

A New Approach to Managing the Debt Crisis

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The debt crisis, and the IMF-sponsored stabilization programs enacted in response to it, have resulted in an excessive degree of austerity for several of the debtor countries. The current creditor strategy, it is argued, is not sustainable over the long term unless the debtor countries are allowed to grow. The author advocates a more generous treatment of debt servicing requirements, in the form of partial debt relief, as the most effective method of promoting LDC growth. One possible strategy for granting debt relief is discussed as well as the type of conditionality which should be imposed in return for debt relief.

THE BAKER PLAN was unveiled in Seoul, South Korea in October 1985 in recognition of the shortcomings of the current approach to the developing country debt crisis. Contrary to the optimistic predictions of many observers after 1982, economic growth and creditworthiness have not been restored in most of the debtor nations in Latin America and Africa. The trade balances of many of the debtor countries have swung sharply into surplus, but not as a result of successful export promotion. Rather, these countries have contracted their imports in response to the cutback in

commercial bank lending after 1982. This import austerity has meant a large loss of markets for US exporters. The loss of markets is particularly dramatic with respect to the debtor countries in Latin America, as shown in Table 1.

The large trade surpluses in Latin America are not an indication that the current debt strategy is working, or that it is sustainable in the future. Historians will remember that Germany succeeded in generating trade surpluses in 1929 to pay for its World War I reparations just on the eve of the collapse of the German economy. The trade surpluses signaled depression rather than recovery in Germany.¹ Instead of examining the trade surpluses, it is important to assess the internal economic situation in the debtor countries, which in most cases remains

very bad, and in some cases is sharply deteriorating.

The central argument that I shall offer is that the degree of austerity now facing several debtor countries is excessive, and that the austerity can be best eased through a more generous treatment of debt servicing requirements, in the form of debt relief in addition to debt rescheduling (my focus will be on the Latin American debtor countries, though the main themes apply in Africa as well). By attempting to secure full servicing of interest on the Latin American debt, the current strategy is: threatening democracies throughout the region; imposing an undue burden of adjustment on the debtor countries; hurting US exporters by excessively squeezing import demands from the region; provoking high inflation and capital flight throughout Latin America; and,

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TABLE 1

	1981	1982	1983	1984	1985
Exports of Latin America	108.2	97.6	97.6	103.9	93.3 a
Imports of Latin America	119.3	96.5	75.9	75.1	50.2 a
Trade Balance	-11.1	1.1	21.7	28.8	43.1 a
US Exports to Latin America	42.1	33.6	25.7	29.7	31.0
US Imports from Latin America	40.8	39.6	43.6	50.1	49.1
US Trade Balance with Latin America	1.3	-6.0	-17.9	-20.4	-18.1

a First half of 1985, at annual rate.

ironically, reducing the long-run value of the creditors' claims on the debtor countries, by discouraging adequate structural adjustments in the debtor economies.

Peru is an example of a country in need of debt relief. The economy is in a state of collapse due to the combined pressures of falling export prices, fifteen years of poor economic management, and the heavy weight of debt servicing. Per capita GNP has declined by 15 percent since 1980, and real wages have fallen by an incredible 40 percent. The social fabric is crumbling. Murder, kidnapping, and terrorism are the daily fare of Lima. Drug trafficking provides one of the few profitable activities in a collapsing economy. However, when President Alan Garcia Perez told the United Nations last year that his country faced the choice of debt or democracy, and that therefore he would unilaterally restrict debt servicing payments, his *cri du coeur* was received as an affront to the banks, and the international financial community has united in opposition to his plea for debt relief.

The situation is little better in many of the other debtor countries. Neighboring Bolivia reached 50,000 percent inflation last year, while Argentina topped 1000 percent and Brazil recently raced to an almost 500 percent annual rate. These three countries now have "shock" anti-inflation programs underway, but the political and economic environment is precarious, and the success of the stabilization efforts remains very much in doubt. Mexico is now reeling under the weight of collapsing

oil prices (not to mention years of remarkably large budget deficits) and its inflation could easily race ahead of 100 percent this year.

The current strategy of the creditor countries for managing the debt crisis, including the new directions of the Baker Plan, has much in its favor, but has at least one deep and unresolved flaw. The strategy properly seeks to treat the debt crisis on a case-by-case basis, since the situation of the various debtor countries differs greatly. The strategy properly calls for policy adjustments by the debtor countries, since without exception, the crisis throughout Latin America reflects serious economic mismanagement by governments in the region, particularly in running irresponsibly large budget deficits for over a decade that left the countries deeply in debt.

