

THE VANISHING MOTIVATION TO SOLVE THE DEBT CRISIS

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Motivation to Solve the Debt Crisis".

Ten years after the Mexican moratorium the debt crisis changed. In 1982 it was a world crisis, as it threatened the major commercial banks in the First World, today it is limited to the highly indebted countries, particularly in Latin America. Through out the 1980s it was marked by high interest rates and rationed international liquidity, in the 1990s low interest rates prevail in the North, while the supply of loanable funds to the highly indebted countries, including the ones that did not negotiate their debts, explodes, perversely attracted by high local interest rates that the debt left as a heritage. Up to 1989 the debt crisis was viewed by the elites and governments in the creditor countries as a unsolved problem; today the crisis is basically assumed to have been adequately addressed by the Brady Plan, although the economic performance in the highly indebted countries remains essentially unsatisfactory with the exception of the countries benefited by a new flow of international funds.

Albert Hirschman once said that "understanding of a problem and motivation to attack it are two necessary inputs into policymaking and problem-solving, but the timing of the two ingredients could be significantly out of phase" (1974: 152). This is exactly the case with the developing country debt crisis. The diagnosis of the crisis and the possible remedies for it are well defined and known, but the motivation to effectively solve it has not yet been sufficient. In the creditor countries the threat of a world financial crisis originated in the debt of Latin America is over, and the Brady Plan is today assumed to have solved the problem. In contrast, in the highly indebted countries, the motivation exists, but the understanding of the alternatives are incomplete and the power to implement them, faltering, or viewed by its elites as such.

The foreign debt of the heavily indebted countries is a fundamental, though certainly not sole, cause of the fiscal crisis that plagues the highly indebted countries. Today it is widely recognized that this fiscal crisis - characterized by a large public deficit that can only be financed by printing money - and the large transfer of real resources to the creditor

countries from the debtor governments are crucial causes of the reduction of the savings and investment capacity of the debtor countries, the stagnation of per capita income, and the increase in the inflation rates that characterized the highly indebted countries in the past decade.¹

It is recognized that the solution must include a *reduction* of the debt, rather than simply new lending. A global strategy to achieve this result was already defined with precision: it would combine a process of adjustment and reform with a financial mechanism to convert the debt into new securities - with lower face value, and submarket interest rates - that would permit the highly indebted countries to benefit from the discounts existing on the secondary market. This process of "securitization" would apply globally, but would be implemented on a case-by-case basis, according to the differing needs of the debtor countries.

But the motivation of the creditors, particularly of the U.S. government and of its larger banks, to solve the crisis is vanishing. The idea of a global solution to the debt crisis, based on the creation of an International Debt Facility, that would securitize the debt, is dead. The Brady Plan, defined in February 1989, ended with the debate. It acknowledged that the debt crisis was not just a liquidity problem, as IMF, the Fed, and the banks used to say when the crisis broke up in 1982, but a solvency question. Thus, it adopted the debt reductions scheme via securitization of the old debt and the relative "de-linkage" of IMF and World Bank in relation to the commercial banks. Yet, the debt deduction made possible by the Brady Plan, was meager, and the Brady solution, too timid to really solve the crisis.

The first country to negotiate its debt according to the Brady Plan was Mexico (August, 1989). The reduction of the total debt was around 15 percent.² But, since then the Mexican economy is presenting a satisfactory performance, confidence of local capitalists and international financial markets increased, capital flows to Mexico boomed, economic growth was resumed. These positive results were attributed to the signature of a Brady agreement, and so, the Brady Plan was viewed as a good and sufficient mechanism to solve the debt crisis in Latin America. Creditors assumed that the debt crisis was essentially resolved.

As a matter of fact, the correlation is spurious. Mexico did not overcome the debt crisis. There is a relation between the debt agreement and the performance of the Mexican economy, but this correlation is much weaker than is generally supposed. The moderately good results the Mexican economy is presenting are rather the consequence of a stern fiscal adjustment, of a competent heterodox stabilization program that froze prices in December 1987, and of bold structural reforms, particularly trade liberalization, than the result of the Brady agreement. The large capital flows, that could be more directly related to this agreement - to the confidence this agreement would have brought to the Mexican economy - actually coincided with a strong increase in international liquidity and the reduction of interest rates in the United States. As a consequence, a country like Brazil, that did not signed a Brady agreement and remained in arrears, was able to receive sizable flow of capital one year later,

1 - Per capita gross domestic product in Latin America, the region more severely hurt by the debt crisis, fell 8.3 per cent between 1980 and 1989.

² - Estimates of the reduction achieved by Mexico vary from 11 percent to 18 percent, according to the method used.

in 1991. Yet, this money for Brazil, as for Mexico, is essentially hot money. According to *The Economist* (December 14, 1991), 75 percent of the money flowing to Mexico is hot money. And the interest rates, in Mexico as in Brazil, are between two and three times the interest rate in the creditor countries, showing clearly that the debt crisis is not over for Mexico as it is not for Brazil.³

Elites in the creditors countries supported schemes of debt reduction via securitization - the Brady Plan was the consequence of this support -, but many in the creditor world believe that the costs for their constituencies exceed the benefits. Many of the leading banks opposed even the Brady Plan and strongly oppose any concerted attempt to solve the debt crisis. They have good reasons to believe that they can do better without a new global approach. They are making very good profits out of the spreads they are able to charge to short term financing to the highly indebted countries.

