

# The International Debt Crisis: The End of the Beginning, not yet the Beginning of the End

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## Introduction

The so-called "international debt crisis" first came to public attention on August 13, 1982, when Mexico unilaterally announced that it could no longer service its \$ 80 billion external debt. Although individual countries like Ghana, Turkey and Indonesia had suffered debt servicing problems in the 1970s, these had essentially been isolated incidents of internal policy mismanagement. In contrast, during the second half of 1982, it became apparent that dozens of other developing countries shared Mexico's problems. Squeezed between world recession and high real interest rates, and suffering capital flight on an unprecedented scale, the developing world found itself incapable of servicing the external debt it had accumulated during the 1970s. As its major creditor, the international banking system faced the prospect of collapse in the event of a generalized default by the developing countries. In this sense, the international debt crisis was initially a *banking crisis* and the solutions advanced for its management were primarily directed at maintaining the solvency of the international banks (Lever and Huhne, 1987).

By the late 1980s, however, the threat of financial disaster had receded. The international banks had set aside sufficient "loan-loss" provisions to secure their balance sheets against the possibility of

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default. The developing countries, on the other hand, had refocused their economies on servicing external debt, compressing imports with serious repercussions for economic growth and development (Warner, 1992; Cohen, 1992). The international debt crisis gradually evolved from a banking crisis into a *development crisis* and new initiatives by the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (IBRD or "World Bank") were launched with the aim of ending what was widely perceived as "debt slavery" (but see Vogl, 1990). This article explores the changing nature of the international debt crisis. It begins with an overview of the changing debt position of the developing world. It then considers the reasons why developing countries become indebted and the causes of the post-1982 crisis. It finally discusses events since 1982, critically assessing the management of the crisis to date.

### The evolving debt position of the developing world

Table 1 provides an overview of the debt position of the developing world over the ten years to 1993. It shows that total external debt has grown steadily, from \$ 879 billion in 1984 to \$ 1451 billion by 1993. Over the same period, debt service payments (*i.e.*, payments of interest and scheduled capital repayments) have also risen by a similar factor, from \$ 124 billion per annum in 1984 to \$ 170 billion per annum by 1993. These crude data must, however, be adjusted in some way to allow for changes in the developing countries' ability to pay, in order to get a truly meaningful picture. One possible approach is to focus on external debt (or debt service payments) as a percentage of developing countries' gross domestic product (GDP). However, the binding constraint on the ability of developing countries to manage external debt is not their GDP *per se*, but rather their capacity to generate the export revenues necessary to meet their debt servicing obligations. For this reason, external debt (and debt service payments) are conventionally expressed as a percentage of export revenues, in order to give a clearer picture of the underlying position of the developing countries.

Expressed in this way, Table 1 shows that there appears to have been a marginal improvement in the situation of the developing countries over the last ten years. As a percentage of exports, total external debt has fallen from 137.0% in 1984 to 112.5% by 1993. Over the same period, debt service payments as a percentage of exports (also known as the "debt service ratio" or DSR) have shown an even sharper decline, from 19.3% in 1984 to 13.2% by 1993.

While Table 1 suggests some marginal improvement in the developing countries' position since 1984, disaggregating the data by region reveals worrying differences. Table 2 shows that in the developing countries of Asia, where external debt was never a particularly serious problem, DSRs have more than halved from their peak in 1986. For the "Asian Tigers" (Hong Kong, Singapore, South Korea and Taiwan), the improvement in the debt situation has been even more impressive, with the DSR dropping from 9.1% in 1984 to 2.8% by 1993. For the developing countries of Africa, and those of Sub-Saharan Africa in particular, however, the last ten years have seen almost no change in their debt position. And while the Latin American countries have enjoyed a decline in their DSRs, debt servicing continues to absorb almost one-third of total export earnings. In other words, at a regional level, the marginal improvement in the debt situation of the developing countries as a group is very unevenly shared out. While Asia has brought an initially modest debt problem under control, Africa has made almost no headway and, despite some progress, the position in Latin America is still bleak.

Moreover, these data on debt cannot be taken in isolation from the economic circumstances in which they arise. A DSR of, say, 25% in 1993 may actually be more worrying than a DSR of 30% in 1984. The obvious reason is that the developing world has undergone a sustained period of adjustment since 1982, as their economies have been refocused on the need to service external debt. To the extent that this adjustment has typically involved deflation (in order to compress imports and free export revenues to service debt), the political capacity of many developing countries to endure continuing high DSRs may be in doubt. This point is explored further below. Secondly, high DSRs in the mid-1980s coexisted with positive net resource transfers to the developing world. Net resource transfers may be defined as:

net resource transfers = new loans *less* debt service payments *less* other net capital outflows

TABLE 1  
THE EVOLVING PICTURE OF DEVELOPING COUNTRY DEBT  
(all developing countries, excluding Eastern Europe and former USSR)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Total external debt (\$ billion)	879	949	1,050	1,173	1,194	1,222	1,281	1,348	1,388	1,451
Total external debt (% of exports)	137.0	154.5	180.4	167.0	148.2	135.3	126.0	125.7	119.5	112.5
Debt service payments (\$ billion)	124	128	131	141	151	147	145	152	169	170
Debt service payments (% of exports)	19.3	20.9	22.5	20.1	18.8	16.3	14.3	14.2	14.5	13.2

Source: IMF, *World Economic Outlook*.