Where the strategy goes wrong is in its refusal to contemplate partial and selective debt forgiveness by private and official creditors in cases where the debtor country is crumbling under the weight of the foreign debt burden, or where debt forgiveness might provide an important spur towards positive adjustment. It would be fatuous to destroy fragile democracies in order to collect the last cent on interest due to the commercial banks, particularly when much of the debt in Latin America is already written down in the books of the US commercial banks, and in their stock market values, though almost none has been forgiven by the banks in their negotiations with the debtor country governments.

My own research has indicated that the market value of claims on the

Latin American debtor countries is already much below par value, and that the stock market valuation of the major commercial banks reflects that market discount.² Both direct and indirect evidence suggests that the marketplace puts a value of about 70-75 cents on the dollar on commercial bank claims on Brazil and Argentina; slightly less on Mexican debt; approximately 35 cents on claims on Peru; and as little as 10 cents on the dollar on Bolivian debt. The irony of this situation is that the US commercial banks could now forgive some of their claims on the Latin American countries without further reducing their market values, which already reflect the anticipation of debt writeoffs.

The current strategy for managing the debt crisis does not, of course, intend to destroy democracies in the quest for debt servicing, but it does presume that a "tight leash" approach is the best way to achieve favorable long-term adjustments in the debtor countries. Even this argument is doubtful. The whole point of the Chapter 11 provisions for corporate reorganization in the Bankruptcy Code, is that debt-riddled companies in need of reorganization sometimes require protection from their creditors, and that such protection is often in the interests of the creditors themselves. Without protection, creditors will needlessly and often recklessly decapitalize a faltering firm, to the ultimate detriment of the creditors themselves. By giving debt relief in a Chapter 11 proceeding, the creditors give the corporation the time and resources necessary to reorganize and to resume profitable growth.

Such bankruptcy court protection is not available for the debtor countries, so that for many of them, the inevitable scramble of creditors to remove their assets is underway. That scramble shows up in two ways: banks are doing their best to reduce their exposure, and residents of the debtor countries are fleeing with their own capital. Consider these developments in the major Latin American debtor countries:

Not only have the commercial banks failed to increase their expo-

TABLE 2

	Change in U.S. Bank Exposure, \$billion	Capital Flight, 1983-1985 \$billion (minus = capital flight)
Argentina	0.1	1
Brazil	-0.3	-3
Mexico	-1.7	-17
Venezuela	-3.9	-6
10 Latin American debtor Countries	-7.5	-30

SOURCES: US bank exposure from Statistical Release of the Financial Institutions Examination Council, 10/15/84 and 4/15/86; Capital flight estimates from Morgan Guaranty **World Financial Markets**, March 1986. The 10 countries are: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, Venezuela.

sure at annual rates of 5-7 percent as was envisioned by policymakers in 1983, but US banking exposure in the 10 major Latin American countries has actually declined by about 7.6 percent since mid-1984. Latin American residents have behaved no differently from the commercial banks, since the private sector in the large Latin American countries has engaged in capital flight on the order of \$30 billion since the beginning of 1983. (See Table 2).

The links between the external debt burden and the problem of capital flight should be precisely understood. Throughout Latin America, the external debt is predominantly owed by the governments themselves. In almost every country that has succumbed to the debt crisis, the foreign debt resulted from a decade of thoroughly irresponsible budgetary policies, which led to an incredible fiscal burden that governments are now finding impossible to meet through normal tax revenues. These governments are now paying for the interest on the external debt in part by cutting investment spending and in part by printing money (hence the runaway inflations in Argentina, Bolivia, Brazil, Mexico, Peru, and Uruguay). The inflation and the prospect of future budget deficits contributes to capital flight, by destabilizing the local economy.

Making loans to a debtor government in order to help it to meet its interest payments only partially solves the problem, since the increasing debt

of the government signals to the private sector that the fiscal burden is going to be even greater in the future. Debt relief (for example in the form of below-market interest charges on the debt) could, on the other hand, significantly ease the current debt burden and improve private sector expectations at the same time. For obvious reasons, though, debt relief should be predicated on commitments by the debtor government to take other steps to restore fiscal discipline in the long run.

Partial debt relief would be much more effective than debt rescheduling in eliciting needed structural adjustments from the most heavily indebted countries. Consider the differing incentives for adjustment that arise from a dollar of debt relief versus a dollar of debt postponement. In

the event of debt postponement, the foreign creditors are the ultimate beneficiaries if the country does well, since the amount of eventual debt repayments will thereby rise. On the other hand, if the debt relief is granted, the country keeps the benefits of its better performance in the future. Thus, debt rescheduling is not so attractive for a politician calling for sacrifice from his fellow citizens. The sacrifice seems to be for the foreign banks, rather than for the country's own future.