On the other hand, this is not anymore a real or a major problem for the creditor countries. It was when their banks were threatened, when a world financial crisis was possible. Now the banks are not necessarily in better financial situation, but their problems derive rather from bad internal loans and wild speculation, than from their foreign loans. Their credits in relation to the highly indebted countries were reduced, their capital ratios, improved. In the creditor countries the debt crisis is almost forgotten. People are bored on the subject. Eastern Europe, privatization, the third oil shock are more interesting subjects. In a significant way, *The Economist* (September 1, 1990), reporting on the Brazilian debt, started with the following phrase: "Remember the Latin American debt crisis? It is still out there, lingering, even after all these years".

In contrast in the debtor countries the motivation to solve the debt crisis exists, at least among the common people, but the level of understanding of the crisis on the part of their elites - among the leading businessmen, politicians, journalists and even economists - is less than satisfactory. The economists in the debtor countries have well recognized the relation of the debt with the deep fiscal crisis, the reduction of investment, the stagnation of growth, and the rise of inflation. But, together with much of the rest of the local elites, these economists are only recently beginning to realize that there are already well defined financial solutions for the crisis and even supporters of such solution within the creditor world. Unhappily, the problem with the elites in the highly indebted countries is not only a question of insufficient information. A lack of real motivation to achieve a definitive solution to the crisis also plays a major role. Many elites share an ideological identification with the creditors; they fear retaliation if they propose more ambitious solutions to the crisis; many have discovered ways of deriving speculative profits from the crisis; and important parts of the elites have so far escaped the economic hardships of the crisis, with their money holdings abroad leaving them well protected against the virulent depreciations of the currency, and a decrepit tax system leaving their financial wealth untouched and untouchable.

³ - The spread on short term loans to finance trade, that use to be 2 percent (already a high spread), are today around 6 percent for Brazil and for Mexico.

Approaches to the Crisis

The creditors' and debtors' approaches to the crisis have been changing in recent years, but not necessarily in the same direction or at the same pace. Among the creditors we should distinguish (1) the official and dominant conception defined by the U.S. government and implemented by the multilateral agencies in basic agreement with the major U.S. banks; (2) a decreasing number of dissenters outside the executive branch of the creditor governments, favorable to a significant and concerted reduction of the debt. In the debtor countries we should distinguish the view of (1) nationalists and populists; (2) government officials and business elites subordinated to foreign interests; and (3) a group of citizens that favour the adoption of a combination of pressures by the debtor governments, including quasi-unilateral measures, oriented to capture the discount in the secondary market in a concerted manner.

The views of the official creditor community, including the governments and the international financial institutions, have evolved over time. In the early years of the crisis, when major banks were at risk of insolvency, the dominant creditor approach was exclusively focused on saving the banks by demanding the debtor countries to pay, at least partially, their debts, no matter how desperate was the situation in the debtor countries. Over time, as the countries adjusted their short term balance of payments problems, but remained in deep economic disarray, while banks recovered, the focus has gradually shifted, away from the banks and towards measures to relieve some of the pressures on the debtor countries. The interests of the banks and the national interests of the creditor countries, that in the beginning of the debt crisis were practically identified, fell clearly apart every year, as the threat of a world financial crisis as a consequence of the debt crisis disappear, whereas United States' exports to the highly indebted countries continued to suffer. More recently, after the Brady Plan and the Mexican and Venezuelan agreements, the concern for the debt crisis slowed down, as the problem was defined as solved, at least for the time being.⁴

But even today, the creditors' strategy, in spite of profound changes it underwent, must still be generally defined as a "muddling through approach" - a strategy of continuous improvisation, that avoids a definitive and rapid solution to the problem. The phases of official management of the crisis are well known. In 1982 the debt was understood as a mere liquidity problem to be solved by a combination of some new lending and sharp austerity in the debtor countries. In 1985 the Baker Plan was introduced, calling for more lending - that never materialized - and for growth with adjustment and structural reforms. The idea of a "menu of options" became then popular. In 1987 and 1988 it became clear that the debt was a solvency problem, and the idea of debt reduction was mandatory. Securitization - i.e., the substitution of the old debt for new securities with a guarantee provided by the multilateral agencies - and de-linkage of the multilateral agencies from the banks became dominant.⁵ In

⁴ - Dornbusch observes, examining the data on the debt and on the U.S. balance of payments that "it is quite apparent that the large size of U.S. external deficit is at least to some extent a counterpart of the ability of debtor countries to service their debt by noninterest surpluses" (1989: 350).

⁵ - These two ideas were the core of the Brazilian strategy for the foreign debt in 1987, when I was finance minister. After a "non starter" from Secretary Baker (September 1987), the two ideas received wide acceptance. See the previous chapter for more details.

these two years a consensus was formed that a new initiative should be taken in relation to the debt crisis - an initiative that included debt reduction via securitization. The Brady Plan, presented by the new Secretary of the Treasury, Nicholas Brady, was the consequence of this consensus. The focus was on "voluntary debt reduction" through securitization. IMF and World Bank should have additional resources to provide guarantees and other "enhancements" on the new securities, to spur the process of debt reduction. This was a major change in the United States' policy towards the debt. It was also a consequence of the views of Japan, France and Italy. These views were never fully defined, but since 1988 it became clear that they supported a major change of the debt policy towards a global solution to the debt.⁶ Essentially the Brady Plan was the result of an increasing number of people in the political and economic elites of the creditor countries that never accepted the liquidity approach. As the Baker Plan failed they realized the self-defeating nature of internal adjustment policies when not coupled with debt reduction, and supported a global solution for capturing the discount existing in the secondary market tied with limited debt relief.