TABLE 2  
DEBT SERVICE RATIOS BY REGION

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Africa	26.0	27.6	27.8	23.4	25.8	25.1	25.5	26.7	28.3	24.6
of which Sub-Saharan Africa	23.5	22.4	24.7	21.6	22.9	21.6	21.4	22.0	22.7	21.8
Asia	12.7	14.3	15.1	14.6	10.9	10.4	8.8	7.9	7.7	7.7
of which four NICs*	9.1	9.3	9.6	10.5	5.6	4.6	3.3	3.0	2.9	2.8
Latin America	40.5	42.2	46.1	39.5	43.9	31.4	27.3	31.5	35.3	29.4

\* Newly-industrializing countries of Hong Kong, Singapore, South Korea and Taiwan.  
Source: IMF, *World Economic Outlook*.

where "other net capital outflows" includes capital flight. Unsurprisingly, the willingness of the international banking system to lend to developing countries has been reduced by the latter's debt servicing difficulties and, as a result, new loans (and so net resource transfers) have fallen sharply. Table 3 shows that while net resource transfers have remained modestly positive for the smallest and least developed economies (mainly African states), the larger middle-income economies (mainly in Latin America) have suffered reverse (*i.e.* negative) transfers on a massive scale. For the so-called "Baker 15" (*i.e.*, the fifteen most heavily-indebted countries which were singled out for special assistance under the Baker Plan – see below), cumulative net reverse transfers between 1984 and 1993 amounted to approximately \$ 300 billion. This raises important issues about the incentive-compatibility of debt servicing, an issue which is explored in more detail below.

### The external dimensions of the 1982 crisis

In searching for external causes of the debt crisis, a useful starting point is the role played by commercial banks in lending to developing countries during the 1970s and early 1980s. Indeed, the history of international banking in its present form dates back only to the 1960s, when technological developments – cheap, reliable air travel, transcontinental telephone and telex communications and the spread of computerization – allowed innovative US banks to escape stifling domestic regulations by establishing branches in Europe. These off-shore subsidiaries initially accepted deposits from, and made loans to, US customers denied access to domestic facilities by the Federal Reserve Bank's monetary policy – and in so doing gave birth to today's "euro-dollar" market.

In the 1970s, US regulations eased, but by then these new international banks had discovered the competitive edge that their off-shore status and early, forced specialisation gave them over more conventional rivals. Unencumbered by national balance sheet regulations, secure in a low-overhead world of wholesale, large denomination business and freed from the need for expensive high street

branching networks, the international banks found themselves able to operate on much narrower margins, offering lending rates that undercut, and deposit rates that outbid, their competitors.

### *The first oil price "shock"*

The growth of the euro-markets apart, the other special contributory factor in the present international debt crisis was the pair of oil price shocks which rocked the international economy in 1973 and 1979. The first more than quadrupled the price of oil, reshaping overnight the international pattern of balance of payments surpluses and deficits: the oil-exporting nations, especially the Middle Eastern states with small populations, enjoyed huge surpluses, while the oil-importing nations suffered sharp deteriorations in their trade balances (see Table 4). Because oil is almost universally priced and traded in US dollars, the so-called "oil surpluses" manifested themselves in a rapid build up of dollar balances with the competitive international banks, which they in turn sought to invest.

Because western governments typically responded to the first oil price shock by deflating their economies in an attempt to restore external balance, investment opportunities in the developed world proved scarce in the latter half of the 1970s. In contrast, the international banks found willing borrowers in the third world. Amongst the oil-importing developing countries, the trade imbalances caused by the sharp rise in oil prices were exacerbated by the slump in primary export sales to the depressed industrialized world. Borrowing from the banks to fill the gap appeared the only way of maintaining growth. And for the oil-exporting developing countries with large populations like Mexico, Nigeria and Indonesia, the anticipation of even larger oil price rises in future encouraged more ambitious growth programmes financed by foreign bank debt. Reflecting the terms on which the deposits were accepted, the loans made by the international banks were predominantly in US dollars, at variable interest rates and on a short term basis, although the normal practice was to "roll over" loans (*i.e.*, to pay off a maturing loan by extending another).