By pushing governments to fiscal collapse and even hyperinflation, therefore, the tight leash can become a noose, strangling the confidence of the government and private sector to make structural adjustments and to invest in future growth. As a result of these stresses, net investment in physical capital in Latin America was a remarkably low 5.5 percent of the GNP during 1982-1985, less than half of the preceding decade. The slowdown in investment spending is clearly crippling the growth prospects of the entire region. As Table 3 shows, per capita GDP has decreased almost uniformly across the region.

It might be argued that some recent developments in the world economy will put the debt crisis behind us. Certainly, the worldwide fall in interest rates and the depreciation of the dollar against the yen and the European currencies are both highly favorable developments for almost all debtor countries. However, the contribution of these developments to recovery in Latin Amer-

TABLE 3

Changes in Per Capita GDP in Latin America

Country	Cumulative Change in Per Capita GDP, 1981-1985	Country	Cumulative Change in Per Capita GDP, 1981-1985
Argentina	-18.5	Guatemala	-18.3
Bolivia	-28.4	Mexico	-4.3
Colombia	-0.1	Panama	0.7
Costa Rica	-11.2	Peru	-14.8
Chile	-8.7	Uruguay	-18.6
Ecuador	-3.9	Venezuela	-21.6
El Salvador	-24.0		

Source: Economic Commission for Latin American and the Caribbean. "The Economic Crisis: Policies for Adjustment, Stabilization, and Growth" April 1986, Santiago, Chile.

ica should not be overemphasized. The dollar prices of many primary commodities have continued to decline in recent months, offsetting many of the benefits of the lower interest rates. And taken as a whole, Latin America is a large net exporter of oil, the commodity with the sharpest decline in price. Of the ten major debtors in Latin America, Argentina, Bolivia, Ecuador, Mexico, Peru, and Venezuela are oil exporters.

As I suggest in greater detail below, there could be significant benefits to the US economy from a coordinated program of partial debt relief for some of the most extremely indebted countries, even after netting out the costs of the US financial institutions receiving lower interest payments. The relief would add directly to the financial resources available to the debtor countries to undertake growth-promoting investments, and would directly stimulate the demand for US exports, particularly in our capital goods industries, which have been severely hit by the debt crisis. Moreover, a dollar of debt relief, if tied to good policies by a debtor country government, would promote much more than a dollar of new investment. By reducing the burden on debtor country governments to service their debts, these governments would be better able to balance their budgets, reduce inflation, and restore confidence in the private sector. Well-directed debt relief would contribute to a reversal of capital flight, by helping to restore confidence in the debtor economies. These countries could then draw on the \$200 billion or so of private capital flight of the past ten years in order to help finance their future investments. The future development of Latin America would be financed mainly by Latin Americans rather than by US banks, and the US banks could expect a restoration of full interest payments on their remaining claims in the region.

The rest of this article is divided into five sections. Section II provides further details on some of the shortcomings in the current debt strategy. Section III outlines some ideas for introducing partial and selective debt relief into the policy

mix. Section IV discusses an appropriate institutional arrangement which would facilitate a debt relief decision-making process. Section V proposes a possible strategy for granting debt relief. Section VI returns to the fundamental question as to the nature of conditionality that should be imposed in return for debt relief.

II. *Further Observations on the Current Debt Strategy*

The strategy to date has put the IMF in the front line of the debt crisis. This has been appropriate, given that the major internal problem in almost all of the debtor countries has been fiscal irresponsibility, and that the major focus of the IMF is the restoration of reasonable fiscal balance. Nonetheless, the current mode of handling the crisis is breaking down for several reasons:

(1) Democratic governments can no longer be seen to be taking orders from the IMF. Of course the Fund has always maintained that the programs originate with the country in any event, but the public in the debtor countries has generally believed differently. Only recently, with the heterodox Austral Plan in Argentina and Cruzado Plan in Brazil, has the IMF been viewed as acceding to the plans of a debtor government, rather than imposing its own plan.

(2) More importantly, the IMF can't offer any substantial financial assistance to most of the Latin American debtor countries in return for those countries accepting IMF conditionality. The IMF judges by how much a debtor government should reduce its budget deficit according to the amount of new external financing that is available to the government. If little foreign money is available, then the IMF demands a very tight adjustment effort as part of its conditionality. In the last two years, private bank lending to the Latin American countries has dried up, and IMF programs have gotten commensurately less attractive. In these circumstances, it doesn't really cost a government that much to boot the IMF out of the country, which is now happening with ever greater frequency.