Among the debtors countries, radicals and populists supported (and still support) a moratorium of the debt that would permit in the short run the increase of wages and internal consumption. The Peru disaster is the better example of this attitude towards the debt. On the other extreme, the governments in the highly indebted country - and their subordinated business elites - are eager to please the creditors and always bow to their demands, while adopting, in their speeches and official communiqués, a rhetoric condemning the debt and asking for debt reduction. Finally the third group that appears in Latin America in 1987 proposes the adoption of firm measures, including unilateral suspension of payments, in order to force a concerted or negotiated securitization of the debt, combined with internal strong fiscal adjustment measures. For this group it is quite clear that it has an important ally in the dissenters of the official view in the creditor countries, but it was obvious also that, besides this support it is essential to use the only bargaining power a debtor country possess: the possibility of suspending payments of interests.

Propositions about the Debt Crisis

After some many years of debt crisis, some basic propositions about it are well established. They could may be summarized in this way:

⁶ - Actually, when, in the beginning of September, 1987, I proposed, speaking for Brazil, the securitization of part of the Brazilian debt, and received a "non starter" from Secretary Brady, the only support I receive came from, Kiichi Miyazawa, then Finance Minister of Japan, that said that "he felt attracted by the idea of converting the old debt into new securities as proposed Brazil" and "suggested that an international financial agency - as the World Bank, through the IFC, International Finance Corporation - presented a precise project on the subject (*Gazeta Mercantil*, 15.9.91, reproducing a *Finical Times* inform). In the 1988 IMF/World Bank meeting, in Toronto, Mr. Miyazawa presented a plan of debt reduction, that was a direct antecedent to the Brady Plan.

1. The excessive international indebtedness in the 1970s and the resulting debt crisis was a consequence, on one hand, of the belief that developing countries should and could receive capital flows for an indefinite period, ignoring that loans follow a necessary cycle of payments and reimbursements, and, on the other hand, on the "Ponzi scheme" adopted by the banks and the multilateral agencies, in which original lenders are paid with money supplied by later lenders, permanently rolling over the old debt (Payer, 1991).

2. The debt crisis is a crisis for the highly indebted countries, not for the creditors; the danger of world financial crisis vanished, given the improvement of the capital-ratios of the banks.⁷

3. The debt is a major problem not only for the huge transfers of real resources to creditors it allowed, but also for its fiscal consequences. The foreign debt is essentially a government debt in Latin America. Around 90 per cent of the long term debt is public. Thus, the debt is an essential ingredient to the fiscal crisis of the state, the essential characteristic of the Latin American crisis.

4. The debt crisis is the major, but not the only, cause for the relative economic stagnation of most of the highly indebted countries. Populist policies, based on the resistance to eliminate the budget deficit and on the attempt to promote economic development and to distribute income in the short run are a second reason, not the first one, for this crisis (Bresser-Pereira and Dall'Acqua, 1991; Bresser-Pereira, 1992; Cardoso and Helwege, 1991).

5. The failure of the adjustment policies that have been effectively undertaken in the highly indebted countries may have an explanation in populist practices, but its main cause is the self-defeating character of adjustment when the external debt is too high. Since the private sector in the highly indebted countries was able to transfer the foreign debt almost entirely to the public sector, the payment of interests on this debt, the real devaluations of the local currency that increase the public debt, and the reduction of real tax revenues due to the acceleration of inflation (Tanzi effect) aggregate the fiscal crisis, turn partially ineffective or self-defeating the efforts to reduce the public deficit.⁸

6. In the first years of the crisis real devaluations of the local currency, that were necessary to achieve high trade surpluses, accelerated strongly the prevalent high inflation rates that are subsequently inertialized through formal and informal indexation systems.⁹ More recently, an opposite movement is taking place. The huge capital flows to Latin

⁷ - Since 1982 the exposure of the nine top U.S. banks in Latin America as a percentage of primary capital was reduced from 179.8 in June 1982 to 74.9 in September 1989 (ECLA, 1990: 43).

⁸ - On the self-defeating character of fiscal adjustment for the highly indebted countries see Bresser-Pereira (1989).

⁹ - It cannot be said that there is a straightforward relationship between debt and inflation, since there are some highly indebted countries with low inflation. The trend, however, is quite clear. Highly indebted countries tend to present high inflation. According to IMF (1990: 61), among the net debtor developing countries, that presented high inflation between 1983-89, 89 per cent had debt-servicing difficulties.

America are leading to the overvaluation of the local currencies. As a consequence inflation rates are reduced, but trade deficits appear, and the local manufacturing industries are endangered. This threat to local industry is augmented by the fact that most Latin American countries are engaged in long overdue trade liberalization programs. Trade liberalization is essential to Latin America, but together with currency appreciation, may be fatal to manufacture, as it happened to Martinez de Hoz's Argentina.