TABLE 3

NET RESOURCE TRANSFERS TO DEVELOPING COUNTRIES  
(\$ billion)

	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993
Small low-income countries	3.5	3.5	2.8	3.5	4.6	4.8	5.5	4.9	4.9	4.7
Least developed countries	2.6	2.1	1.6	1.5	2.2	1.8	2.9	3.1	3.1	2.8
15 heavily-indebted countries	-45.6	-44.7	-22.4	-29.7	-33.1	-40.7	-42.1	-16.7	-8.0	-11.5
Countries with recent debt-servicing difficulties	-41.5	-44.4	-14.7	-30.6	-30.9	-40.3	-46.8	-21.2	-10.2	-14.5

Source: IMF, *World Economic Outlook*.

TABLE 4

THE CURRENT ACCOUNT EFFECTS OF THE TWO OIL PRICE SHOCKS  
(current account balances, \$ billion)

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
Major oil exporters	6.7	68.3	35.4	40.3	29.4	-1.3	56.8	102.4	45.8	-17.8
Other developing countries	-11.3	-37.0	-46.3	-32.6	-29.6	-33.2	-49.7	-74.4	-95.0	-73.2
Industrial countries	20.3	-10.8	19.8	0.5	-2.4	14.6	-25.6	-61.8	-18.9	-22.2

Source: IMF, *World Economic Outlook*.

### *The second oil price "shock"*

In 1979, oil prices doubled, with much the same effects on the global economy as the 1973 shock; indeed, until 1982, history seemed to be repeating itself, with both the oil-importing and large population, oil-exporting developing countries increasing their borrowing from the international banking system. The important difference lays in the west's reaction to the second price shock. Years of electorally-unpopular inflation and the rise of monetarism as a political force caused many western governments to respond to the surge in OPEC-induced inflation by sharply tightening monetary policy. In the US, where this change in policy stance took place against the background of loosening fiscal policy, the effect was particularly dramatic: interest rates, which in real terms had been negative during the 1970s, soared in both nominal and real terms between 1979 and 1982. With the bulk of developing country debt short term and denominated in dollars, the impact on debt servicing costs was almost immediate.

The huge stocks of overseas bank debt, which had been accumulated in the expectation of continuing low or negative real interest rates, simply became unmanageable by mid-1982. One after another, third world countries were inexorably squeezed into financial crisis. Against this background, it is clear that the fundamental cause of the present debt crisis was not an epidemic of internal debt mismanagement across the third world, but rather a combination of largely external factors which affected the developing countries as a group (see also Sachs, 1989). In assessing the measures used to contain the crisis since 1982, it is important to bear this analysis firmly in mind.

#### Phase one: "muddling through" the debt crisis, 1982-89

The International Monetary Fund (IMF) played the key role in managing the early stages of the debt crisis. Its approach was predicated on the underlying assumption that the developing countries' external debt *should*, and with appropriate policy changes *could*, be repaid in full and was driven by the overriding need to prevent a generalized default which could threaten the stability of the international banking system. The Fund adopted a twin-track

strategy, seeking to maintain the net flow of capital to the developing countries in the short term to allow them a breathing space, while at the same time promoting "structural adjustment" within the debtor countries in order to increase their debt servicing capacity in the longer term (see also Healey, 1990, for a critique of muddling through).

In relation to the scale of the debt crisis, the Fund's resources were (and remain) so limited that direct financial assistance to all but the smallest developing countries is, of itself, little more than symbolic. Total quota subscriptions by the Fund's members, for example, currently amount to approximately \$ 120 billion – little more than the outstanding debt of Brazil alone. For this reason, the Fund was forced to enlist the reluctant support of the international banks in dealing with the crisis. Its *modus operandi* for the more heavily-indebted developing countries was to negotiate three-sided deals: the banks (often through the so-called "London Club") agreed to "reschedule" (*i.e.*, rollover) existing debt and provide additional loans to maintain economic development, provided the developing country government undertook to implement an IMF package of policy "reforms".

#### *The Baker Plan*

The Baker Plan marked the high water mark of the "muddling through" approach to the debt crisis. In October 1985, the then US Treasury Secretary, James Baker, announced a plan which effectively formalized muddling through and the twin-track approach taken by the IMF to date. It emphasized, on the one hand, the need for the banks to continue lending to the developing world (the Baker Plan called for a further \$ 20 billion over three years to the fifteen most heavily-indebted countries) and, on the other, growth-oriented structural reform programmes in the debtor countries. New money was, as hitherto, to be highly contingent on adherence to IMF-orchestrated adjustment policies. The only novel feature of the Baker Plan was the inclusion of the World Bank as a joint partner with the IMF. The plan was thus predicated on the clear assumption that, with appropriate policy reforms, the developing world could be induced to repay its external debt in full.