(3) Whatever the merits of Fund programs, they are not adhered to with any regularity. Only when a government is disposed to use a Fund program as a way to bolster its own policies in the face of internal opposition do the Fund's conditions have a good chance of fulfillment. On the other hand, when a country is led kicking and screaming into an agreement, the chances for compliance have turned out to be slight. Thus, in recent years the Fund has found a greatly diminished rate of compliance with its performance criteria, and this drop in compliance has led to a further tightening of Fund programs (more preconditions, a shorter leash on debtors). A recent study of mine gives further details of declining compliance.³

(4) The current arrangements give the United States government insufficient flexibility for helping those governments that are key to US foreign policy-interests. The success of the Alfonsin government is key to many US objectives in the region, and yet the international and US responses to the ambitious Austral plan have been meagre. The creditor governments might logically have tried to organize a postponement of interest repayments, or to make cuts in interest rates, to bolster the plan in a strong way. Instead, the Fund has insisted on deep austerity, and continued servicing of interest at market rates. The US government, for its part, has lectured the Argentine government about the need for supply-side policies (privatization, liberalization, etc.) that are politically difficult for President Alfonsin to carry out until the stabilization part of the Austral Plan is firmly successful.

A basic strategy of the Baker plan, it appears, is to substitute the World Bank for the IMF in managing the crisis over the next few years, and to emphasize microeconomic "supply-side" considerations, over the austerity of the IMF programs. If this basic interpretation is correct, the Baker Plan is subject to several serious shortcomings:

(1) Budget reductions remain the top adjustment priority in most of the countries in Latin America. In

the absence of some form of debt relief, or in the absence of much greater amounts of foreign finance, budget austerity will be necessary as a matter of simple budgetary accounting. There is no real luxury of choosing between IMF austerity and World Bank growth-oriented policies, unless the budget constraints on the debtor countries are somehow eased.

(2) The amount of short-term relief mentioned in Secretary Baker's initiative (\$20 billion from the commercial banks and \$9 billion from the multilateral agencies over three years) is surely too low, whether that money is managed primarily under the auspices of the IMF or World Bank, or some other multilateral entity. Moreover, by urging the commercial banks to continue lending, the US government makes itself vulnerable to future demands by the banks that the government indemnify them in the event that the new loans go bad.

(3) The degree of intrusiveness of the IMF will pale in comparison with the degree of World Bank intrusiveness, since the World Bank is set up to monitor the fine structure of microeconomic management in the recipient country. World Bank Structural Adjustment Loans dictate terms with respect to dozens or even hundreds of sectoral policies, that cut to the heart of the political fabric of a country. The outcry over World Bank terms will be even more severe than over IMF terms, if nothing else is done to sweeten the deals with the debtor countries. This is illustrated by the recent "World Bank riots" which erupted in Panama in the past couple of months, over the imposition of labor market liberalization as condition of a World Bank loan.

(4) The "supply-side" policies stressed in the Baker initiative (privatization, foreign direct investment, and trade liberalization) would be useful in most of the Latin American countries, but the list of policies ignores several key features of what is "wrong" with the countries in question. In particular, the political elites in many of the debtor countries have run the state as much for private gain as for economic develop-

ment, with the result that the government sector is nearly bankrupt in several countries. Mexico, Venezuela, Argentina, Peru, and Bolivia, have all been characterized by widespread corruption in the past ten years; cheap loans to powerful political interests made by the government; extensive capital flight, through which the economic elites have protected themselves, even as wages have been severely squeezed; and in some cases, government takeovers of private sector debt at terms favorable to the private debtors (the same group, by and large, with substantial capital flight abroad).

A successful resolution of the debt crisis, and a return to growth and stability in Latin America, will require at least three new directions for policy. First, for many countries, the terms for debt servicing will have to be eased, especially in the new democracies that we are interested in nurturing. Easing the terms will in practice mean interest relief from the private and official creditors, since in the era of Gramm-Rudman budgetary stringency we cannot rely on major amounts of new money from official creditors, and in any event, we cannot expect major increases in private bank loans. Second, the IMF and the World Bank should become just two institutions among many for managing the crisis. Rather than letting the IMF take all of the responsibility for the design of a stabilization program, the responsibility should be centered in a broader group, set up on a country-by-country basis, to include the IMF, World Bank, the creditor governments, commercial banks, and other major creditor interests. Similar creditor groups have been set up in the past, with great success, for Indonesia, Turkey, and a few other countries. Third, the content of conditionality and the concerns of the creditors should be extended beyond budget control (*à la* the IMF), microeconomic efficiency (*à la* the Baker initiative), to include considerations of equity, and the strengthening of democratic institutions. The politics as well as the economics of Latin America need reform. The elites in many countries have systematically plundered the state finances. Real success cases,

such as Korea, Singapore, Hong Kong, and Taiwan, all show far more equal distributions of income and fiscal burden than in Latin America.

III. *The Case for Partial Debt Relief*

Most corporate workouts and corporate reorganizations under the bankruptcy code involve writedowns of debt, even in cases where the original shareholders and management retain control over the corporation. An overly indebted corporation needs protection from its creditors, both in the timing and the terms of repayment, in order to have the chance to make the difficult management moves needed to get the company back to a profitable condition. Existing debts are written down and often subordinated to new credits during the adjustment period. The presumption is that the ultimate value of the creditor's claims will be enhanced by a policy of stretchouts, partial writedowns, and even subordination of debts to new creditors.