7. Inertial inflation is resistant to conventional monetary and fiscal policy. The successful Israeli and Mexican experience in controlling inflation show that a combination of incomes policies and social agreement with orthodoxy policies are indicated.¹⁰

8. The economic stagnation of the 1980s is now giving place to modest rates of growth. In 1991 GDP increased 3 percent. For the first time in four years it was above the population growth rate. Yet, income concentration increased and wages remain very low. It is too soon to speak of economic recovery in Latin America. And the new democracies that have been established in these countries in the beginning of the 1980s' are far from being consolidated. The attempted coup in Venezuela early 1992 demonstrates this fact.¹¹

9. In adopting the muddling through approach the creditor governments protect or bail out some banks, but due to the reduction of exports to the highly indebted countries, provoke losses of jobs and of profit opportunities in their own countries.

10. Given the failure of the conventional strategy for the debt crisis (a combination of adjustment and financing), the only alternative left is to reduce the debt. In order to cut annual net transfers from Latin American countries (around 25 per cent of Latin American exports) to a manageable 5 per cent, debt reduction or the reduction of debt service will have to be between 60 and 70 per cent (Knox, 1990; Trebat, 1990).

11. The strategy of the creditor countries eventually changed in the right direction - debt reduction - but its last manifestation, the Brady Plan, albeit should be welcomed, was a timid and insufficient move to solve the debt crisis, as it is based on voluntary mechanisms. It is an indication of the hesitations and dilemmas faced by governments of the creditor countries in relation to the debt. They know that a solution must be found to the debt crisis, but don't want to confront their own banks. The Mexican agreement is a good indication of this fact (Lustig, 1990; Castañeda, 1990). The effective debt reduction eventually obtained was around 15 percent; the cash flow saving, around 1 billion dollars per annum. Inflation is relatively under control in Mexico, but the economy only recently started growing as a strong

¹⁰ - On the theory of inertial inflation see Bresser-Pereira and Nakano (1987). On the need of combining orthodox and heterodox policies to control this type of inflation see also Ramos (1986) Bacha (1987) Kiguel and Liviatan (1988), Beckerman (1990), Bruno et al. (1991).

¹¹ - The failed *coup d'état* in Venezuela, in February 1992, is a good example of the political instability associated with tight fiscal and monetary policies, while the foreign creditors are spared from the adjustment burden. There is a large literature on the relations between stabilization policies and the consolidation of democracy. A partial survey of this literature is in Bresser-Pereira, Maravall and Przeworski (1992).

capital flow, attracted by local high interest rates and the new stability of the Mexican economy, and promoted confidence in the international financial markets.

12. Given the lack of motivation of the creditor countries to solve the debt crisis, a possible solution would be a quasi-unilateral reduction of the debt, followed by an agreement with the creditors. By quasi-unilateral reduction I mean the decision the debtor country takes to pay a given percentage of the interests on the debt independently of any agreement with the banks, while tries to negotiate a long term solution. This pay will be the one consistent with a macroeconomic consistency plan that takes into account the fiscal situation of the country and the need to limit real resources transferences and resume growth with price stability. We have already an example of this type of solution: Costa Rica that, after many years of arrears and soft negotiation, was recently able to reduce her debt on around 60 per cent. The Brady Plan worked as a general umbrella for the agreement.

13. The other alternative is to have a limited debt reduction, according to the Brady Plan, as Mexico, Venezuela and the Philippines got, and to count on a generous capital flow, originated mainly from repatriation of capital by local capitalists, as confidence in the economy is increased. This is today the more likely "solution" for the crisis, as these countries are profiting from the increased international liquidity. As the interest rate declines sharply, tending to become negative in real terms, international capital looks for more profitable opportunities in the highly indebted countries, which are succeeding in convince the financial markets that the new debt will have a fully different treatment as compared with the old one. A Brady Agreement helps to build this new confidence. The problem with this alternative, besides that confidence is a precarious asset when the debt remains high, is that these countries, that are already deeply indebted, may very well be victim of another Ponzi scheme. They continue to face an enormous interest burden on the old debt and are paying incredibly high spreads on new debts.¹²

Two Alternative Strategies

The official strategy of the creditor countries remains the Brady Plan. It was a major advance, as it meant the recognition by the creditor countries (a) that the debt must be reduced, (b) that securitization is the best way to achieve this objective, (c) that IMF and World Bank should support the policy of debt reduction including with the supply of collaterals, and (d) that these two institutions should be partially de-linked from the banks, i.e., the would now be able to make agreements with de debtor countries even if they did not an agreement with the commercial banks.¹³

¹² - Yet the interest burden on the foreign debt is decreasing, giving the lower international interest rates. The total debt of the region remains approximately in the same level of 1986 (401 billion dollars in 1986 against 426 billion in 1991), but the interest burden fell from 37 percent of total exports in 1986 to 22 percent in 1991 (ECLA, 1991).

¹³ - On the Brady Plan see Bacha (1989, 1991), Devlin (1989b) and Sachs (1989b).

The Brady Plan, however, is limited as a solution for the debt crisis. To understand why, it is necessary to distinguish clearly the two basic strategies towards the debt crisis that today dominate the debate on the subject. The idea of debt reduction, that was taken as a threat to the banks a few years ago, today is widely accepted. Securitization is the basic strategy to achieve this result. The problem is how much this reduction should be. On one side we have the ones that favour a concerted and global reduction of the debt based on the creation of an International Debt Facility that will manage the whole process on a case-by-case method. On the other side we have the Brady Plan, today firmly supported by the major creditor countries, favoring "voluntary", market controlled, debt reduction¹⁴. Let's call the first, the concerted approach and the second, the "voluntary" or more precisely "free rider" approach to debt reduction.