In the event, the Baker Plan failed to take into account the changing nature of the debt crisis. Even as it was announced, the crisis was turning from a banking to a development crisis. As the banks managed to reduce their exposure and the threat of insolvency receded, their willingness to commit new money was sharply curtailed. At the same time, years of deflation and economic stagnation were taking their toll in the developing world. The Baker Plan was further undermined by the weakening of commodity prices and the collapse of oil prices in 1985-86, which led to further economic dislocation in many developing countries. Not only was new lending by the commercial banks not forthcoming on the scale envisaged, but net lending by the multilateral development banks, the IMF and bilateral official creditors also fell well below projections.

While muddling through "succeeded" in averting the banking crisis, in the sense that it headed off widescale defaults and consequent bank collapses, it suffered from two major flaws, which became increasingly apparent in the latter half of the 1980s: first, it ran directly counter to the objective of the banks, which was to reduce their exposure to the developing countries rather than increase it further; and it forced the burden of adjustment on the poorest countries of the world, locking them into apparently unending "debt slavery".

#### *Muddling through: the view from the developing world*

From the point of view of the developing countries, "muddling through" meant falling living standards and continuously rising debt: growth was sacrificed to make the switch from capital-importer to capital-exporter, while the stock of outstanding debt continued to mount (Fieleke, 1990). Table 5 summarizes the experience of the 1980s for the most heavily-indebted developing countries. It shows the scale of the cumulative compression of imports (which declined by as much as 8.4% per annum over the period 1982-90 in Nigeria) and the knock-on effects this had for investment, which contracted sharply. The starkest statistics are for the growth of per capita consumption. In twelve of the fifteen cases, per capita consumption fell between 1982 and 1990, with countries like Côte d'Ivoire (-4.7% per annum) and Nicaragua (-6.5% per annum) recording declines of catastrophic proportions.

The Fund's early approach to managing the crisis was, moreover, vulnerable to criticism in several other respects. The first was its refusal to view the debt situation as the result of an external shock and its consequent preoccupation with internal adjustment policies. Even if there were scope for adjustment within an individual country, the same could not logically be true of the developing world taken as a whole. One country's imports are another's exports. If Argentina cuts its imports, it buys less from Chile, Brazil and Mexico, which in turn must embark on further rounds of austerity themselves - leading to an endless, downward spiral.

A second problem was that many third world countries export the same raw materials, for which world demand is both price- and income-inelastic. The huge IMF-inspired increases in the third world's output basic commodities like cotton, coffee, cocoa and copper depressed prices, often leading to lower export revenues despite the higher export volumes. Table 6 shows the steady deterioration in the terms of trade (the value of exports relative to the value of imports) for the developing countries, with Africa and Latin America suffering particularly damaging declines.

These "fallacies of composition" apart, the logic of internal adjustment was also dangerously misconceived for a third reason. There is no escaping the stark fact that cutting imports and increasing exports meant reducing the real living standards of the world's poorest peoples to generate the surpluses needed to service debt. In many cases, the depth of the cuts required was so socially unacceptable, and the political structures so weak, that this form of adjustment proved simply unworkable. In the latter half of the 1980s, 25 of the developing countries which had sought assistance from the Fund experienced serious civil disorder as public hostility to the IMF-imposed austerity measures spilled over into violence. The worst disturbances were in Venezuela, where so-called "IMF riots" led to hundreds of deaths in 1989.

#### *The emergence of market-based debt reduction*

Towards the end of Phase One, secondary markets began to emerge in developing country debt (Barston, 1989). These markets were particularly attractive to smaller banks, which could reduce their exposure by selling their claims on developing countries at a discount.

TABLE 5  
DEBT AND GROWTH IN SEVERELY-INDEBTED COUNTRIES

	Outstanding debt, 1990 (\$ billion)	Debt/GDP, 1990 (%)	Interest/exports, 1990 (% per annum)	Average GDP growth, 1982-90 (% per annum)	Average import growth, 1982-90 (% per annum)	Average investment growth, 1982-90 (% per annum)	Average growth of per capita consumption, 1982-90 (% per annum)
Algeria	26.8	52.9	15.1	1.9	-2.2	-1.2	-0.6
Argentina	61.1	61.7	18.4	-0.0	1.2	-8.3	-1.1
Bolivia	4.3	101.0	15.9	1.0	2.2	-10.5	-1.7
Brazil	116.2	22.8	8.6	2.5	-0.1	1.3	0.5
Bulgaria	10.9	56.9	6.4	1.0	-0.2	3.0	3.8
Congo	5.1	203.6	9.3	1.1	0.7	-18.9	-0.7
Côte d'Ivoire	18.0	203.9	13.3	-0.4	2.8	-12.4	-4.7
Ecuador	12.1	120.6	14.5	2.0	-1.5	-4.1	-0.5
Mexico	96.8	42.1	16.7	1.6	5.0	-2.6	-1.1
Morocco	23.5	97.1	11.7	4.0	5.4	1.4	0.9
Nicaragua	10.5	-	3.0	-3.8	-0.8	-7.5	-6.5
Peru	21.1	60.1	5.2	-1.4	-1.8	-9.3	-3.5
Syria	16.4	118.1	3.9	1.8	-2.6	-9.1	-1.7
Venezuela	33.3	71.0	15.6	1.1	-7.7	-10.7	-1.2
Nigeria	36.1	117.9	12.1	1.9	-8.4	-9.6	-2.3

Source: IMF, World Development Report.