The current strategy for the developing countries, on the other hand, operates on the premises that all debt must be serviced at market rates, that interest payments must remain timely, and that any missed payments of principal should be capitalized at market interest rates for later servicing. Such a rigorous condition for repayment has rarely worked in the past once a country has fallen into severe debt-servicing problems.

The experience in the 1930s and 1940s is instructive. After the collapse of commodity prices in the early 1930s, most of the Latin American debtor countries suspended debt servicing on foreign bonds that they had floated in the US and UK during the 1920s. The debt-servicing moratorium was unilateral, with little negotiation between creditors and debtors before World War II. In the late 1940s, the debtor countries came up with revised debt servicing plans so that they could qualify for the loans of the newly created World Bank, which was requiring from each country an agreement between the government and its creditors as a precondition for World Bank disbursements.

The terms of agreement were generally very favorable. The unpaid interest during the period of default was generally summed without capitalization, and added to the total stock of principal due. Thus, a \$100 coupon due in 1932, and unpaid for the next fifteen years, was charged to the country at \$100, rather than at \$100 compounded at market interest rates for fifteen years. The resulting "total debt due" (principal plus interest) was then refinanced through a new bond issue, usually at maturities of 30 to 50 years, at very low interest rates. Bonds that originally floated for 7 percent were refinanced at rates of 2 to 3 percent. Those bonds from the late 1940s are now coming due in many cases.

In reality, the debt burden was reduced far below even this small amount. One reason is that the debtor countries secretly entered the bond market in a big way in the late 1930s and early 1940s, in order to buy back their debt at prices of 10 to 15 cents on the dollar. Thus, as an example, of a \$42.5 million issue of Republic of Chile Bonds (dated 1926 at 6%, due 1960), the principal outstanding in 1946 was only \$20.8 million, the rest having been bought back by the Chilean government during 1935-45. A second crucial reason for the reduction of the debt burden was the substantial rise in commodity prices during World War II, that reduced the debt burden by as much as 50 percent in real terms.

Note that the predominance of bond debt after World War II, rather than bank debt, provided a safety valve that does not now exist. Because of the extensive second-hand market bonds, the debtor governments were able surreptitiously to buy back their own obligations. Of course the low market quotations proved that the countries were not creditworthy, so that the countries could not borrow again until the debt situation was resolved, but at least they could steadily reduce the outstanding burden without enormous public fanfare.

The current situation holds no obvious safety valve. The second-hand market is thin, and much worse,

if a bank sells its claims on a debtor country at below par, it exposes the bank to the demands of its accountants that it write down all of its claims against the debtor country, and not just the amount that it sells on the market. The implications of this accounting rule are that: (1) most transactions in the secondary market for bank loans are swaps, rather than outright sales; and (2) banks rarely sell their paper on the second-hand market until they have been forced by the bank supervisors to make across-the-board writedowns in their books against the country in question. Such writedowns have so far been required only in the cases of Bolivia, Peru, Nicaragua, Poland, Zaire, and the Sudan.

Moreover, up to this date, all interest and principal arrears to the commercial banks have been capitalized at market interest rates (plus penalties), so that the passage of time in no way eases the debt burden. Also, unlike the experience in the 1930s and 1940s, commodity prices (except coffee) for the major debtors at least until now continue to fall, so that the real debt burden continues to rise.

If debt relief is to be granted, it should be guided by several considerations. First, and most important, debt relief should be granted to the debtor countries on a *selective*, rather than universal basis. Guidelines should be formulated to decide which countries should receive relief, and which should continue to operate under current rules of the game. Selectivity serves two purposes: it directs relief to the countries most in need; and it helps to protect the general notion that contracts *should* be honored except in cases of extreme duress. If that general principle were to break down for sovereign lending, the future capacity of the international loan markets to function at all would be undermined.

A reasonable kind of guideline would limit relief to countries that have already experienced an "x" percent drop in real per capita GDP in the past 5 years, with "x" set at 10 percent or 15 percent. That rule would have several advantages: (1) countries would presumably not go

out of their way to qualify for relief (i.e. the moral hazard problem would be minimized); (2) the guidelines could be objectively applied; (3) only the most severely hit countries would qualify, and many of the largest debtors would not (Brazil and South Korea have had rising per capita incomes, for example). Thus, the banks could afford to grant the relief.