The concerted approach can be summarized in this way:

First, the securitization of the long term debt of the highly indebted countries, that is, the conversion of the debt into long term bonds, capturing the discount in the secondary market, is the basic financial device to solve the debt crisis.

Second, these new bonds will only make sense for the banks if they have the guarantee of the creditor countries.

Third, the obvious organizations to offer this guarantee are the IMF and the World Bank, given that both multilateral institutions are directly involved in managing the debt crisis and that their main stockholders are the creditor countries.

Fourth, the Bank and the Fund, in order to reconcile their policies, should create an International Debt Facility (IDF) that, besides giving guarantees to the new bonds, would administer the debt crisis.

Fifth, the Board of the IDF, after evaluating the economic capacity of the country to pay its debt, taking as the basis but not exclusively, the discount in the secondary market, and after debating the issue with the debtor and the creditors, would come to a concerted (but not necessarily unanimous) proposal about the discount the country would be entitled to receive. This decided it would make a once and for all offer to the banks; the free rider strategy would not be permitted.

Sixth, in order to receive the discount the debtor country would have to meet the conditionalities agreed with the IDF; the discount would be permanently dependent on the ability of the debtor to adjust and maintain adjusted its economy.

Seventh, the cost of this alternative would be low to the creditor countries, but anyway there is a cost for offering guarantees; thus a fund should be established by the creditor governments in the IDF.

¹⁴ - The view of the banks, that evolved towards voluntary debt reduction beginning in September 1987, is well exemplified in the December 1988 issue of *World Financial Markets*, published by Morgan Guaranty ("LDC Debt Reduction: a Critical Appraisal").

If the creditor governments adopted this approach, it would be possible to envisage an effective resolution of the debt crisis. If, however, the creditors stick to the present policy, to the Brady Plan, that is, to the market or free rider approach, rejecting the creation of an IDF and not supplying the Fund and the Bank with special funds to back the guarantees, I believe that the debt reduction will be limited and will take a long time - a time that is not reasonable to ask the debtors to wait. Countries that sign a Brady agreement with the banks, as Mexico or Venezuela, will continue to face an enormous debt burden and to pay very high spreads for short term financing.

The Ineffectiveness of the Voluntary Approach¹⁵

The banks, that are specialists in semantics, like to call their present approach to the debt reduction the "voluntary or market approach", as if the concerted or global approach were not also voluntary and based in the market. The first and more important difference between the two approaches is that one allows for the free rider strategy while the other, does not. A second difference is that free rider approaches favour also debt-equity conversions as a good strategy to reduce the debt, while the global approaches exclude these deals.

The idea of market controlled debt reduction has been around for some years, but the actual accomplishment of debt reduction has been meagre. The main channel for debt reduction has been debt-equity swaps, which ironically are the kind of debt reduction that is typically harmful to the debtor country. In fact, despite the enormous pressure from the commercial banks for such programs, they have been suspended in almost every country that has introduced them, with the exception of Chile. Actually, without a bankruptcy institution, and without the official creditor community attempting to design concerted agreements as in the bankruptcy country, real debt reduction will almost surely not be accomplished even with a broaden "menu of options" that includes more debt reduction mechanisms.

Debt reduction schemes should be measured against the standard of restored credit-worthiness of the debtor country. Specifically, the debt reduction should be extensive enough to accomplish the following goals: (1) to allow the debtor country to service the external debt on the revised contractual basis without the need to further refinance interest payments; (2) to allow the private sector in the debtor country to attract suppliers' credits, trade credits, and project finance, on a decentralized basis.

Under "voluntary" arrangements, a small number of banks can frustrate a comprehensive settlement of a country's debt overhang.

In a "voluntary" debt reduction mechanism, each creditor is free to choose whether to participate or not. Non-participation means that the creditor continues to hold the original claim, and can attempt to collect as much as possible on that claim. Thus, there is a basic arbitrage condition which attaches voluntary schemes: participation in the scheme must, on the margin, be no worse than holding out, and sticking with the original claim. Thus, in a voluntary scheme, the creditor must compare the value of the existing claim after the debt

¹⁵ - This section was originally written with Jeffrey Sachs.

reduction has taken place with the value of the alternative claim that is available through participation in the debt reduction schemes.

But now an obvious paradox arises, which is best illustrated in the case of certainty. A full restoration of credit-worthiness would imply that all claims on the debtor, including "old" debt which does not participate in the debt reduction process, will rise in value to its face value. The secondary market price of the old debt will be 100 cents on the dollar after the debt reduction, if full credit-worthiness is indeed restored. Thus, under certainty, there would be no motivation for an individual creditor, that has a small share of the overall debt, to participate in a voluntary scheme if the creditor receives something less than 100 percent of face value.

The result, which was formally demonstrated by Helpman (1988) is that voluntary debt reduction may be impossible as a market equilibrium even when the creditors as a whole would benefit from the debt reduction relative to the status quo. Thus, the insistence that debt reduction be voluntary actually hurts the creditors as a whole.

"Voluntary approach" is an appealing expression, but misleading. What we have, really, as the alternative to the concerted approach to the reduction of the debt is the free rider approach - the last version of the muddling through approach adopted by the creditors since the very beginning of the debt crisis. Stanley Fischer, analyzing the possible solutions for the debt crisis, favored the creation of a debt facility, but warned that this scheme "creates a free rider problem. If the International Debt Discount Corporation¹⁶ buys up much of the developing country debt and makes some form of debt relief possible, then the credit of the debtors improves. Those creditors who stayed out of the IDDC have a capital gain. For that reason an IDDC would have to find some means of ensuring almost complete participation by the creditors" (1987: 320-321).