TABLE 6  
CHANGES IN TERMS OF TRADE  
(annual changes, %)

	1974-83	1984-88	1988	1989	1990	1991	1992	1993
Africa	3.9	-7.0	-5.0	-0.8	3.7	-6.3	-3.0	-0.1
Asia	-	-0.2	0.3	0.7	-1.3	0.6	-0.4	-0.1
Latin America	1.4	-3.6	-0.7	-0.4	-1.2	-5.2	-0.6	1.1

Source: IMF, World Economic Outlook.

The price at which the debt traded was a function of the debt service payments the buyer *expected* the debtor country to make over time (in technical terms, the price of the debt was equal to the discounted or "present value" of expected debt servicing payments to maturity). The buyers of discounted debt initially comprised other small banks which had low exposure to sovereign debt, but the practice quickly spread to embrace multinational companies and the debtor countries themselves. By the late 1980s, several distinct transactions had become commonplace (Helpman, 1989):

*i) Debt Buybacks:* while the secondary market offered a way for banks to reduce their exposure, interbank transactions made no difference to the debtor country. It was still contractually obliged to service the debt at its full face value, even though the new owner had acquired it at a discount. Debt buybacks allowed debtor countries to capture the benefits of this discount, by repurchasing their own debt in the secondary market. For example, if a country's debt were trading at 50 cents on the dollar, it could buy back its outstanding obligations at 50% of their face value. One difficulty with debt buybacks is that they necessarily affect the price of such debt in the secondary market (*i.e.*, by reducing its stock of outstanding debt, the debt servicing capacity of a developing country is increased, leading to a rise in the price of its debt). Large scale buybacks were therefore unattractive to developing countries as a way of significantly reducing their debt.

*ii) Debt-for-Equity Swaps:* multinational companies became significant buyers of debt in the secondary markets in the late 1980s, normally with the intention of exchanging the debt acquired with the debtor government for local assets. In some cases, the debtor country would swap local currency for its debt (with which the multinational could finance purchases of shares in local companies), in others the debtor government would swap shares directly (*e.g.*, by transferring control of a former state-owned enterprise to the multinational).

*iii) Debt-for-Debt Swaps:* some developing countries attempted to buy back debt in exchange for "senior" debt, rather than hard currency. The principle of senior debt is that it commands a first claim on the debtor country's reserves. Suppose its existing debt were trading at 50 cents on the dollar. The debtor country could buy back debt with a face value of \$ 2 million in exchange for new senior debt

with a face value of \$ 1 million. Because the preferential terms of the senior debt imply that it will be paid in full, the market value of the senior debt would be exactly the same as the old debt which had been retired, so that the lender would be unaffected (although it would have to accept the formal write-down of its book assets). For the debtor, its contractual debt servicing costs would have been halved. Although a secondary market price of 50 cents on the dollar reflects a market expectation that the debtor will only meet half of its debt service costs in the long run, in the short run the developing country may actually be paying most or all of its debt service costs; in this case, the saving from the debt-for-debt swap would be a real one. Moreover, there are other penalties which may stem from being in arrears or partial default, not least the denial of access to new loans. A successful debt-for-debt swap may unlock new money in the future. Variations on this basic theme included the swapping of collateralized debt for existing debt (*i.e.*, debt that was guaranteed in some way, for example, because it was underwritten by a third country).

### Phase two: debt forgiveness and the Brady Plan

By the late 1980s, it had become clear that the banking crisis had been successfully averted. The international banks had greatly strengthened their balance sheets, to the extent that a generalized default no longer threatened the stability of the system. On the other hand, evidence of a growing development crisis was mounting (Fischer and Husain, 1990). In aggregate, the developing countries had a higher debt-export ratio in 1988 than in 1982, while their DSR was only 1% lower. For the severely-indebted low-income and middle-income countries, the position was much worse. Arrears grew to \$ 52 billion by December 1988, while the failure of many debtors to carry through adjustment policies was reflected by the decline in secondary market prices: between 1986 and 1989, the weighted average of debt for the major developing countries halved from 70 cents in the dollar to 35 cents in the dollar.