Second, relief should be distributed equitably across all creditors, rather than restricted just to the private banks or to the official creditors. Nobody can be seen to be bailing out anybody else. The specifics of debt relief would have to depend on the legal and regulatory status of the various creditors (which will vary by country, whether the creditor is in the public versus private sector, etc.) To best implement some partial relief, for example, it might be best for some creditors to reduce interest payments, for others to forgive principal; and for others still to make grants of new money. In order to get equitable and adequate across-the-board relief, new mechanisms for negotiation will have to be created, as are described below.

Third, the bank regulators should tailor the accounting rules to permit an orderly and lenient treatment of any debt relief. For instance, cuts in interest rates for a given year should affect the bank's current income only, but not the book value of all of the bank claims held against the country. Moreover, any writedowns of principal should be amortized over several years rather than immediately. This kind of lenient treatment will facilitate writeoffs and will also reduce the chance of financial instability resulting from a loss of bank income.

IV. *A New Forum for Negotiations*

A major problem with the current arrangements for managing the debt crisis is the lack of adequate safety valves (e.g. the chance for countries to buy back their debt at discount) and the absence of an adequate creditor forum to discuss debt relief. The current system puts an undue amount of stress on the IMF. The official

creditors and the banks wait for the IMF to work out an agreement with the country, and the IMF proceeds with a presumption about the amount of foreign finance available. It has no power to broker a debt relief scheme among the major creditors. It has no systematic ability to allow for easier terms in politically sensitive cases. Rather, it must work with the amount of external finance that it believes is available from the rest of the world, add in its own modest amount, and base a program on this "exogenous" bottom line. The result can easily be a breakdown of negotiation.

Any debt relief must involve a complicated deal among the creditors. The problem is the absence of a forum for such an arrangement. A partial but instructive model for the appropriate forum would be the Indonesian bailout of 1970. It will be remembered that Sukarno had left the Indonesian government on the verge of bankruptcy and hyperinflation (inflation reached over 1000% in 1966). After a civil war, a new military regime under Suharto began to bring order to the country. The Suharto regime first received debt relief from official creditors (in those simple days, the commercial banks were hardly involved) as of late 1966, when three years of grace on all principal and interest payments were granted. Moreover, the interest was not to be compounded, so that the postponement reflected substantial relief in present value terms. In 1970, this arrangement was put on a more permanent basis. A standing committee of creditor governments, known as the Intergovernmental Group on Indonesia (IGGI) was constituted, and this creditor group negotiated new terms with the Indonesian government. Since that time, the IGGI has overseen Indonesian macroeconomic developments on a year to year basis.

The specific nature of the Indonesian debt relief was as follows. The debt was consolidated, with principal to be repaid in thirty equal annual installments, and interest (at 3%, much below market levels) to be repaid in fifteen installments, to begin as late as 1985 and to run

through the year 2000. The arrangements even included the provision that Indonesia could postpone up to three annual payments in the event of a shortfall in export earnings. The package, in all, represented substantial debt relief in present value terms.

The arrangements were made with the intergovernmental group, in which a key aspect was that the general arrangements had to be further negotiated in detail by Indonesia with each of the country creditors. In other words, the arrangement provided a general framework within which Indonesia could negotiate with its creditors on a country-by-country basis, in which the detailed settlements could respect the differences in regulations, accounting, etc. among the creditor nations. That kind of flexibility will be crucial in any debt relief extended by a large number of official and private creditors from several different countries.

The Indonesia operation was enormously successful. The hyperinflation ended by the late 1960s, and since that time (with the exception of the debt problems of Pertamina in 1975) the Indonesian macroeconomic performance has been among the best in the developing world. From a situation of near hyperinflation and civil strife, the economy has grown at over five percent per year for a decade, with low inflation. And with the constant tutelage of aid agencies and development specialists the quality of macroeconomic management has been dramatically improved.

That kind of debt relief could be extended to several of the most seriously indebted countries. The general framework should be an ad hoc workout committee for each major debtor country, which includes all of the major creditors, both official and private. The IMF and World Bank should be key members of the committee, but should be there to provide funds and expert advice and judgment on a proposed program, rather than to set terms with the country. A typical workout committee should have about fifteen members, including representation of the IMF, World Bank, the relevant regional development bank, representatives from the creditor governments,

the commercial banks, and other creditors (suppliers, bondholders). The committee should aim to reach an agreement in principle with the debtor nation, which can then be negotiated on a creditor-by-creditor basis by the debtor country.

Such an arrangement would have several advantages over the current set-up. The IMF would not be set up to speak for the banks or for the official creditors: the various creditors would be represented at the same negotiations along with the Fund. The IMF would be there to provide expert advice as to whether a proposed plan shows basic macroeconomic feasibility. By having all of the creditors together, it would be possible to share the burden of debt relief. It is not possible now, for example, for the IMF to bargain with the country a program in return for bank interest relief, since now the IMF has no authority over commercial bank interest rates.