I hope that now it is clear why the Brady Plan is insufficient to face the debt crisis. Its limited character derives of two other reasons besides its insistence in the "voluntary" approach: it does not provide funds for the IMF and World Bank to offer the guarantees and it says nothing about a joint action of the two institutions creating a debt facility. Given these limitations, we have to ask ourselves which will be the size of the discount the highly indebted countries will get with the Brady Plan. Some part of the debt will be reduced anyway. This is already taking place, but at a very slow pace. We are afraid that the Brady Plan will change the situation very little. A solution to the debt crisis will continue to be postponed, when a definitive solution is now possible and necessary. The Brady Plan seemed to "work" in the case of Costa Rica, but it can be hardly said that this was a case of voluntary solution. Banks were forced to agree to a sizeable debt reduction by the firm although always polite standing of the Costa Rican government and, eventually, by the support of the U.S. Treasury. In the case of the larger debtors, like Brazil, a firm standing will most likely be

¹⁶ - International Debt Discount Corporation was the name of the debt facility proposed in a pioneering way by Peter Kenen (1883), when the discount in the secondary market did not yet exist. Felix Rohatyn (1983) made a similar proposal at that time based on the financial strategy he used to solve the debt crisis of the City of New York. James Robinson III (1988), chairman of the American Express Bank, made a similar and very detailed proposition.

more necessary, given that the support of the Treasury, pressured by the banks, will tend to be limited.¹⁷

Obstacles to the Concerted Approach

If a concerted securitization of the debt is the obvious solution to the debt crisis, why did it not materialize up to this moment? Why for the creditor countries the Brady Plan was the limit. It is not difficult to identify the obstacles to this approach - obstacles that are originated in the creditor and in the debtor countries.

The barriers on the creditors side to a concerted reduction of the debt are: (1) the inherent collective-action barrier to comprehensive debt reduction; (2) the problem of precedents; (3) the problem of the public sector bail outs; (4) the distorted incentives of the large banks; (5) the structure of the bargaining cycle (see Jeffrey Sachs, 1989); and, more recently, the relatively good performance of the countries that signed a Brady agreement.

The inherent collective-action barrier is related to the insistence in the "voluntary" schemes that we already discussed. The problem of the precedent applies specially to the small countries; a solution is not reached for the debt of this crisis given, according to the banks, "the risk of a precedent". The third reason why a concerted debt reduction is difficult is the continuing signal from the official community that public money will come to the rescue of the faltering renegotiation process; to the extent that the banks limit new lending or debt reduction, they know that the official community will make at least part of the difference in official lending to the debtor countries. Forth, there is a strong resistance of the large American banks to debt write-downs because of the greater LDC exposure relative to capital, because they have superior access to debt-equity swaps than do the small banks, and because they will be better off if another smaller creditor voluntarily makes a concession to the debtor. Fifth, in the negotiating cycle the bargaining power of the debtor countries is weakened because an agreement with the banks has been made the sine qua non condition of good relations with the creditor governments. In the case of the Brazilian moratorium of February, 1987, this last phenomenon was quite clear. The solidarity of the creditor governments and of the multilateral agencies to the banks was quite evident.

¹⁷ - This fact was again very clear in September 1990. Brazil was ready to obtain a stand by agreement with IMF. The letter of intention was agreed. The Fund, however, under the pressure of the banks and the U.S. Treasury, decided not to go ahead with agreement while it was not clear that Brazil's negotiation with the banks had "good perspectives of a satisfactory solution". In spite of the Brady Plan have admitted the "de-linkage" between the banks and the Fund, authorizing IMF to sign agreements with debtor countries in the absence of payment to the banks, this institution once again sided with the banks. It not sided, however, fully with the banks. It is quite clear that the official strategy on the debt changed. But this fact shows that this change is for the moment limited. Anyway, in January 1992, with a new Finance Minister in Brazil, IMF, now supported by the Treasury, finally accepted a new Brazilian letter of intention without an agreement with the banks.

These factors were decisive in the rejection of the concerted approach and the adoption of the Brady Plan, in 1989. Since then countries that signed the debt agreements according to this plan, as Mexico and Venezuela, are having a moderately successful economic performance. Inflation, which was already under control in Mexico and in Venezuela, remains under control, and the large capital flows to these countries, contributing to the resumption of growth, are usually attributed to the confidence originated from the debt agreements. This leads the elites in the creditor countries to believe that the Brady Plan "solved" the debt crisis, eliminating from the agenda the concerted approach.

Obstacles on the Part of the Debtors

This last point brings us to the obstacles to a concerted debt reduction on the part of the debtor countries. They are naturally interested in this reduction; or were interested when the problem was in the agenda of the creditor countries. This interest became official for the first time in the Acapulco meeting of the eight Latin-American presidents, in November, 1987. But the elites in the debtor countries and their respective governments are unable to exert sufficient pressure on the creditors, adopting the unilateral decision of suspending the payment of interests and reducing the debt, for three reasons: (1) because they fear retaliation, (2) for ideological identification with the creditors, and (3) because the elites suffer less with the debt, that, particularly in the case of the debt-equity swaps, may be a source of speculative profits¹⁸.