In March 1989, the then US Treasury Secretary, Nicholas Brady, advanced a new approach to managing the debt crisis (Fried and Trezise, 1989). Unlike the previous Baker Plan, which was based on

the assumption that sovereign debts would be repaid in full, the Brady Plan argued that debt forgiveness rather than further borrowing was the key to restarting economic growth in the developing world (see also Krugman, 1988). A key feature of the Brady Plan was its use of the newer, market-based debt reduction techniques as a means of easing the debt burden. The Brady Plan had three main dimensions:

*i)* it urged commercial banks to develop a broader range of alternatives for financial support, to include debt service reductions and debt forgiveness;

*ii)* it called on Western governments to amend national banking regulations, so that accounting rules did not impede debt forgiveness by their banks (*e.g.*, see the rules of performing loans above); and

*iii)* it encouraged the IMF and the World Bank to provide funding for debt and debt service reduction purposes (*e.g.*, by lending money which developing countries could use to buy back their debt in the secondary market).

At the heart of the Brady Plan was the proposition that developing countries should be able to capture the benefits offered by the discounted price of their debt in the secondary market. In May 1989, the IMF and the World Bank adopted guidelines for lending in support of debt and debt service reduction and a number of such packages has so far been agreed, including agreements with the Philippines, Costa Rica, Venezuela, Uruguay and Niger. By far the largest has been the agreement involving Mexico, under which \$ 49 billion of debt was restructured. The package was highly complex, involving all of the market-based debt reduction techniques outlined above. The banks were offered a menu of options: they could swap old debt (at 65 cents on the dollar) for new debt bearing market interest rates; they could swap old debt at par for fixed interest rate bonds (where the fixed rate was below the prevailing market rate); or they could swap old debt for equity. In the case of the debt-for-debt swaps, the new debt was partly collateralized with US Treasury bonds (the purchase of which was financed by the IMF and the World Bank to guarantee the principal on the new bonds) and backed by a special pool of earmarked foreign exchange reserves which provided a rolling eighteen month guarantee that interest payments would be met.



Since the deal was completed, Mexico's IMF programme has remained broadly on course and the secondary market price of its debt has increased sharply. Nevertheless, the complexity of the deal and the length of time it has taken to arrange similar, less ambitious agreements for other debtors suggest that the impact of the Brady initiative is likely to remain limited (Unal *et al.*, 1993; Rogoff, 1992). Moreover, it is easy to overstate the value of the Brady deal to debtor countries. In the case of Mexico, for example, although \$ 49 billion of debt was involved, it has been calculated that the actual value of the debt relief to Mexico was only \$ 12-13 billion, from which must be deducted the \$ 7 billion cost to Mexico of providing collateral for the new bonds (Bank of England, 1991).

#### *The Paris Club and the 1988 Toronto Economic Summit*

The Brady Plan's analysis of the emerging development crisis was shared in the late 1980s by an important sub-set of the developing world's creditors, namely the so-called "Paris Club" of official lenders. At the 1988 Toronto Economic Summit, the British Chancellor of the Exchequer, Nigel Lawson, preempted his US counterpart by calling on official lenders to grant debt relief to the poorest debtor nations (*i.e.*, those with per capita GDP of less than \$ 600). Under the Toronto terms (since amended by the 1990 Trinidad agreement), debt may be rescheduled at concessional interest rates in cases where DSRs exceed 25%. Some twenty countries have taken advantage of these arrangements, all of them African with the exception of Bolivia and Guyana. Given the small relative size of the countries so far involved, however, these initiatives have made only a marginal impact on the overall debt situation.

#### *The case for and against debt forgiveness*

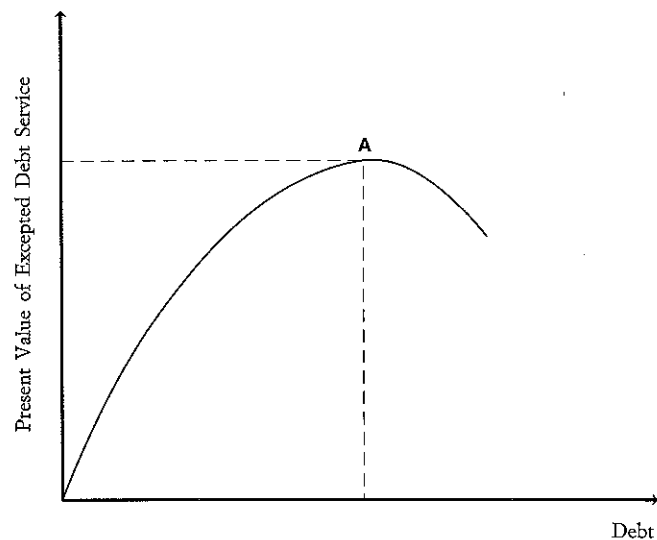
The Brady Plan and the Toronto Agreement have been widely criticized, on the grounds that debt forgiveness rewards developing countries for their past profligacy and undermines their incentive to pursue internal adjustment policies. The basic argument follows "moral hazard" lines and suggests that widespread debt forgiveness may actually prove counterproductive, increasing the likelihood of

further debt servicing problems in the future. This critique implicitly assumes that the cause of debt problems is internal mismanagement, rather than some external combination of unforeseeable circumstances and may be effectively challenged on this basis. There are, however, compelling reasons to consider debt forgiveness as a solution to debt servicing difficulties, regardless of their ultimate causation.

