via the fluctuations of the market value of their paper. Likewise, any sharp devaluation of assets in the market could provide potential debt relief via an opportunity to repurchase the obligations at lower values.[35]

What are the costs? There may be some of importance.

The first cost is related to what would happen to the banks and future access to credit. A generalized debt conversion into bonds, or a moratorium, would force the banks to write off a considerable part of the value of their loans to developing countries, much as would happen in a competitive market solution. This would imply heavy accounting losses for the banks. Moreover, the losses will be borne to a disproportionate extent by the big United States lending institutions, which are the least diversified with respect to Latin American debt.[36]

[31]The best-known proponent of this solution is Celso Furtado, of Brazil.

[32]See R. Dornbusch, "A stabilization program for Brazil", Cambridge, Mass., mimeographed text, 1983, and Conferencia Económica Latinoamericana, *op. cit.*

[33]What has not been mentioned, and would be even more appropriate, is a real interest rate calculated on the basis not of international inflation, but of the borrower's terms of trade.

[34]See M. Guerguil, "Conversión de la deuda en bonos: una tentativa de evaluación", ECLA, Economic Development Division, mimeographed text, December 1983.

[35]*Ibid.* This relief is only potential because the burden also would depend on the value of the means of payment (foreign exchange) and hence the terms of trade.

[36]See D. Wyss and R. Napier, "The world debt crisis and the U.S. economy", *Data Resources U.S. Review*, September 1983, pp. 1.24-1.29.

These losses would probably prejudice future access to credit. On the one hand, they would represent a serious threat to the solvency of many of the world's largest financial institutions. These are unlikely to go bankrupt, thanks to the quick intervention of central banks, but uncertainties would paralyse all credit markets and spark a rapid major rise in interest rates from their already excessively high levels. This in turn could cause the debt crisis to spread to markets in the North, stifling economic recovery in the OECD area,[37] and hence make the creditworthiness of Latin America even more problematical.

On the other hand, creditors have long memories with regard to accounting losses, as witnessed by the reluctance of institutional investors to reenter the developing countries' bond market after their disastrous experience in the 1930s. These negative repercussions are intensified in a modern banking system. First, there are the aforementioned negative externalities that make the crisis permeate the entire financial network. Secondly, the losses would be disproportionately concentrated in the big banks, which are the most internationally-oriented and to a large extent are responsible for mobilizing credit from the hundreds of small- and medium-sized domestically-oriented banks that provide the bulk of loanable funds in the market. Furthermore, the big banks also have some control over bond markets since they frequently underwrite such instruments. In other words, if the big banks were estranged from Latin America, credit would become extremely restricted[38] even if there were an objective improvement of creditworthiness in Latin America. It is precisely for these reasons that a unilateral settlement of the debt crisis would seem attractive only under conditions in which the alternative —bilateral reschedulings on fair terms— was not economically viable.

As for the benefits of developing a secondary market, this possibility too is problematical. First, there is the question of who would purchase the paper.[39] Secondly, a unilateral bond emission by one or several small borrowers would involve values that would be too low to support an efficient secondary market. Although such action by a big borrower and/or many smaller borrowers could create values sufficient to form a secondary market, the losses imposed on the banking system might be so large and immediate that in all likelihood primary and secondary markets would be in disarray for a considerable length of time, adversely affecting both access to new credits and trading of old debt.

Finally, not all countries are in a position to initiate a unilateral settlement. Just as in a bilateral settlement, there might be very high costs for an innovator in the form of retaliation from the banks and their governments. Probably, therefore, the unilateral option could be adopted only by i) a very large borrower which enjoys a "balance of terror" with the banks; ii) a country of considerable geopolitical significance to the North; and/or iii) a group of borrowing countries acting in conjunction. Once a precedent was set without retaliation, other countries could more easily follow similar repayment programmes.

IV

Final considerations

The conditions necessary for a unilateral approach to the debt problem are, in reality, fairly straightforward. Given the high degree of pessimism reigning in certain circles as to the possibility of sustained recovery in the OECD

[37] *Ibid.*

[38] There is, of course, the theoretical possibility of emitting bonds on debts to banks that find such an arrangement acceptable, such as smaller United States banks and European institutions which have had less to do with Latin America. But this theoretical possibility is stifled by the legal requirements of cross-default clauses which in practice leave all banks in the same boat. Moreover, this boat is piloted by the big United States institutions.

[39] See Guerguil, "Conversión de la deuda ...", *op.cit.*

area,[40] predictions of persistently high interest rates, and the severe economic deterioration in most Latin American countries, a unilateral solution may be tempting for a number of borrowers. Nevertheless, caution should be counselled. It would be premature to forecast the future direction of the world economy, and present difficulties within Latin America should not be tackled with short-sighted strategies. It might prove wise to probe the banks respecting their attitude towards a better rescheduling package along the lines suggested here. If they accept, countries would lose very little by signing such an agreement. Should the world economy in fact move in a positive direction over 1984-1986, repayment capacity would be restored in most countries, and they could then pursue alternative, less heavily indebted routes to development without need for rescheduling. Furthermore, new credit, albeit not in the unusual volume of the 1970s, should be available if required. But if the OECD economies were to show definite signs to a renewed slump over 1984-1986, the borrowers would have a fairly clear picture of a difficult future ahead, making unilateral action —in the absence of an international public solution— the only prudent road to relief and future development. Meanwhile, the cost of having waited to implement unilateral action in the form of a larger debt would lose some of its relevance because values would be eroded by the softer repayment terms imposed upon the banks.

[40]See O. Sunkel, "Past, present and future of the international economic crisis", in this same issue of the *Review*.