The threat of retaliation is always present in the bankers' speech, and, despite the fact that these retaliations never materialize, they continue to cause fear among the debtor elites. In all instances of moratoria, the retaliations have been minor. In the case of the Brazilian moratorium the declaration of the new Finance Minister of Brazil, in February 1988, that it caused more harm than benefits to the country due to the retaliations, is meaningless. He was just trying to justify the suspension of the moratorium and the signature of a conventional agreement with the banks that solved none of the Brazilian problems. Actually the retaliation against Brazil was very small. The commercial banks reduced moderately their short term credits and World Bank, for the first time in that year, presented a negative cash flow with Brazil. This may have caused a loss of reserves to Brazil of - maximum - 1.3 billion dollars against a gain of 4.3 billion - the interests that should be paid in 1987 to the commercial banks on long term loans.

Actually, the banks have no interest in suspending their short term loans to the highly indebted countries. They get large spreads from these loans and the discount in the secondary market for them is very small. If they decide, as retaliation, to suspend these credits, the debtor country will not pay, and the loan will be immediately transformed in a long term credit burdened with a much larger discount in the secondary market. The loss for the banks will be abrupt and large. They are well aware of this fact and thus do not retaliate. Banks are interested in making profits - now and in the long run. Threats may help in achieving this goal, retaliations, no.

¹⁸ - For a more complete discussion of this problem see Bresser-Pereira (1988).

A second obstacle for the elites exerting a stronger pressure on the creditors, which should include in certain cases, the declaration of a moratorium, is their ideological identification with the creditor countries. They want to be part of the First World. They want respect and they identify the First World with the banks and the U.S. government. Just now they are beginning to realize that elites in the creditor countries are divided, that it should not be reduced to the bankers, and that there is an increasing number of very influential citizens in the First World that are pressing for a concerted debt reduction.

Finally, the poor and not the elites are the ones that suffer more with the debt crisis. Actually, for some the debt is a chance for speculation and profit. Specially debt-equity swaps make possible huge gains for local bankers, brokers, investors, lawyers. Actually the debt-equity swaps are not just inefficient - as is the case of the "voluntary" debt-bond swaps - in solving the debt crisis. They are a false solution that harms the economies of the highly indebted countries. Effective investments coming from these conversions are very small. On the other hand, they represent for the beleaguered public sectors of the highly indebted countries the exchange of an external debt for internal debt - generally at a higher real interest rate - or for printing money. In the case of Brazil, where the internal debt is quasi-money (overnight maturity), we have the worse of both worlds: with the debt-equity conversions the state pays higher interests while printing quasi-money.

Arrears are no Solution

The failure of the conventional (muddling through) approach to the debt crisis, the limitations of the Brady Plan and the lack of motivation to adopt a global securitization solution for it led an increasing number of countries to arrears. Negotiations lost basically sense, as the "new money" device - the basis of the conventional approach - proved illogical even from the stand-point of the banks. The only alternative to new money would be sizeable negotiated debt reductions - reductions that the professional managers of the banks could not accept.

Arrears are undeclared moratoria. They are the obvious and only alternative when negotiations fail. This already happened in the debt crisis of the 1930s, as Robert Devlin remembers us: "at the outset of 1988 the situation of the region (Latin America) began to display some remarkable parallels with the debt crisis of the 1930s... Only a few countries maintained a regular payments status with their creditors; the majority of debtors in fact were, in one form or another, in a state of arrears even on rescheduled debt service" (1989a: 234).

Arrears are not a solution to the debt crisis. They are a negative form of responding to it, as long as nothing is really solved. Economic theory says that economic agents behave according to expectations. Expectations that are rational and self fulfilling for some economists, expectations that underline the uncertainty of economic behavior for others. But always expectations are based on facts. If the economies of the highly indebted countries tend to be victim of a fiscal crisis, if a substantial part of the budget deficit is originated in the interests paid by the state on the foreign debt, expectations in relation to inflation will tend

necessarily to be high. On the other hand, investor will tend to have negative expectations about the economy of a country with an enormous debt overhang.

A publication of an organization that represents the interests of the commercial banks - the Institute of International Finance - announced a similar idea in its title. "Arrears are not the way" said the publication (IFF, 1990). Agreement, however, stopped in the title. Contrarily to what suggests IFF's document, the alternative to arrears is not trying to pay the debt, is not a combination of voluntary market mechanisms of debt reduction with new money, is not substituting official support for banks' credit, is not to use IMF to pressure the debtors,¹⁹ is not to "moderate" expectations of the debtor countries.

The document criticizes the Brady plan because it led to "a marked deterioration in discipline within the international system, including a sharp build-up of interests arrears to all creditors" (IFF, 1990: 6). Its objective is "to improve the official debt strategy", that, since 1987, is beginning to favour the debtors. The Brady Plan's "unintended effects" - "the alarming increase in interest arrears" - are the target of the document". Obviously the Brady plan cannot be credit for the arrears. They are a necessary consequence of the exhaustion of the banks' strategy to deal with the debt.

We already see that the Brady Plan represented a great towards a correct analysis of the debt crisis, as long as it officially recognized that debt reduction is an essential part of the solution of the problem, but it is not realistic to expect that it will solve this crisis, as long as a voluntary approach was adopted to debt reduction and that the plan is underfunded; World Bank and the Fund do not dispose of enough capital to make the plan really work. It is also not realistic to expect that the creditor governments will do much more to solve the debt crisis of Latin America. Actually, giving the economic and political limitations, the U.S. government went most likely as far as it could with the Brady Plan.