The calculus of debt repudiation (*i.e.*, complete unilateral default on debt obligations) suggests that with rising adjustment costs and negative net resource transfers, debtor countries face an increasing incentive to renege on their obligations. Knowing that the banks are better able to withstand the balance sheet losses that would follow, such action may further embolden some debtors, since they may expect the hostile reaction by lenders (and their national governments) to be less muted than hitherto. It may be, therefore, that if developing country debt is allowed to exceed a certain level, the flow of debt service payments may decline. Under these circumstances, debt forgiveness could actually increase the flow of interest and capital payments to the lenders. This concept is captured by the "debt relief Laffer curve" (see Figure 1). It shows that, as the stock of outstanding debt rises, so the present value of expected debt servicing payments also increases, but at a decreasing rate. If point A is exceeded, the debtor countries will find it increasingly attractive to default, sacrificing the opportunity of future credit for the immediate savings in debt service costs. It follows that, if countries are allowed to accumulate debt beyond point A, debt forgiveness by the banks will actually increase the present value of expected debt servicing payments. (N.b.: As noted above, the price of debt in the secondary market is simply the capitalized value of future expected debt service payments, so debt forgiveness should lead to a rise in the price of a country's debt for countries to the right of point A.)

The economics of debt repudiation may be more formally explored within the framework of the simple model developed by Krugman and Obstfeld (1988); see also Schwartz and Zurita (1992). In judging whether or not to default, a debtor country must weigh the benefits of default (namely, the savings in foreign exchange earnings which will no longer be diverted into debt service) against the costs (*i.e.*, the loss of access to new loans).

FIGURE 1



For a given stock of external debt,  $D$ , a given interest rate on this debt,  $r$ , and scheduled repayment of principal,  $D^*$ , the benefit of default is given by total debt service payment due in the current period; *i.e.*,  $rD + D^*$ . Against this benefit from default must be set the cost of default, namely the loss of new loans,  $L$ . The net benefit from default is the net resource transfer ( $RT$ ) from the debtor to the creditor country (see above); *i.e.*:

$$RT = D^* + rD - L.$$

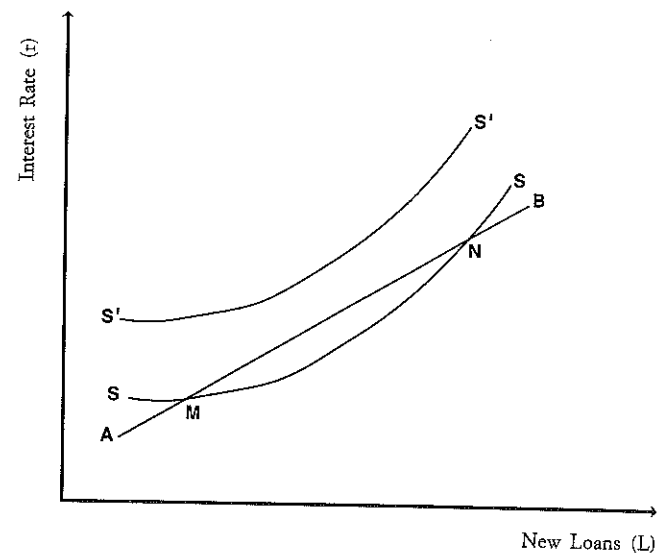
If  $RT$  is positive (*i.e.*, if  $D^* + rD > L$ ), then there is a positive benefit from default. Conversely, all other things equal, a negative resource transfer eliminates the incentive to default. From this basic relationship may be derived schedule  $AB$  in Figure 2 below, which shows combinations of  $L$  and  $r$  at which the benefits of default are equal to the costs for a given  $D$ ,  $D^*$ ; *i.e.*, along the length of  $AB$ :

$$RT = 0$$

or equivalently,

$$D^* + rD = L$$

FIGURE 2



The  $AB$  schedule is upward-sloping, because an increase in  $r$  increases the debt service obligations, requiring an offsetting increase in  $L$  to maintain a zero  $RT$ . At combinations of  $r$ ,  $L$  above  $AB$ , the debtor country is likely at default (*i.e.*,  $RT > 0$ ). On the other hand, at combinations below  $AB$ , the debtor country will continue to service its debt (*i.e.*,  $RT < 0$ ).