It would be most important that the debtor country approach the creditor committee with its own plan, rather than having the plan dictated or designed from the outside. The debtor government should undertake the domestic political fights to make a program, and then approach the committee, rather than appearing to bend over to external pressures. This is the approach recently chosen by Alfonsin, Garcia, Paz, and Sarney, and it has greatly enhanced the political appeal of their recent stabilization efforts. Such an approach also provides far more guarantees to the creditors that the plan will actually be carried out, since the government becomes instrumental in devising its own stabilization policies.

The country's plan should be evaluated by the IMF, which would provide a technical memorandum in support or opposition to the proposal. However, the IMF's judgment would now just be one voice among many in any final decision to go ahead with a plan. The IMF could certainly decide not to go ahead with its own loan on the basis of an unfavorable review of a program, but it could no longer effectively veto a relief package or rescheduling agreement agreeable to the other creditors.

Agreements between the debtor government and the external creditors will by nature have to be reached by the unanimous agreement of the various major classes of creditors, since there is no supranational power that can force an agreement among the different creditors. However, the commonality of interests among the creditors in restoring growth and debt-servicing potential in the debtor country should mean that such an agreement will generally be within reach. Moreover, as already stressed, the agreement should be stated in general terms, so that the terms can be made to conform with the regulatory environment in individual countries. Note that while creditor governments cannot necessarily dictate that the private bank creditors offer debt relief, they have administrative means to press banks into complying with a relief package (e.g. by varying the classification that supervisory agencies attach to the problem loans of a debtor country).

V. A Strategy for Granting Debt Relief

One workable basis, as mentioned above, might be to grant relief, on a progressive scale, to countries that have experienced declines in per capita incomes relative to previous peaks in magnitudes of 10 percent or more. The kind of relief that I consider is a suspension of interest payments for a given period, without capitalization of the missed payments. As a rough example, suppose that countries whose living standards have declined by 10-15 percent are permitted to forego interest payments for 3 years. Countries with a decline of 15-25 percent are permitted to forego interest payments for five years. Countries with a decline of more than 25 percent in living standards would get to forego interest payments for 10 years. (In reality the scales would have to be examined with greater care so that countries would not have the incentive to reduce incomes to earn more relief. Different degrees of relief on debts of differing vintages would have to be worked out. Moreover, considerations of the country's size, level of living standard, size of external versus

internal shocks, extent of hidden income through capital flight, might be part of the formula). In addition to the interest relief, I presume that principal payments would be fully re-scheduled for a period of several years.

Consider how this simple example would work for the Latin American economies through the end of 1985 (Table 4). The calculations are based on an interest rate of seven percent. The amount of relief shown is the present value of the skipped interest payments.

Overall relief by US banks would total \$8.6 billion and by all commercial banks, \$18.61 billion. The forgiveness by US banks would represent approximately 8.1% of US bank capital. Presumably, regulators would allow the banks to amortize the writeoff of the debt over several years (for instance, income could be reduced simply as the interest payments are missed), to smooth the effects on the banks' earnings.

VI. The Contents of Conditionality

There remains the question of what policies a country should stress in order to qualify for a relief package. The current emphasis in the Baker

Plan is on conditions for microeconomic efficiency: liberalization of trade, privatization of state enterprise, and opening to foreign direct investment. Recent research (by Bela Balassa, myself, and many others) tends to confirm that liberalization should certainly be part of a long-term adjustment program.⁴ However, the strong focus on this policy dimension is problematic in some ways.

First, the long history of macroeconomic policymaking and debt crises suggests that macroeconomic imbalances should be treated prior to extensive supply-side surgery. The double-barrel approach of doing everything at once was tried in the Southern Cone countries (Argentina, Chile, and Uruguay) in the 1970s, with disastrous effect. Most observers now see that the macroeconomic goals of price stability and balanced budgets conflicted with the liberalization goals of undervalued exchange rates and tariff reductions. The result was general policy inconsistency, with neither the macroeconomic or microeconomic targets being well served. The success stories of Korea, Taiwan, and Indonesia, all show the pattern of a return to low inflation for a few years before a major assault on trade restrictions.

TABLE 4
Debt Relief With GDP Rule (end-1985 bank exposures)

GDP Decline (per capita)	Bank exposure (\$b)		Amount of debt relief (\$b)		Relief as % of US Bank Capital
	US banks	BIS banks	US banks	BIS banks	
10-15%					
Costa Rica	0.4	0.9	0.07	0.18	0.1
Peru	1.5	5.2	0.29	1.02	1.4
15-25%					
Argentina	7.4	27.8	2.27	8.53	2.1
Uruguay	0.8	2.1	0.25	0.64	0.2
Venezuela	18.4	25.8	5.64	7.92	5.4
25% or more					
Bolivia	0.1	0.6	0.05	0.32	0.0
Total	28.6	62.4	8.57	18.61	8.1

NOTE: The figures given are preliminary. For further information, see Jeffrey D. Sachs, Paper presented to the Brookings Panel on Economic Activity, Washington, D.C., September 11-12, 1986, forthcoming.