Quasi-unilateral Debt Reduction

Thus, if undeclared moratoria are a bad solution, if debt reduction is essential, if gradual, voluntary, market controlled debt reduction is not consistent with the solution of the crisis, if the shortcomings of the Brady Plan are quite clear, and if we cannot expect bolder initiatives on the part of the creditor countries, it becomes clear that debt reduction will only be possible through unilateral or quasi-unilateral debt reductions decided by the debtor countries, as part of larger stabilization programs.

¹⁹ - IFF's document identifies the delinkage between IMF and the banks with "IMF toleration of interest arrears" (1990: 7). Actually Brazil proposed formally this delinkage in 1987. IMF's role should not just to uphold the banks. Its inclusion in the Brady Plan represented a decisive change in the official strategy in relation to the debt.

David Knox, a former vice-president of World Bank, recognized that quite clearly in a recent paper. According to him, "in last analysis the (debt) problem will be solved by the unilateral action of the debtors, since there is no one else to impose a solution" (1990: 6).²⁰

Actually we could say that the solution will be "quasi-unilateral" because, after the decision taken by each individual debtor to reduce the debt, negotiations will necessarily follow between the debtor and the creditor banks. Besides that, the debtor country does not need to affirm that it is "canceling" the old debt. It only says how much it will pay each quarter, giving some kind of enhancement to the banks that accept to the securitization of the old debt with a discount.

The bargaining power of the debtor would certainly be enhanced if simultaneously a stabilization program had the supervision of IMF or was already achieved, if structural reforms were under way with the participation of World Bank. But the debt reduction would have a basically quasi-unilateral character as long as the government of the debtor country would inform the creditor banks - including the banks of the Paris Club - that it would only be able to pay the banks that agreed to reduce the debt and to extend the payment of the new securities. The other banks would also receive quarterly a payment, but clearly a smaller one.

On the same time this government would orient the people engaged in calculating figures for the balance of payments and for the government budget that the part of the debt and the corresponding interests that were reduced should be eliminated from the accounting statements. In this way, expectations of economic agents would not be anymore influenced by an enormous external debt that they know that cannot be paid, nor influenced by large interests due and not paid.

Conclusion

In 1989 the chance debtor countries would adopt a quasi-unilateral solution was considerable; today, they are much smaller. The change was the relative success of the Brady Plan, uniting the elites in the creditor countries. As a result, the motivation in the creditor countries to solve the debt crisis, that was hesitating, practically vanished.

The adoption of a quasi-unilateral debt reduction will depend on the courage and determination of the governments of the debtor countries, but depend more on the attitude of the elites within creditor countries. These attitudes are transparent in the press, in the parliaments, in the meetings of the businessmen and intellectuals. They reflect in the views of the governments and the multilateral agencies. David Knox observed that, if and when a unilateral decision was taken, "the true task of financial diplomacy is how to bring about that result without doing irreparable harm to the creditors and indeed to the debtors as well" (1990:6). Debtors should be firm but never aggressive.

²⁰ - A pioneering book on the debt crisis and on the possibility of unilateral solutions was Anatole Kaletsky's *The Costs of Default* (1985).

The elites in the creditor countries were divided between 1986 and 1989. It was the realization of this fact a decisive factor that convinced me of the opportunity to propose, in 1987, as Finance Minister of Brazil, a concerted solution for the debt crisis. I would not have made the proposals I made if I did not see that the elites in the creditor countries were divided. That a large sector of these elites favored some kind of debt relief.

At that time, however, these elites sympathetic to the debtors always assume that the initiative should come from the creditor governments. It was difficult to them to admit that the initiative to reduce the debt could be of the debtors. Today, even this limitedly favorable attitude vanished, as the Brady agreements are supposed to have been successful. As a matter of fact, these agreements did very little for Mexico, Venezuela or Philippines. The debt reduction was meagre. The burden of the internal adjustment was almost entirely supported by the people in the debtor countries. The positive international capital flows are related to the Brady agreements, but in a limited way. More important is the increased international liquidity and the very low interest rates in the international markets, stimulating flow to the debtor countries, where the rate of interest is two or three times higher. These flows started to be very big to Mexico, but more recently countries that did not stabilize nor signed a Brady agreement, as Brazil, are also receiving sizeable capital flows.

Some highly indebted countries, like Chile, Mexico and Venezuela, after adopting strong internal fiscal adjustment measures are showing good economic results. But the overall performance of Latin America remains very poor. In 1991 GDP growth was limited to 3 percent.

Any way, the motivation to solve the debt crisis in the creditor countries vanished. The debt crisis is not anymore a source of crisis for these countries, and the new international liquidity is making everybody believe that for the debtor countries the crisis is also over. This is a mistake, since the interest burden remains high. Governments in the debtor countries owe around 90 percent of the debt overhang and have a limited fiscal capacity to pay. Thus, the debt remains a real resources transfer problem and a fiscal problem. A problem that will reduce the rates of growth of the debtor countries for many years. Yet, it is not anymore a problem for the banks. The old debt was already basically solved by establishing reserves. And from new short term loans to the debtor countries, the banks derive incredibly high spreads that stimulate them to muddle through these crises that are not theirs for an indefinite period of time.

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