While  $AB$  represents the combinations of  $r$ ,  $L$  at which the debtor country will be indifferent between defaulting and servicing its debt,  $SS$  represents the supply of new loans from the international banks (*i.e.*, the feasible combinations of  $r$ ,  $L$  open to the debtor country). The  $SS$  schedule slopes upwards because, for a given market rate of interest, the banks will charge individual borrowers a higher rate of interest as the supply of loans increases (see also Thapa and Mehta, 1991). The reason is that, as the supply of loans to an individual borrower increases, the likelihood of default in the long run is increased, inducing banks to demand a higher return to compensate for the increased risk. Thus while an increased flow of funds reduces the probability of default in the current period, it raises the likelihood of default in subsequent periods by increasing the stock of outstanding debt,  $D$  (and so future debt service payments).

Provided that some portion of the SS schedule is below AB, then there exist feasible combinations of  $r$ ,  $L$  at which the debtor country has an incentive to continue servicing its debt. For example, in Figure 2, SS intersects AB at points M and N. At any point along the section of SS between M and N, the debtor country will choose to continue to service its debt rather than default. Suppose, however, that the SS schedule were to shift to the left to  $S'S'$ . With the new loan supply schedule, there is no feasible combination of  $r$ ,  $L$  at which the debtor country has an incentive to continue servicing its debt. Under such circumstances, default is inevitable.

This model suggests that there is a strong likelihood of debt repudiation on the part of certain debtor countries. In the early 1980s, the SS curve shifted sharply to the left (e.g., to  $S'S'$  in Figure 2), as monetary conditions in the United States levered up the prevailing market interest rate on dollar-dominated instruments (thereby driving up the marginal cost of funds to the international banks). The result was to temporarily force many developing countries into a position where default became attractive. Although market interest rates have subsequently eased from the levels reached in 1982, a rightwards shift in the loan supply schedule from  $S'S'$  (i.e., back towards SS) has been inhibited by two factors. First, banks have revised their judgement of the riskiness of lending to the developing countries, so that they are less willing to advance new funds at any given interest rate. And secondly, their willingness to lend has been further reduced by the loan-loss provisioning of the international banks, which has strengthened their capacity to write-off existing debt. The result is that despite the easing in market interest rates, the loan supply function remains at  $S'S'$  (i.e., above the AB schedule) for many developing countries, making default incentive-compatible.

Debt forgiveness would have the effect of reducing the debtor's external debt,  $D$ , shifting the AB schedule upwards (until eventually it cuts the  $S'S'$  schedule). This is because at any given interest rate, the debtor country would require a smaller flow of new loans to ensure a zero RT. Under circumstances in which default is incentive-compatible, therefore, some form of debt forgiveness may be the only way of preventing outright default and ensuring that debt service payments continue to be paid (in part, at least).

## Conclusions

Since the debt crisis first began in 1982, the threat of widespread default and the collapse of the international banking system has receded. However, by the end of the 1980s, it had become clear that "muddling through" had led to the creation of a *development crisis*, with an increasing number of third world countries facing years of economic stagnation and internal unrest, during which income and wealth would flow massively – and regressively – to the industrialized world. For a large group of developing countries, the benefits of formal debt repudiation, namely the retention of debt service payments for domestic uses, now outweigh the costs, namely exclusion from overseas credit markets. Several Latin American nations, notably Bolivia and Peru (but also on occasions Brazil) have been in *de facto* default for some years.

It is now generally recognized that the ultimate solution to the debt crisis must be through economic growth, rather than austerity. Demand-side adjustment policies have not been successful and are logically misconceived. Longer-term supply-side adjustment policies are the only way forward and for such policies to succeed the restoration of positive net capital transfers from the west to the developing countries is essential. Given the scale of the problem, some form of generalized "debt forgiveness" is a *sine qua non* of a lasting solution, but such measures can only ease the negative resource transfers – debt and debt service reduction cannot, *per se*, bring about a resumption of positive capital flows to the developing world. Herein lies the real danger.

The experience of the Baker and Brady Plans highlights the difficulties of levering new money from a commercial banking system that has seen its faith in the security of sovereign lending terminally damaged. The multilateral agencies, including the IMF and the World Bank, have also experienced difficulties in setting in place structural adjustment projects on the scale needed and western governments have strongly resisted further quota increases in the resources of such agencies. With the governments of the major industrialized countries currently dealing with serious fiscal deficits, the prospect of a spontaneous recovery in bilateral aid flows is remote. Finally, the creation of new regional trade blocs (e.g., the EC's single market and the North American Free Trade Area) and the opening

up of Eastern Europe are attracting flows of FDI away from the developing world. Nor is it clear that there is any strong political will in the industrialized world to tackle the new development crisis. Unlike the earlier banking crisis, which threatened the stability of the international financial system, the consequences of developing country debt for economic development command little public interest. The most likely outcome is that defaults and arrears will quietly mount, while economic development in the world's poorest nations will continue to be retarded into the next century.

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