Source: US data from "Country Exposure Lending Survey," same as Table 3. BIS data from BIS/OECD, "Statistics on External Indebtedness: Bank and Trade-Related Non-Bank External Claims on Individual Borrowing Countries and Territories at end-December 1985," Paris and Basel, July 1986.

Even then, liberalization must proceed slowly. The simple and sad truth is that liberalization rarely succeeds, and that successful liberalization takes a long time. Extensive liberalization simply cuts across too many powerful political interests, whose power usually helps to explain the reason for the restrictions in the first place. In a celebrated study by Krueger and Bhagwati of 23 liberalization attempts during the 1950s, 1960s, and early 1970s, only 4 actually succeeded in the "long term" (up to the point of publication of the study). And in all of those four cases, the initial conditions at the time of liberalization were vastly superior to the conditions now facing Argentina, Brazil, Mexico, or most of the other Latin American countries. And when liberalization does succeed, it usually does so slowly.

One of the most celebrated liberalizations in the past thirty years is that of South Korea, started in 1964. And yet after 21 years of liberalization policies, nobody would actually call South Korea a case of open trade. Rather it is a case of a unified exchange rate that is not systematically overvalued; a declining number of quantitative restrictions; and a relatively uniform and rational tariff structure. But *laissez faire* it is not!

Perhaps the most troubling part of the current emphasis on supply side measures is its exclusive emphasis on efficiency, without looking at all to

the question of equity and fairness in the Latin American societies. I think that it is fair to say that healthy societies (not otherwise ravaged by war) do not reach hyperinflations or high inflations of the sort seen in Argentina, Brazil, Bolivia, Peru, Chile, Mexico, Uruguay, and other countries in the hemisphere. In each of these cases, there is something grossly wrong with the legitimacy of the government, its ability to tax its citizens appropriately or to reduce spending to influential groups, and its ability to call on the private sector for the kinds of sacrifices needed for economic stabilization. It should be stressed that the Asian countries in general suffered the same shocks as did the Latin Americans in the 1970s, but continued to grow through them with low inflation and economic stability.

The elites in the Latin American societies have done rather well in recent years, while the urban poor and working classes have suffered markedly. The rich took their money out in the form of capital flight. Crude estimates by Morgan Guaranty put cumulative capital flight during 1976-1985 at \$53 billion in Mexico, \$26 billion in Argentina, \$30 billion in Venezuela, and \$10 billion in Brazil. Available data show approximately \$30 billion of capital flight during 1983-85 alone, after the onset of crisis in 1982. With a large cache of dollars outside of the country, many rich families can live even better now than before 1982, because

of the sharp fall in dollar prices in the Latin American economies (following the collapse of overvalued exchange rates with the onset of the debt crisis).

Without due care, the social inequities can be exacerbated both by standard IMF programs and by the emphasis on liberalization and privatization. The IMF package typically squeezes the urban middle and lower classes, to the benefit of the rural sector and the urban elites (who hold large amounts of wealth abroad). Rather than raising taxes on the rich, who haven't paid much in years, recent adjustment efforts have more often focussed on budget cuts and real wage reductions in the public sector. It isn't that such policies are wrong from a narrow macroeconomic viewpoint, but they may be unfair. The same problems arise in the context of liberalization. Such policies are correct microeconomically, but they can exacerbate income inequalities and inequities.

The creditor governments, and especially the United States, should urge the Latin American governments to come up with fair and equitable burden sharing within their countries as part of the conditionality package. A central goal of the US government is to build durable and prosperous democracies in the region. These goals will be best served if conditionality focuses on issues of equity as well as economic efficiency.

NOTES

1. See H. G. Moulton and L. Pasvolsky, *War Debts and World Prosperity*, Brookings Institution, 1932, especially pp. 306-307.
2. See *The Economist*, 11/16/85, p. 96, for estimates of the market value of debt on the secondary market. With a co-author, Steven Kyle, I have demonstrated that as early as mid-1983, the commercial bank stocks were discounted by about 20 cents per dollar of exposure in Argentina, Brazil, and Mexico. See "Developing Coun-

try Debt and the Market Value of Large Commercial Banks," NBER Working Paper Series, No. 1470, September 1984.

3. See "Conditionality and the Debt Crisis: Some Thoughts for the World Bank," Harvard University, 1986.
4. See, for example, my paper "External Debt and Macroeconomic Performance in Latin America and East Asia," *Brookings Papers on Economic Activity*, 1985:2.

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